

OPERATIONS MANUAL BANK POLICIES (BP)

These policies were prepared for use by ADB staff and are not necessarily a complete treatment of the subject.

SECTOR LENDING

A. Introduction

1. Sector lending is a form of ADB assistance to a developing member country (DMC) for project-related investments based on considerations relating to a sector or subsector of the DMC as a whole. The purpose of a sector loan is to assist in the development of a specific sector or subsector by financing a part of the investment in the sector planned by the DMC. Such lending is particularly appropriate when a large number of subprojects in the sector or subsector are to be financed. A sector loan is expected to improve sector policies and strengthen institutional capacity.

B. Definitions

2. The term “subprojects” refers to projects that make up a sector loan.

3. The term “capacity” refers to the broad institutional framework within a DMC that is responsible for the direction, management, and sustenance of the development process in a sector or in the economy as a whole. Capacity dictates a country’s receptivity to policy reform and adjustment; its ability to raise and manage domestic resources; its efficiencies and effectiveness in creating necessary infrastructure, maintaining it, and delivering required services; and its openness and skill in catalyzing participation.

C. The Policy

1. Eligibility Criteria

4. Certain criteria need to be satisfied in order to meet ADB’s policy on sector lending:

- (i) the borrowing DMC has a sector development plan to meet the priority development needs of the sector;
- (ii) the borrowing DMC has the institutional capacity to implement the sector development plan; and
- (iii) the policies applicable to the sector are appropriate and will be improved, if warranted.

5. If these criteria are not met adequately, technical assistance (TA) may be given for project preparation, sector analysis, and capacity building before or together with the provision of a sector loan.

6. Sector lending is expected to achieve a greater impact on a sector than stand-alone project lending by enabling an integrated focus on sector policies, sector development perspectives, and sector development plans, and on the adequacy of institutions to formulate and manage such plans for the sector as a whole. Sector lending assists a DMC to achieve economic and social progress in a sector or subsector through project-related investments in a geographic area (area slice), over a period of time (time slice), or both, based on considerations relating to the sector as a whole.

2. Sector Analysis

7. Sector projects need to be supported by a comprehensive sector analysis that covers the factors that affect performance, including the policy, institutional, legal, and regulatory frameworks; recent trends in current and capital expenditures; the type and composition of the expenditures; the respective roles of the public and private sectors and their relationships; pricing policy; the sustainability of investments; and the possibility of intrasectoral resource allocation. Such analysis also needs to address social dimensions, environmental considerations, and issues of good governance in sector management. Where feasible, the analysis needs to establish well-defined indicators and benchmarks of sector performance that can be monitored throughout implementation of the sector project, and serve as a basis for assessing performance and also for operations evaluation. Where the necessary analysis and information are available and of good quality, these also serve as a basis for the formulation of sector projects.

3. Institutional Analysis and Capacity Building

8. The success of sector lending depends upon the capacity of the executing agency in terms of investment planning, coordination, and implementation; post-investment operation and maintenance; and the involvement of private, voluntary, and community institutions. Assessment of institutional capacity is therefore a prerequisite for sector lending, to identify institutional shortcomings and their causes, leading to the selection of suitable advisory TA to remedy the constraints and enhance the capacity of institutions and their performance.

9. In the context of sector lending, institutional analysis is to be carried out before the provision of the sector loan to assess levels of efficiencies and effectiveness in the executing agency and to plan capacity-building measures as required. While the assessment of institutional capacity remains a value judgment for ADB, three broad conditions underpin a decision to proceed with sector lending without capacity building. The overall assessment of institutional capacity must be positive. This means that the executing agency is willing and able to take the lead. There must also be acceptable levels of capacity in project management, especially in terms of procurement and financial management (including disbursement, accounting, and internal control systems), as well as in environmental impact assessment and social analysis. In addition, there must be reasonably well-developed and articulated strategies for the sector, as a sector loan project cannot exist in a policy vacuum and cannot be just the sum of all existing or intended expenditure programs.

4. Lending Terms

10. ADB lending terms are the same for a sector loan as for a project loan. The terms of a sector loan from ordinary capital resources depend on the average life of the subprojects and the typical implementation period. For a sector loan from the Asian Development Fund (ADF), ADF's standard terms apply.

5. Use of Loan Proceeds

11. Sector loan proceeds are utilized primarily to meet the foreign exchange costs of subprojects making up the sector loan. Recurring costs (e.g., fuel, essential supplies) and local currency expenditures of subprojects may also be financed under a sector loan in accordance with ADB's relevant policies.¹

6. Cost Recovery

12. In revenue-earning subprojects of a sector loan, full cost recovery (including depreciation and debt service) will be sought to the extent feasible. When benefits² are difficult to quantify (as in public health, population, education, and some other sectors), the need for the subprojects should be evaluated and the least-cost option established.

¹ See OM Section H3 (Local Cost Financing and Cost Sharing).

² See OM Section G1 (Economic Analysis of Projects).

- Basis:** This OM section is based on:
- ADB. 1999. Doc. IN181-99, *Review of the Bank's Sector Lending Policies*, July. Manila.
 - ADB. 1984. Doc. R186-84, *A Review of Sector Lending Operations*, 28 December. Manila.
 - ADB. 1980. Doc. R52-80, *Sector Lending*, 15 Day. Manila.
- This OM section is to be read with OM Section D3/OP.
- Compliance:** This OM section is subject to compliance review.
- For inquiries:** Questions may be directed to the Director; Strategic Planning, Policy and Interagency Relations Division; Strategy and Policy Department.

OPERATIONS MANUAL OPERATIONAL PROCEDURES (OP)

These procedures were prepared for use by ADB staff and are not necessarily a complete treatment of the subject.

SECTOR LENDING

A. Introduction

1. ADB policy governing sector lending allows the use of this lending instrument where the policy and institutional framework of a developing member country (DMC) can be improved through a sector project. Conversely, the existence of an adequate policy and institutional framework does not preclude the use of sector lending if ADB has a meaningful role to play in filling the resource gap in a sector. Full application of ADB policy and operational procedures governing sector lending generally entails strategic integration of sector policy reforms, institutional development, and investments.

B. Application of the Policy

1. Procedural Aspects

2. In processing a sector loan,¹ the following procedures are to be followed:
 - (i) The borrowing DMC submits to ADB: an acceptable medium or long-term sector/subsector development plan); a statement on sector policies that affect the development of the sector/subsector concerned; and an assessment of the technical and managerial capabilities of the sector institutions to develop, process, and implement projects.
 - (ii) Subject to the general acceptability to ADB of the sector plan, policies, and institutions, and prima facie justification for ADB assistance, a mission holds discussions with the borrower to assess the sector development plan, the financing needs of the sector, and the adequacy of the institutional arrangements available or proposed for implementing the sector loan; and to identify key sector policy issues including cost-recovery aspects.
 - (iii) Based on the findings of the mission, and after Management has cleared the loan proposal, a mission determines the scope and amount of the proposed sector loan; examines the availability and types of subprojects for financing; assesses the technical and managerial capabilities of the executing agencies, and whether technical assistance is needed; formulates relevant technical, financial, and economic criteria for selection and appraisal of subprojects, including social and environmental criteria;

¹ Forward planning is necessary to identify sectors that are suitable for sector lending sufficiently in advance for inclusion in the country strategy and program; to analyze sector issues in detail, and assess the need and scope for capacity building and sector policy reforms; and to locate the sector loan project in the right context.

agrees on the threshold for approval of subprojects by ADB; assesses institutional risks in regard to processing and implementing capabilities; and assesses the scope for resolution of key policy issues, including cost-recovery aspects, necessary to achieve sectoral objectives.

3. The processing stages applicable for project loans² also apply to sector loans.

2. Appraisal of Subprojects

4. Under a sector loan, the borrower or the executing agency is primarily responsible for identifying, prioritizing, formulating, appraising, approving, and implementing subprojects in accordance with technical, financial, and economic appraisal criteria, including social and environmental criteria, mutually agreed upon between ADB and the borrower/executing agency. ADB will be minimally involved in processing subprojects, except that in the initial phase, if deemed necessary, a few subprojects may be appraised by ADB to serve as models. Based on the experience and capability of the executing agency, a suitable threshold for appraisal of subprojects (in physical or financial terms) may be established. Subprojects above the threshold should be submitted to ADB for approval, while subprojects below the threshold may be fully processed and approved by the borrower or the executing agency in accordance with the agreed upon criteria. ADB, however, will review these subprojects on a selective basis to ensure compliance with the agreed upon criteria.

5. Flexibility will be available to the borrower/executing agency to replace some subprojects with others prior to the start of their implementation or to reallocate funds among components of ongoing subprojects. Prior ADB approval is required for replacement of subprojects above the threshold.

3. Delegation of Authority

6. A discriminating approach is to be adopted in delegating authority to executing agencies that is in line with their institutional capacity and the complexity of the sector projects envisaged. A review of overall performance and compliance by the executing agency with set standards is to be conducted by ADB in the context of the yearly assessment of progress in implementing the sectoral strategy.

4. Policy Dialogue

7. Policy dialogue is an important means to reorientate government policies and introduce reforms in the sector, where needed. Effective dialogue based on targeted sector policy reforms assists in the design of a sector loan project, and in strengthening local ownership and management.

5. Coordination

8. ADB needs to consult with the World Bank, other multilateral development banks, and major bilateral aid agencies when formulating sector projects. Coordination particularly addresses the interface of the ADB-supported policy and investment

² See OM Section D11 (Processing Loan Proposals).

program with macroeconomic aspects. Coordination among major aid agencies operating in a sector maximizes the complementarity of their assistance programs. Where sector investment and maintenance lending by the World Bank ongoing, consistency between the World Bank and ADB of sector policy reforms and capacity building needs to be ensured. However, coordination does not preclude ADB or other aid agencies from pursuing different policies.

6. Conditionality

9. Well-designed loan covenants facilitate the borrower's and executing agency's adherence to the agreed upon sector policy reforms, which contribute to a sector loan project's success. Loan covenants therefore need to concentrate on the critical goals of a sector loan project, be appropriately time based over implementation of the project to avoid leaving the most difficult sector policy reforms until late in the sector project, and be within the institutional capacity of the borrower. However, conditionality per se does not guarantee success. It is accepted that policy conditionality is not a necessary condition for sector lending, though it may be required in certain situations.

7. Procurement

10. Goods and works financed under a sector loan are to be procured in accordance with ADB's *Guidelines for Procurement Under Asian Development Bank Loans*.³ Besides international competitive bidding, other procurement procedures such as international shopping, domestic procurement, direct purchase, repeat order, and force account may be followed, where appropriate.

8. Disbursement

11. ADB's standard disbursement procedures⁴ are normally used. For qualified executing agencies, ADB may agree to the use of an imprest account for payments of goods and services related to subprojects, not exceeding 6 months' estimated expenditures; and the statement of expenditures procedures up to the free limit for subprojects may also be used.

9. Supervision and Monitoring

12. The borrower or its executing agency is responsible for the direct supervision of subproject implementation and monitoring of subproject operations and performance. ADB, however, reviews the execution of subprojects on a selective basis, monitors the capability and performance of the executing agency, and assesses any change in circumstances that may have a bearing on the sector development plan in general and on the implementation and operation of the sector subprojects in particular.

³ See OM Section J3 (Procurement).

⁴ See OM Section J6 (Loan Disbursements).

- Basis:** This OM section is based on OM Section D3/BP and the documents cited therein.
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