ADB

Policy Paper

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Refining the Performance-Based Allocation of Asian Development Fund Resources

Asian Development Bank

ABBREVIATIONS

ADB	–	Asian Development Bank
ADF	–	Asian Development Fund
AfDF	–	African Development Fund
CPA	–	country performance assessment
GNI	–	gross national income
IDA	–	International Development Association
OCR	–	ordinary capital resources
PBA	–	performance-based allocation
PCPI	–	post-conflict performance indicators

NOTE

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

CONTENTS

EXECUTIVE SUMMARY

The quantity of concessional financing needed by countries in Asia and the Pacific far exceeds what can be financed from the Asian Development Fund (ADF). The Asian Development Bank (ADB) developed the performance-based allocation (PBA) system to ration ADF support fairly among the many competing needs, and to direct the funds to where they will be used most effectively. The PBA policy, introduced as part of the seventh ADF replenishment (ADF VIII), was substantially revised during ADF IX to strengthen the link between performance and allocations.

The bulk of ADF support is distributed using the PBA formula. However, the amount of support to the poorest countries eligible only for ADF funding has declined since the system was introduced. This paper proposes modifying the PBA of "blend" borrowers (those with access to ordinary capital resources as well as the ADF) to ensure an appropriate level of financing for poorer countries. A threshold of 14% of resources distributed under the PBA formula per country will be set to determine which blend countries will be subject to the modified PBA. Blend countries with PBA greater than the threshold will retain half of the amount above the threshold. The resources freed up will be redistributed among the other ADF-eligible countries outside of the Pacific according to their PBA shares.

Experience implementing PBA has shown that portfolio performance ratings tend to be the most volatile element in the PBA formula. This volatility means that changes in the portfolio performance score have greater influence on changes in allocations than was intended. To reduce the volatility of portfolio performance, this paper proposes adopting a new conversion scale for portfolio performance ratings matched to the country performance assessment rating distribution. The link between potential problem projects and country allocations creates a disincentive to report problems early. This paper proposes limiting the portfolio performance definition of projects "at risk" to only those projects actually experiencing problems.

ADB's Pacific developing member countries are among the most vulnerable. The paper proposes continuing the practice of providing a separate ADF pool for Pacific developing member countries equivalent to 4.5% of the resources distributed under the PBA formula.

During ADF IX, ADB adopted the International Development Association (IDA) framework for post-conflict countries. This framework includes a 7-year period of exceptional assistance (including a 3-year phaseout period) before the country is brought into the regular PBA system. IDA recently extended the period of exceptional assistance by doubling the phaseout period to 6 years. This paper proposes that ADB similarly extend the phaseout period and begin the phaseout for Afghanistan and Timor-Leste with their 2009–2010 allocations. The approach to the phaseout will be tailored to the specific needs of the two countries.

The demand for subregional projects from ADF countries is expanding. ADF X donors agreed to earmark 10% of the ADF program for the subregional pool. To enhance country ownership of subregional projects, the paper proposes changes to the project eligibility and prioritization criteria for subregional pool funding. ADF financing for eligible projects will include one-third from the country allocation and two-thirds from the subregional pool. To ensure this does not place unnecessary pressure on countries with small ADF allocations, the required contribution from countries will be limited to 20% of their country allocations. The country ownership criteria will apply whether the country is eligible for ADF loan or grant financing. A prioritization criterion promoting wider geographical distribution of the subregional funds will also be included.

The modified PBA policy will be applied beginning with the 2009–2010 allocations.

I. INTRODUCTION

1. The quantity of concessional financing needed by countries in Asia and the Pacific far exceeds the amount supplied by the Asian Development Bank (ADB). A mechanism is needed to ration Asian Development Fund (ADF) support fairly among the many competing needs, and to direct the funds to where they will be used most effectively. To meet these objectives, ADB developed the performance-based allocation (PBA) system for ADF resources. The PBA policy, introduced as part of the seventh ADF replenishment (ADF VIII),[1] was substantially revised during ADF IX as one of the core elements of ADB's reform agenda.[2] The revised system provides a stronger link between performance—as measured by the country performance assessment (CPA)—and ADF allocations. The transparency of the process was also enhanced in the revised PBA system.

2. As part of the ADF IX midterm review and ADF X replenishment meetings, ADF donors, borrowing country representatives, and ADB staff discussed ways to refine the PBA system. The concurrent changes made to the PBA systems of the International Development Association (IDA) and African Development Fund (AfDF) were also considered.[3] In addition to the PBA system, discussions with ADF stakeholders covered other allocation issues. The approach to phasing post-conflict country allocations into the PBA system and the earmarking of ADF funds for subregional projects were considered. This report proposes refinements to the PBA system to (i) enhance the allocations to the poorest countries, (ii) improve the measurement of portfolio performance, (iii) meet the special needs of Pacific developing member countries, (iv) implement the post-conflict phaseout, and (v) reinforce the country ownership of subregional projects.

II. APPROACH TO PERFORMANCE-BASED ALLOCATION

A. Revised Performance-Based Allocation System

3. ADB conducts annual CPAs for all countries with access to the ADF.[4] Each country's performance is assessed based on its quality of macroeconomic management, coherence of structural policies, degree to which its policies and institutions promote equity and inclusion, and quality of governance and public sector management. In the revised PBA system, ADB uses IDA's country policy and institutional assessment questionnaire as the basis for the CPA. An important feature of the IDA questionnaire is the use of narrative descriptions to guide scoring for each criterion. Each year, the CPA write-ups must make their case for the scores, which are compared to the narrative descriptions in the questionnaire and other countries' write-ups to ensure cross-country consistency in ratings. In contrast, the practice under ADB's original PBA system was to assess changes in circumstances from the previous year, leading to some rigidity in ratings. In addition to the IDA questionnaire, countries are rated on the performance of their ongoing ADF loan portfolio.

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

[2] ADB. 2004. *Review of the Asian Development Bank's Policy on the Performance-Based Allocation of Asian Development Fund Resources*. Manila. This paper will refer to the system implemented under the 2004 PBA policy as "the revised PBA system."

[3] The IDA 15 and AfDF 11 replenishment discussions were concluded in December 2007. ADB staff participated in the replenishment meetings as observers, while IDA and AfDF observers joined the ADF X meetings. ADB staff further discussed the proposed changes to the system in the fourth multilateral development bank and multilateral financial institutions technical workshop on PBA methods held in Rome, Italy, 3–4 April 2008.

[4] For countries with populations of 1 million or less that are not considered weakly performing, the assessment can be done biennially. A separate performance assessment is done for post-conflict countries, which is discussed in section IV.

4. Appendix 1 illustrates how the 16 CPA indicator ratings and the portfolio performance rating are combined to determine the composite country performance rating. The policy and institutional rating is effectively the weighted arithmetic mean of the 11 CPA criteria for (i) economic management, (ii) structural policies, and (iii) policies for inclusion and social equity. The governance rating is a separate variable, which is the average of the CPA's five criteria on public sector management and institutions. The composite country performance rating is a multiplicative formula of the policy and institutional rating (with an exponent of 0.7), governance (with an exponent of 1.0), and portfolio performance (with an exponent of 0.3).

5. The allocation formula is a multiplicative formula of three variables: the composite country performance rating (with an exponent of 2.00), population (with an exponent of 0.60), and gross national income (GNI) per capita (with an exponent of –0.25). The result is multiplied by a scaling factor to ensure that the PBA shares sum to 1 (Appendix 2). The positive exponent on population is less than 1 so that allocations increase with population but at a decreasing rate per person. The result is a small-country bias—smaller countries will have larger per capita allocations, all else being equal. Even with the small-country bias built into the allocation formula, Pacific countries would not have programs large enough to provide meaningful support if they were to compete for resources with the larger ADF recipients. To address this, a separate ADF pool for the Pacific was introduced, from which the countries receive their allocations based on the PBA formula. The Pacific pool is equivalent to 4.5% of the resources distributed using the PBA formula.

6. The revised PBA system clarified the institutional accountabilities for PBA. A PBA unit was established in the Strategy and Policy Department to provide independent oversight of the CPA process. The unit was established outside of the departments responsible for country operations to avoid conflicts of interest. The work of the PBA unit is supported by an interdepartmental CPA working group and a review panel of directors general. Teams from the regional departments prepare the initial CPA drafts, which are discussed in an annual workshop with a group of technical experts from the specialized departments to strengthen the CPA process.[5] Based on their review and the workshop discussions, the technical group recommends revisions to the write-ups or ratings to ensure consistency of the CPAs across countries. The revised CPAs are again reviewed by the technical experts, who convey the revised assessments to the CPA working group along with their comments. The CPA working group submits their country rating recommendations to the CPA review panel, based on the technical group's findings. The CPA review panel finalizes the country ratings, and submits them for Management approval.[6]

7. To promote transparency, consultations with government authorities on draft CPAs are a part of the assessment process. Discussing the preliminary assessments with country authorities has broadened awareness of the PBA and helped strengthen the link between CPAs and policy dialogue. Final country ratings are made public through ADB's website after they are approved by Management.

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

[6] The steps taken in the 2007 CPA exercise are detailed in ADB. 2008. *Annual Report on the 2007 Country Performance Assessment Exercise*. Manila.

B. Experience with the Revised PBA System

1. Trends in Country Allocations

8. The ADF's purpose, as stated in the regulations governing the fund, is to provide "resources on concessional terms for the economic and social development of the developing member countries of ADB, having due regard to the economic situation of such countries and to the needs of the less developed members."[7] The introduction of the PBA system has revealed an inherent tension between addressing the needs of the weakest countries and upholding the principle of rewarding performance. The switch to the revised PBA policy coincided with an increase in the volume of concessional resources from an annual average of less than $1.5 billion in ADF VIII to nearly $1.9 billion in ADF IX. Despite the larger pool of funds, the quantity of assistance to borrowers eligible only for ADF resources declined under the revised PBA system, constraining ADB's ability to support these countries' development efforts.

9. Countries receiving ADF resources through the PBA system were grouped to better highlight the differential impacts of the policy changes on allocations. Pacific developing member countries are considered separately because they compete for funds within a separate pool.[8] As Table 1 shows, countries outside the Pacific were classified into groups defined by population, per capita GNI, and access to loans from ADB's ordinary capital resources (OCR). Data used for GNI per capita and population were from 2004, the last benchmark year before the start of ADF IX. The countries with access to only ADF resources (ADF-only countries)

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

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

ADF = Asian Development Fund, GNI = gross national income, Lao PDR = Lao People's Democratic Republic, PBA = performance-based allocation.
Notes: The reference date for GNI per capita and population data is 2004, the year before the start of ADF IX. The data were taken from the World Bank's online World Development Indicators: http://publications.worldbank.org/WDI/, accessed 2 August 2007.
Sources: Asian Development Bank and World Bank.

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

8 The countries in the Pacific group are Cook Islands, Kiribati, Marshall Islands, Federated States of Micronesia, Papua New Guinea, Samoa, Solomon Islands, Timor-Leste (from 2005), Tonga, Tuvalu, and Vanuatu.

include all member countries with annual incomes below $400 per person. Countries with access to both the ADF and OCR ("blend" countries) are not necessarily much better off, but they tend to benefit from other factors that enhance their debt-repayment capacity, such as a more diversified export base. The blend borrowers include the three most populous countries with access to the ADF: Bangladesh, Pakistan, and Viet Nam.

10. Planned annual ADF commitments increased by nearly 25% from ADF VIII to ADF IX (Table 2).[9] Country set-asides in particular grew sharply, mainly to cover ADB's pledge to finance post-conflict reconstruction in Afghanistan, which doubled from $100 million annually in ADF VIII to $200 million annually in ADF IX. While the amount distributed through the PBA system grew by about 22%, differences across country groups are notable. In the first biennial period of ADF IX, $30 million less per year went to the poorest ADF-only countries. This is equivalent to the average lending program for a country like the Kyrgyz Republic or Lao People's Democratic Republic. The quantity of assistance recovered in the second half of ADF IX because favorable exchange rate changes led to a higher expected commitment authority. However, the average annual allocation to the poorest ADF-only countries for the full replenishment was still less than in ADF VIII ($246 million per year in ADF IX compared with $250 million in ADF VIII). In contrast, the large blend countries have benefited greatly under the revised system—their combined annual programs gained more than $200 million per year.

11. For ADF funds allocated through the PBA formula, in the move from the original to the revised system, the share of the poorest countries decreased from 21% to 17%, where it has

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

	Average Annual Allocation ($ million)			Change from Previous Period (%)	
Country Group	**2002–2004**	**2005–2006**	**2007–2008**	**2005–2006**	**2007–2008**
Pacific[a]	53	59	72	10.0	23.0
ADF Only	297	287	339	(3.4)	18.1
Poorest	250	221	271	(11.9)	22.6
Other	47	66	68	41.8	3.0
Blend	843	959	1,193	13.7	24.5
Largest	681	791	1,022	16.1	29.3
Other	162	168	171	3.6	2.1
PBA Total	1,194	1,304	1,605	9.3	23.0
Other Allocations	291	397	403	36.4	1.5
Country Set-Asides[b]	211	300	320	42.1	6.7
Subregional Pool	80	97	83	21.2	(14.5)
ADF Total	1,485	1,701	2,008	14.6	18.0

( ) = negative value, ADF = Asian Development Fund, PBA = performance-based allocation.
[a] The Pacific group includes the set-aside for Timor-Leste of $10 million on average per year since 2007–2008.
[b] Includes allocations outside of PBA to Afghanistan and Indonesia in all years and a one-time start-up allocation to Georgia in 2008.
Source: Asian Development Bank.

[9] Due to the effect of favorable exchange rate changes on expected commitment authority, 2007–2008 country allocations were increased by $700 million in July 2008. The calculations reflect this adjustment.

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

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

( ) = negative value, ADF = Asian Development Fund, PBA = performance-based allocation.
[a] Pacific group includes the set aside for Timor-Leste of $10 million on average per year since 2007–2008.
Source: Asian Development Bank.

stabilized (Table 3). However, the largest countries gained in every period, with their share increasing from 57% to nearly 64%. As a comparison, consider what would have occurred in the absence of performance differences: if only population and GNI per capita differences affected the allocation shares, the poorest ADF countries would receive about 24%, while the largest would receive 56%—close to the shares that prevailed during ADF VIII.

2. Effect of Policy Changes on Allocation Trends

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

13. The original PBA system had limits on the size of changes in allocations—the so-called collar—to avoid large fluctuations that would disrupt country programming.[10] While preventing abrupt shifts in allocations, the limits also delayed the transition to a full PBA system. All of the poorest countries benefited from the collar in some years of ADF VIII, with Cambodia, Kyrgyz Republic, and Lao People's Democratic Republic benefiting every year. On the other hand, allocations for Bangladesh and Pakistan, two of the large blend countries, were held down by the collar in some years, as the increase would have exceeded the upper limit. If the original system had not included the collar, the share of the poorest countries would have been about 18% during ADF VIII, which is still greater than their actual 2005–2006 shares. This suggests that removal of the collar is not the sole explanation for the observed allocation trends.

14. During the time that ADB has applied PBA, the measurement of country performance has evolved (Appendix 3). The performance of the poorest countries has generally risen, but not as rapidly as the largest blend countries. Differences in performance ratings among country groups are relatively small. However, under the new formula these small differences are magnified, which reduces the allocations to the poorest borrowers, other things being equal.

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

Moreover, although the average governance rating for the poorest ADF-only countries has been trending upward, it has not kept pace with the improvement by the largest blend countries. As such, the additional weight on governance in the formula would have helped widen the gap between the poor ADF-only countries and the largest blend countries.

3. Portfolio Performance Measurement Issues

15. The measurement of portfolio performance in the revised PBA system is based on the proportion of approved projects "at risk." The number of projects considered at risk is taken from the project performance reporting system and divided by the total number of ongoing approved projects. The average of the quarterly data from the period covered by the CPA exercise is used (September of the previous year through June of the current year). Newer projects are less likely to be identified as at risk, not because the portfolio is necessarily better managed, but because problems have not had time to materialize. As such, the ratio will overstate the quality of a portfolio with a relatively high percentage of new projects. To correct for this bias, an age-adjustment factor is added to the average projects-at-risk ratio for portfolios that are younger than the average age of all ADF projects. The age-adjusted percentage of projects at risk is converted to a portfolio performance rating using a linear formula.[11]

16. The choice of conversion scale is somewhat arbitrary. While the ADB scale is linear, IDA used a nonlinear conversion scale with a 1–6 range in IDA 14. Among the performance criteria, portfolio performance is the most volatile, a problem also experienced by IDA. The policy and institutional rating and the governance rating are averages of several criteria (Appendix 1), many of which are based on the ratings of a number of sub-criteria. On the other hand, portfolio performance is based on a single indicator. Between 2005 and 2006, the elements of composite country performance other than portfolio had average absolute differences in ratings of 0.1–0.3 points. CPA scores tend to change in small increments from year to year—movements of a full point on any indicator are rare. In contrast, portfolio performance had an average absolute difference in ratings of 0.8 points, and three countries experienced changes in scores of 2 or more points.

17. Although project performance reports take into account some aspects of project performance—indicators of implementation progress, project impacts and outcomes, and flags for potential problems—a project is only at risk when multiple elements are less than satisfactory.[12] Because the system does not distinguish degrees of risk, it can lead to wide swings in performance ratings, especially for countries with small portfolios (Table 4). In the 2006 CPA exercise, the average portfolio performance rating was 4.5. In this case, countries with five or fewer ongoing projects would have received below-average ratings with only one at-risk project. Even for a country with 20 projects—which is a large portfolio among ADF borrowers—an improvement or deterioration in the risk rating of two projects in a year could lead to a 1 point change in the portfolio performance rating.[13]

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[11] If x denotes the age-adjusted percentage of projects at risk for a given country averaged over the four quarters, the conversion scale is determined by the formula $6–10x$ rounded to the nearest 0.5 (with a minimum score of 1). The rating scale ranges from 1 to 6. For countries with fewer than two ongoing projects in their portfolios, the average rating for all countries rounded to the nearest 0.5 is used to determine their PBA shares.

[12] Within the project performance rating system, implementation progress and project impacts and outcomes are rated according to several indicators using a scale of "highly satisfactory," "satisfactory," "partly satisfactory," and "unsatisfactory." Projects rated partly satisfactory or unsatisfactory on either implementation progress or impacts and outcomes are considered problem projects. For details on how the ratings are determined, see ADB. 2008. *Project Administration Instructions*. PAI 5.10: Project Performance Ratings. Manila.

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

Table 4: Illustration of Portfolio Performance Ratings by Portfolio Size
Linear Conversion Scale

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

— = not applicable.
Source: Asian Development Bank.

18. A project is deemed at risk if it has actual problems (i.e., if it is rated as partly satisfactory or unsatisfactory in implementation progress or in achieving its intended impacts and outcomes), or if it is flagged as a potential problem. The independent evaluation departments of ADB and the World Bank have noted a tendency to underreport project risks.[14] The link between portfolio quality and future concessional fund allocations reinforces this bias. To address this, IDA moved to a system where only projects actually experiencing problems are considered at risk. While this does not fully resolve the incentive to underreport problems, it does separate the identification of potential problems from the allocation decision. Eliminating this disincentive should lead to more potential problems being flagged early for portfolio managers.

III. REFINING THE ALLOCATION METHODOLOGY

A. Enhancing Allocations to the Poorest Countries

19. The share of the poorest ADF-only countries has declined, even though their performance has improved. The decline in concessional resources to ADB's poorest members hinders the institution's ability to support the development efforts of those most in need. Under the new grant framework, the amount of assistance to many of these countries is reduced further.[15]

20. The poorest ADF-only countries have limited options to finance their development plans. The largest blend countries, on the other hand, have access to OCR loans in addition to the ADF. They may also be able to take advantage of other funding sources for public investments, including the international financial market in some cases. Discussions with ADF stakeholders

[14] ADB Operations Evaluation Department. 2007. *Annual Report on 2006 Portfolio Performance*. Manila; and World Bank Quality Assurance Group. 2007. *Annual Report on Portfolio Performance, Fiscal Year 2006*. Washington, DC.
[15] ADB. 2007. *Revising the Framework for Asian Development Fund Grants*. Manila.

highlighted this issue. The idea of modifying the PBA system to increase the allocations to the poorest countries was broadly supported, as long as any modifications preserve the performance incentives of the allocation system for all countries.

21. Modifying the PBA of blend borrowers is proposed to ensure an appropriate level of resources for poorer countries. A threshold of 14% of resources distributed under the PBA formula per country will be set to determine which blend countries will be subject to the modified PBA.[16] Blend countries with a PBA greater than the threshold will retain half of the amount above the threshold. For example, a blend country with a regular PBA share of 16% would receive 15% under the modified PBA; a blend country with a regular PBA share of 20% would receive 17%. The resources freed up will be redistributed among the other ADF-eligible countries outside of the Pacific according to their PBA shares. Under this approach, only the largest blend borrowers are expected to receive less than their regular PBA shares during ADF X. The modified PBA preserves incentives, even for blend borrowers with allocations above the threshold, while enabling a larger flow of assistance to the poorest countries.

B. Improving Portfolio Performance Measurement

22. The portfolio performance rating was meant to carry less weight in the allocation formula (as indicated by the lower exponent), but the larger changes in scores between years means it has greater influence on changes in allocations than was intended. As a result, volatile portfolio ratings can obscure the impact of CPA indicator changes on country allocations.

23. The volatility can be seen in the comparison of the distributions of CPA scores and portfolio performance ratings. The range of CPA scores is much narrower than the range of portfolio performance ratings. Although individual CPA indicator scores can range from 1 to 6, no country scores at the top or bottom of the range on all indicators in practice. As a result, the average CPA scores are distributed in a tight cluster around the middle. Figure 1A shows the distribution of the CPA scores for all countries during 2005–2007.[17] The distribution ranges from 2.5 to 4.5 and is nearly symmetric. The mean of the CPA distribution is 3.5—the middle of the range of possible scores—with a standard deviation of 0.48. Figure 1A also shows the distribution of the 2007 portfolio performance ratings using the current linear conversion scale. The portfolio performance rating distribution is skewed toward the higher scores—the average is 4.6—and it ranges from the 1.0 to 5.0. The standard deviation of 1.05 is more than double that of the CPA distribution.

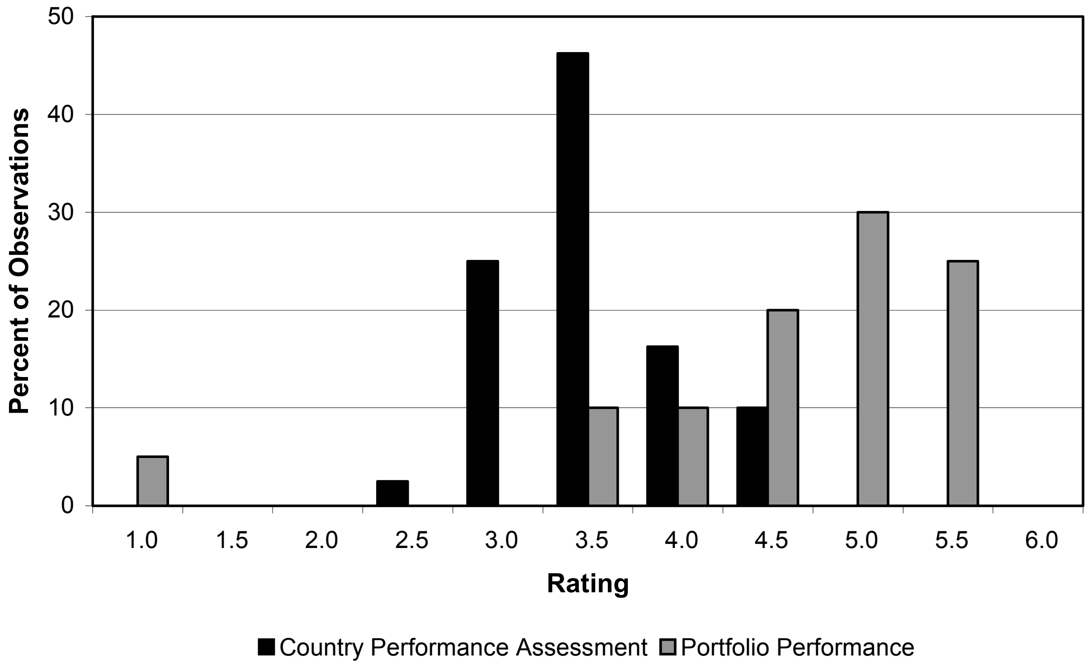
24. This volatility can be addressed directly by adjusting the conversion scale so the distribution of portfolio performance ratings matches the CPA distribution. The new scale would be derived as follows: (i) the distribution of CPA scores is used to determine the range of portfolio performance ratings and the percent of countries that will fall within each rating category, and then (ii) the projects-at-risk ratios are matched with this distribution. Figure 1B illustrates this process using pooled CPA ratings for 2005–2007 and the portfolio performance ratings for 2007, as in Figure 1A. To approximate the CPA distribution, the lowest portfolio performance scores (i.e., the ones with the highest percentage of projects at risk) were given a rating of 2.5 until the share of observations was approximately the same as the share of

[16] The resources distributed according to the PBA formula are equivalent to the expected commitment authority less the funds earmarked for subregional projects and other special country circumstances (e.g., exceptional post-conflict allocations).

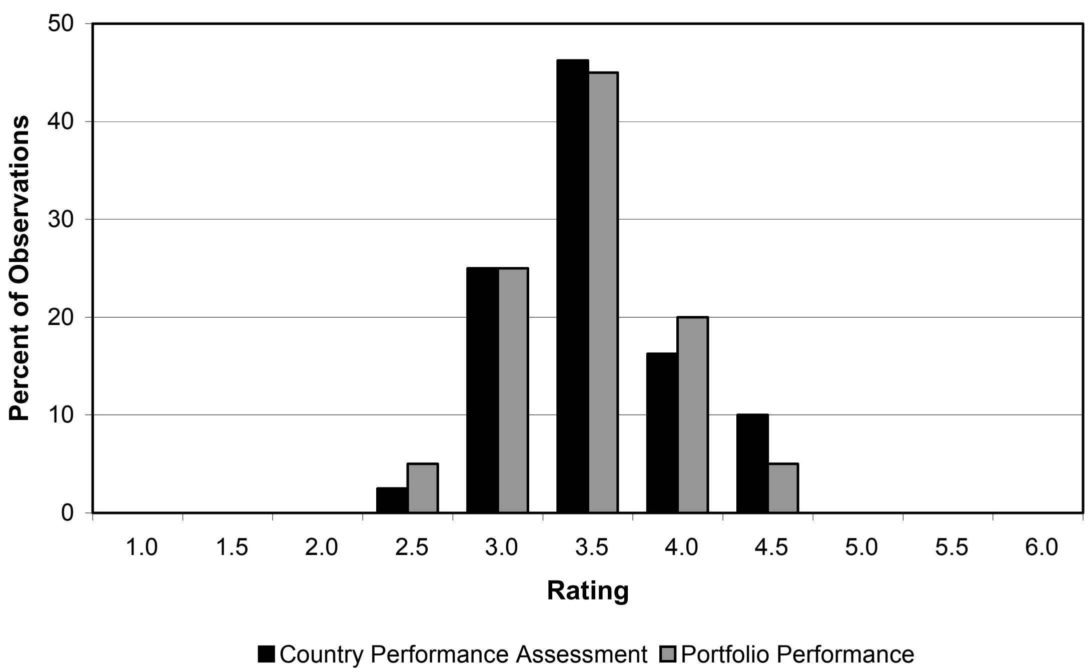
[17] The score used to derive the CPA distribution is the unweighted average of the ratings for (i) economic management, (ii) structural policies, (iii) policies for inclusion and social equity, and (iv) governance. The average is rounded to the nearest 0.5.

Figure 1: Distributions of Country Performance Assessment Ratings and Portfolio Performance Ratings

A. Linear Portfolio Performance Conversion Scale



B. Matching Portfolio Performance Conversion Scale



Source: Asian Development Bank.

countries with average CPA of 2.5. Then the next lowest were given a score of 3.0 and so on. Because of the different numbers of observations for the two distributions, the fit is not exact. However, the result is that the portfolio performance rating on the matched scale has a mean and standard deviation that is similar to the CPA distribution. With this matched scale, the portfolio ratings would be no more volatile than the CPA ratings. The outlined change to the conversion scale is in line with the methodology now used by AfDF and IDA.

25. To reduce the volatility in portfolio performance, it is proposed that ADB adopt a conversion scale for portfolio performance ratings matched to the CPA rating distribution. The new conversion scale for ADF X will be set after the 2008 CPA exercise is finalized in the fourth quarter of 2008. The pooled CPA results from 2006–2008 will be used for the ratings distribution. Similarly, the pooled percentage of projects at risk for 2006–2008 will be used to determine the matching scale. By pooling multiple years, the revised scale should avoid the idiosyncrasies of any single year, providing a more robust conversion scale. The new conversion scale will be applied to the 2008 projects-at-risk ratios to determine the portfolio ratings to be used for the 2009–2010 biennial allocation. While the adjusted scale is expected to be used for the entire ADF X period, the scale will be assessed at the time of the midterm review to ensure it remains appropriate.

26. The link between the project progress reports and the allocation system creates a disincentive to report problem projects. The project officer has considerable discretion in flagging a potential problem in the project performance management system. Flagging a project with potential problems is a useful early warning that allows managers to respond to project risks before actual problems materialize. To remove the disincentive to report potential problems, it is proposed that the PBA system limit projects considered at risk to those projects actually experiencing problems.

C. Meeting the Special Needs of Pacific Developing Member Countries

27. Pacific developing member countries are particularly vulnerable to natural disasters and other external shocks. They also have some of the greatest needs in terms of capacity development. However, even with the small-country bias built into the allocation formula, Pacific countries would not have programs large enough to provide meaningful support if they were to compete for resources with the larger ADF recipients. Recognizing this, the PBA policy established a separate pool for the Pacific, from which the countries receive their allocations based on the PBA formula. During ADF VIII and ADF IX, the size of the Pacific pool was set at 4.5% of the total ADF resources allocated according to PBA. Although the country composition within the Pacific pool will change, this share of funds remains appropriate.[18] It is proposed that 4.5% of ADF distributed through PBA (before the application of the grant framework) continue to be earmarked for the Pacific pool.

IV. IMPLEMENTING THE POST-CONFLICT ASSISTANCE PHASEOUT

A. Approach to Post-Conflict Country Allocations

28. The original PBA policy (footnote 1) recognized the need for flexibility in ADF allocations to post-conflict countries. However, the PBA system at that time did not provide guidance on how such flexibility should be applied. Under the disaster and emergency relief policy approved

[18] Beginning in ADF X, Cook Islands will graduate from ADF assistance while donors agreed to provide Nauru and Palau access to ADF. (ADB. 2008. *Review of the 1998 Graduation Policy of the Asian Development Bank*. Manila.)

in 2004, ADB committed to use the IDA framework as a reference for planning ADF assistance.[19] The revised PBA policy reiterated the commitment to use the IDA framework. The IDA framework prevailing at that time had been agreed upon as part of the IDA 13 replenishment.[20] It was modified during subsequent replenishments, but the allocation principles remain the same.

29. The IDA framework provides exceptional post-conflict assistance to eligible countries in three stages: an initial allocation, followed by exceptional allocations linked to performance norms, and then a phased return to regular PBA. Eligibility for exceptional treatment depends on the duration and intensity of the conflict.[21] An IDA staff assessment in a transitional support strategy determines the initial allocation. In addition to the immediate rehabilitation needs, the strategy includes an assessment of the prospects for social and economic recovery. This assessment covers four dimensions: prospects of peace, needs, government commitment to sustainable development, and moral hazard concerns (Appendix 4, Table A4.1). ADB is aligned with the IDA approach to determine country eligibility for exceptional treatment. ADB has also been involved in the preparation of the post-conflict needs assessments for the eligible countries in the region.

30. After the first year, country performance affects the level of assistance. IDA has developed a set of performance indicators to fit the needs of post-conflict countries. The post-conflict performance indicators (PCPI) cover some of the same areas as the country policy and institutional assessment. However, the PCPI assumes a lower level of performance for a given rating level and has additional performance criteria geared toward the needs of countries recovering from conflict (Appendix 4, Table A4.2). The PCPI ratings are used to determine per capita assistance norms. Higher PCPI ratings correspond to higher per capita allocations. In the scale in effect during IDA 14, a PCPI rating in the range of 2.0–2.5 corresponds to a maximum per capita allocation of $3.4, while a rating in the range of 4.5–5.0 corresponded to a maximum allocation of $17.0 per capita.[22] The IDA PCPI allocation scale is calibrated based on IDA's institutional circumstances and its available resources. The scale balances the needs for concessional financing of conflict-affected countries with those of the other IDA members. As a regional development bank, ADB has a different proportion of post-conflict countries and a smaller resource envelope. As such, the scale does not provide the same balance between allocations to conflict-affected countries and others within Asia and the Pacific. While ADB uses the PCPI as a monitoring tool, allocations to post-conflict countries have been agreed upon with donors during replenishment discussions at levels well below the maximum IDA allocations.

31. After 4 years of exceptional assistance, IDA brings a country into the regular PBA system in phases. During IDA 14, the phaseout period was 3 years for a total of 7 years of exceptional treatment.[23] During the phaseout period, a country receives its PBA formula-based allocation plus a declining share of the post-conflict premium, where the premium is calculated as the difference between the PCPI rating-based allocation and the PBA formula-based

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[19] ADB. 2004. *Disaster and Emergency Assistance Policy*. Manila.

[20] IDA. 2001. *Adapting IDA's Performance-Based Allocations to Post-Conflict Countries*. Washington, DC.

[21] The IDA framework has the following three types of eligible countries (footnote 20, para. 12): (i) a country that has suffered from a severe and long-lasting conflict that led to a substantially reduced or inactive support program from IDA, (ii) a country that has suffered a short but highly intensive conflict that led to a disruption in IDA involvement, or (iii) a newly sovereign state that emerged through the violent breakup of another sovereign entity. In addition, the intensity of the conflict is considered to determine whether exceptional assistance is needed.

[22] IDA. 2007. *Operational Approaches and Financing in Fragile States*. Washington, DC.

[23] When the system was established in IDA13, it was envisaged to provide 5 years of total exceptional assistance, including a 2-year phaseout period. This was extended to 7 years of total exceptional assistance with a 3-year phaseout at the IDA13 midterm review.

allocation. For these countries, both the PCPI and the country policy and institutional assessment are prepared to derive the allocation. As of ADF IX, countries receiving exceptional post-conflict support from ADB had not begun the phaseout from such assistance.

32. The IDA 15 replenishment discussions considered the duration of exceptional post-conflict assistance based on implementation experience with the IDA post-conflict framework. IDA noted that many countries took longer than the current 7-year period to return to pre-conflict levels of gross domestic product, governance indicators, and country policy and institutional assessment ratings. Recent research[24] and best practices[25] of bilateral donors also suggest that at least 10 years is needed for recovery from conflict. IDA also highlighted that the sharp drop in allocations during the phaseout was disruptive to country programming. Therefore, IDA decided to extend the duration of exceptional assistance to 10 years by doubling the phaseout period from 3 to 6 years. In line with the changes in the IDA framework, it is proposed that ADB also extend the phaseout period to 6 years.

B. Application to Post-Conflict Countries

33. In Asia and the Pacific, only Afghanistan and Timor-Leste have been eligible for exceptional post-conflict ADF assistance since the PBA system has been in place. IDA began the phaseout for Afghanistan in FY2008 and for Timor-Leste in FY2007.[26] For both countries, it is proposed that the 6-year phaseout from post-conflict ADF assistance begin with the 2009–2010 allocations. However, the approach to the phaseout will be tailored to the specific needs of the two countries. Given the complex development environment in post-conflict countries, the implementation of the phaseout will be discussed with the ADF donors at the time of the ADF X midterm review. This will allow adjustments to the approach to be reflected in the 2011–2012 allocations, if necessary.

1. Afghanistan

34. During ADF IX, ADB earmarked $400 million in post-conflict assistance to Afghanistan each biennial period of the replenishment. This amount was considerably lower than the maximum allocation according to its PCPI assessments.[27] ADB provided less than the maximum to Afghanistan so it could balance the scarce concessional funds among ADF countries. IDA recently adjusted upward the PCPI-based allocation scale in proportion to the increased IDA 15 replenishment. To define the post-conflict premium, ADF X donors agreed to scale up the exceptional biennial allocation in proportion to the increase in the planned level of ADF operations from ADF IX to ADF X. This amounted to $670 million at the time of the replenishment discussions.[28] The post-conflict premium during the ADF X period would be calculated as follows:

(Post-Conflict Premium) = ($670 million) – (PBA Formula-Based Allocation).

[24] Collier, Paul, and Anke Hoeffler. 2003. *Aid, Policy and Growth in Post-Conflict Countries*. World Bank Policy Research Working Paper no. 2902. Washington, DC; and Chauvet, Lisa, and Paul Collier. 2004. *Development Effectiveness in Fragile States: Spillovers and Turnarounds*. Unpublished working paper, Oxford University.

[25] Organisation for Economic Co-operation and Development–Development Assistance Committee. 2007. *Fragile States: Policy Commitment and Principles for Good International Engagement In Fragile States and Situations*. Paris.

[26] The IDA fiscal year ends on 30 June.

[27] Afghanistan has consistently scored in the 3.5 to 4.0 range in ADB's assessment of the post-conflict performance indicators. Using the IDA allocation scale prevailing in ADF IX, Afghanistan's PCPI scores would have translated into a maximum annual per capita allocation of $11.9 or total biennial allocations of $740 million.

[28] ADB. 2008. *Allocation of ADF X*. Manila.

35. Applying the IDA post-conflict framework, Afghanistan would receive its PBA formula-based allocation plus a declining portion of the post-conflict premium. For the first year of the phaseout, the country will receive its PBA formula-based allocation plus six-sevenths (6/7) of the post-conflict premium. For the second year, the country will receive its PBA formula-based allocation plus five-sevenths (5/7) of the post-conflict premium. The 6-year phaseout period covers three biennial allocation periods.[29] ADB will prepare a PCPI and the regular CPA for Afghanistan during the phaseout period (beginning with the 2008 CPA exercise). In the biennium following the post-conflict phaseout, Afghanistan would receive its allocation through the regular PBA system.

36. The proportion of grant assistance to Afghanistan will be based on its risk of debt distress, in accordance with the ADF grant framework. The latest debt sustainability analysis indicates the country is at high risk of debt distress.[30] Consequently, the country will receive its ADF allocation on a 100% grant basis. As stipulated in the grant framework, no volume discount will be applied because of the country's post-conflict status.

2. Timor-Leste

37. Timor-Leste has made considerable progress in establishing the foundations of statehood since its independence in 2002. Although Timor-Leste has entered the phaseout period from post-conflict assistance according to the IDA framework, the risks to peace and development remain daunting. Timor-Leste was provided with 40% of its ADF IX allocation as grants because of its post-conflict status, but it did not make use of the loan portion of its allocation as a matter of Government policy. This resulted in a considerably lower level of ADF support to the country than had been envisaged at the time of the replenishment discussions. The country has no external or domestic debt. The International Monetary Fund has noted the prudence of the Government's borrowing restrictions, but has also highlighted the need for a large increase in investment to achieve the economic growth required to reduce poverty substantially.[31] However, because the country is not at risk of debt distress as a consequence of this policy, Timor-Leste would not be eligible for grants under the ADF grant framework (footnote 15).

38. Based on the experience under ADF IX, the Timor-Leste authorities have been more concerned about the terms of post-conflict assistance than the quantity. It is proposed that ADB take a cautious approach to providing assistance to Timor-Leste by providing ADF grants on an exceptional basis regardless of its debt distress status during the post-conflict phaseout

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[29] Matching the IDA framework to ADB's biennial allocation cycle, allocations in the first biennium of the phaseout period would be:

$$\text{(First Biennium Allocation)} = \text{(PBA Formula-Based Allocation)} + (6/7)\times\text{(half of the Post-Conflict Premium)} + (5/7)\times\text{(half of the Post-Conflict Premium)}$$

or

$$\text{(First Biennium Allocation)} = \text{(PBA Formula-Based Allocation)} + (11/14)\times\text{(Post-Conflict Premium)}.$$

The exceptional post-conflict allocation used to calculate the premium for the third biennium will depend on the outcome of ADF XI replenishment discussions and may differ from the $670 million used during ADF X.

[30] IDA and International Monetary Fund. 2007. *Islamic Republic of Afghanistan: Enhanced Heavily Indebted Poor Countries Initiative—Decision Point Document and Debt Sustainability Analysis*. Washington, DC.

[31] International Monetary Fund. 2006. *Democratic Republic of Timor-Leste: 2006 Article IV Consultation*. Washington, DC.

period.[32] Lending would be gradually introduced over the phaseout period. Timor-Leste would receive 100% of its allocation as grants in 2009–2010, 67% grants and 33% loans in 2011–2012, and 33% grants and 67% loans in 2013–2014 (the last year of the phaseout). No volume discount will be applied because of the country's post-conflict status. In subsequent years, the ADF grant framework would determine grant eligibility. However, to strengthen the performance incentives, it is proposed that Timor-Leste be provided its allocation from the Pacific pool according to the regular PBA formula beginning with its 2009–2010 allocation. The 2007 CPA results show that its ratings are not far below the average for Pacific countries. This approach would still provide a larger biennial allocation in 2009–2010 than ADF IX, even with the country being subject to the higher performance standards of the CPA.

V. SUBREGIONAL PROJECT ASSISTANCE

A. Earmarking for Subregional Projects

39. Regional cooperation and integration can leverage the growth potential of individual countries, helping enable them to achieve greater reductions in poverty.[33] Cross-border projects make this possible by integrating these countries with neighbors that are growing more rapidly through backward and forward links. ADB has a mandate to promote regional cooperation and has played a key role in supporting subregional initiatives, such as the Greater Mekong Subregion, Central Asia, South and Southeast Asia, and the Pacific. Post-evaluations of ADB subregional projects show that they have helped to reduce poverty significantly. Poverty reduction results from more trade and investment, greater employment, and higher incomes in participating countries. Under the long-term strategic framework 2008–2020 (Strategy 2020), ADB will scale up its support for regional cooperation and integration initiatives.[34]

40. Despite the potential gains, regional projects in developing countries remain underfunded due to coordination and market failures. The risks of investing in a regional project are higher than for a national project because the outcome—and hence the benefit—depends on the performance of other partners. Unless there is some compensation for this increased risk, investments in regional projects will be suboptimal. In addition to coordination failures, projects that produce regional public goods have the risk of market failure. In this case, social benefits may outweigh private costs, resulting in externalities and free-rider problems. By earmarking ADF funds to finance subregional projects, ADB can help offset the disincentives created by coordination and market failures.

41. In the ADF VIII replenishment, when the PBA system was introduced, donors agreed that ADB should allocate an appropriate amount of ADF resources for subregional cooperation projects. However, specific guidelines were not provided on how such funds should be allocated among ADF recipients. A number of changes were introduced in the revised PBA system. The amount of funds earmarked for subregional projects was capped at 5% of the ADF IX replenishment. An allocation system was established for the subregional pool, with explicit criteria for project eligibility and prioritization (in the event funds were insufficient to fund all eligible projects). ADF X donors agreed to increase the share of the subregional pool to up to 10% of the ADF replenishment.

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[32] IDA is taking a similar approach during IDA 15. Timor-Leste will receive the grant element of its allocation (i.e., 60%) all on grant terms, regardless of its debt distress classification. However, no IDA lending is currently being considered.

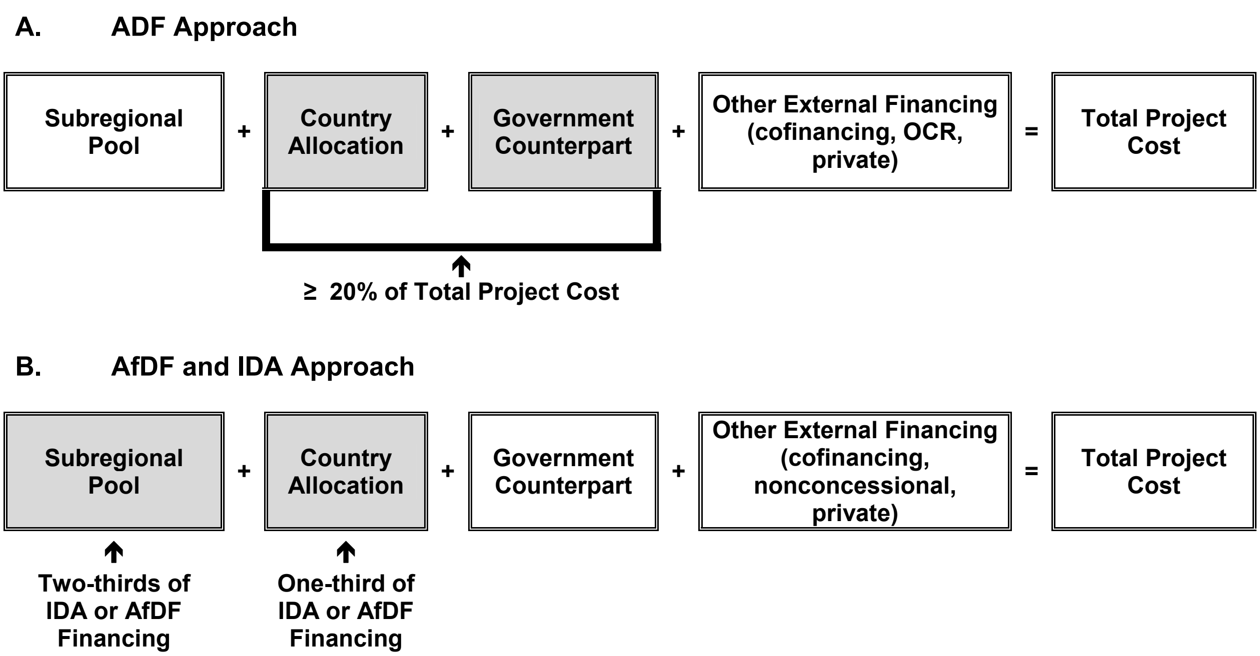
[33] ADB. 2008. *Regional Projects in ADF: Impacts and Funding Issues*. Manila.

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

B. Reinforcing Country Ownership of Subregional Projects

42. To support a larger subregional program, strong country ownership of such projects is needed to ensure continued success. ADF, AfDF, and IDA all require countries to demonstrate ownership by providing some of their own resources to be eligible for subregional funds (Figure 2). Under the revised PBA system, countries must provide 20% of the total project cost from national resources, which are defined as the sum of government counterpart funding and any amount provided from the country allocation (i.e., PBA or post-conflict country allocation). Although ADB Management can waive the 20% contribution, this has not occurred for ADF loans. Of the subregional loans approved in ADF IX, many had government counterpart financing exceeding 20% of the total project cost. In general, national contributions were more than 30% of the total cost.[35]

Figure 2: Comparison of Approaches to Country Ownership of Subregional Projects



ADF = Asian Development Fund, AfDF = African Development Fund, IDA = International Development Association, OCR = ordinary capital resources.
Sources: ADB, African Development Bank, and IDA policy papers.

43. In the AfDF and IDA approaches, for every $2 allocated from the equivalent of their subregional pools, a country must provide $1 from its country allocation. That is, within the funds provided from their concessional resources, two-thirds will be from the subregional pool and one-third from the country allocation. To allow smaller countries to take advantage of the subregional pool without undermining support for national projects, both AfDF and IDA allow

[35] The calculations exclude ADF IX grants of $38 million, which had no national contributions, and a project in Viet Nam that had $896 million in OCR financing. These exceptional projects distort the general picture. It should be noted that, while the Viet Nam project's national contribution was less than 20%, the amount from the subregional pool was matched dollar-for-dollar by a contribution from its PBA.

exemptions from the one-third contribution from country allocations. Once a country has provided 20% of its country allocation to subregional projects, it need not provide any more for the project to be eligible.[36]

44. It is proposed that ADB revise the country ownership criteria to harmonize them with AfDF and IDA, as illustrated in Figure 2, panel B. Experience indicates that projects financed by the ADF subregional pool are already close to the AfDF and IDA allocation mix (two-thirds subregional pool, one-third country). Therefore, adopting country ownership criteria closer to those of AfDF and IDA would not involve a major change from current practice. Limiting the required contribution to 20% of the country allocation would mitigate the effect that a change in the country ownership eligibility criterion might have on smaller countries. For countries choosing to provide funds from their allocation beyond the required amount, the additional funds will be considered part of the external resources leveraged when eligible proposals are prioritized.

45. Under the initial ADF grant framework, subregional funds could be provided only on a grant basis for projects addressing HIV/AIDS and other communicable diseases. Under the new grant framework, subregional projects will be on grant or credit terms depending on the country's risk of debt distress. Since grant eligibility is no longer based on sector considerations, it is proposed that the country ownership criteria also apply to ADF grant-funded subregional projects. It is also proposed that an additional prioritization criterion be included to promote wider geographical distribution of the subregional funds, given the larger pool of resources that will be available. The proposed revisions to the eligibility and prioritization criteria are summarized in Appendix 5.

VI. RECOMMENDATIONS

46. The President recommends that the Board approve the following modifications to the PBA policy:

(i) With respect to PBA formula-based allocations:
   (a) Modify the PBA of blend borrowers with allocation shares exceeding 14%, allowing them to retain half of the amount above this threshold (para. 21).
   (b) Adopt a new conversion scale to reduce the volatility of portfolio performance ratings (para. 25). To determine the proportion of projects at risk, limit the definition to only those projects actually experiencing problems (para. 26).
   (c) Continue earmarking 4.5% of funds distributed through the PBA for the Pacific pool (para. 27).

(ii) With respect to post-conflict allocations, extend the phaseout period to 6 years (para. 32) and begin the phaseout for Afghanistan and Timor-Leste with their 2009–2010 allocations (para. 33). For Timor-Leste, provide the country a declining share of ADF grants on an exceptional basis regardless of its debt distress status, with the amount of assistance determined by the regular PBA formula (para. 38).

[36] AfDF allows smaller countries a further exemption from the required contributions. For countries with allocations less than SDR100 million for the 3-year replenishment period, the limit on required contributions is 15% of the country allocation; and for countries with allocations less than SDR20 million, the limit on required contributions is 10%. The current proposal for ADF does not provide for these further exemptions.

(iii) With respect to subregional pool allocations, revise the project eligibility and prioritization criteria (paras. 44 and 45).

47. If approved, the modified PBA policy will be applied beginning with the 2009–2010 allocations.

CALCULATION OF THE COMPOSITE COUNTRY PERFORMANCE RATING

A. Economic Management Rating

Average of scores for
1. Macroeconomic management
2. Fiscal policy
3. Debt policy

(Rating Range: 1–6)

B. Structural Policies Rating

Average of scores for

4. Trade
5. Financial sector
6. Business regulatory environment

(Rating Range: 1–6)

C. Social Inclusion/Equity Policies Rating

Average of scores for

7. Gender equality
8. Equity of public resource use
9. Building human resources
10. Social protection and labor
11. Policies and institutions for environmental sustainability

(Rating Range: 1–6)

Policy and Institutional Rating

Average of scores for A, B, and C

(Rating Range: 1–6)

Governance Rating

Average of scores for

12. Property rights and rule-based governance
13. Quality of budgetary and financial management
14. Efficiency of revenue mobilization
15. Quality of public administration
16. Transparency, accountability, and corruption in the public sector

(Rating Range: 1–6)

Portfolio Performance Rating

(Rating Range: 1–6)

Composite Country Performance Rating

$$= (\text{Policy and Institutional Rating})^{0.7} \times (\text{Governance Rating})^{1.0} \times (\text{Portfolio Performance Rating})^{0.3}$$

(Rating Range: 1–36)

ALLOCATION FORMULA FOR ASIAN DEVELOPMENT FUND RESOURCES

1. The allocation formula is a weighted geometric function of the composite country performance rating, per capita income, and population. The allocation shares are scaled so that they sum to one; that is, the formula is calibrated to ensure that total allocations will equal total available resources. Let CCPR denote the composite country performance rating, PCI denote per capita income (gross national product), and POP denote population. For each country, i, the share of ADF resources allocated, is determined by the following formula:

$$(\text{country allocation share})_i = \text{CCPR}_i^{2.00} \times \text{PCI}_i^{-0.25} \times \text{POP}_i^{0.60} \times (\text{scaling factor})$$

2. The scaling factor is a constant term that is equal to:

$$(\text{scaling factor}) = 1 \div \sum_i (\text{CCPR}_i^{2.00} \times \text{PCI}_i^{-0.25} \times \text{POP}_i^{0.60})$$

3. The effect of the squaring of the consolidated country performance rating on its component parts is as follows:

$$\text{CCPR}_i^{2.00} = (\text{policy and institutional rating})_i^{1.40} \times (\text{governance rating})_i^{2.00} \times (\text{portfolio performance rating})_i^{0.60}$$

which highlights the importance of the governance rating in the overall country allocation.

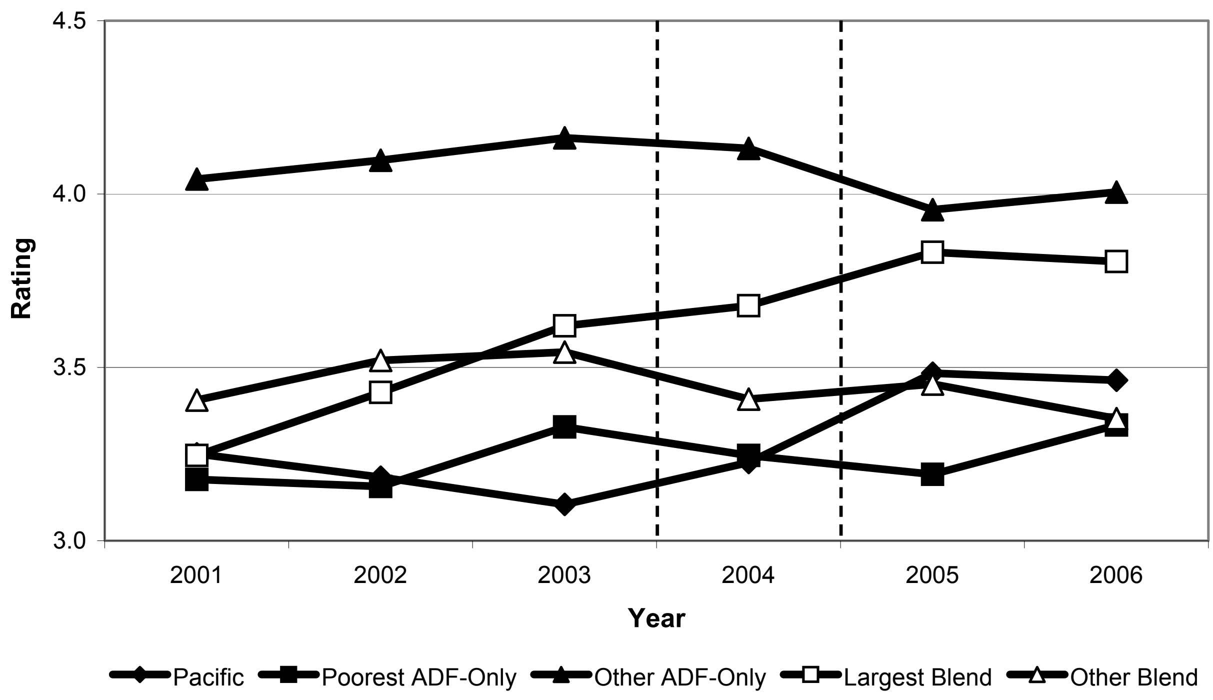
4. Each country's indicative lending level is then calculated by multiplying the expected Asian Development Fund commitment authority by its country allocation share.

THE CHANGING APPROACH TO COUNTRY PERFORMANCE MEASUREMENT

1. During the time the Asian Development Bank has applied performance-based allocation to Asian Development Fund (ADF) resources, the measurement of country performance has gone through three distinct phases. In 2001–2003, a performance questionnaire and formula for the composite country performance rating were used to derive allocations. In 2004, the same questionnaire was used, but it was mapped into the new formula for the composite rating. From 2005, the International Development Association country policy and institutional assessment questionnaire was used with the new composite rating formula. Because of these changes, comparisons of ratings over time need to be treated with caution.

2. Figure A3 presents the composite country performance ratings by country group. The square roots of the new formula composite ratings are used so that the scales are the same in every year. Looking at the 2004 results (which were used to determine 2005–2006 allocations), measured performance for most country groups declined when the new composite rating formula was introduced. Within each period where the same approach to measuring country performance is used, the performance of the poorest countries has generally risen. However, relative performance is what matters for allocations. Although not obvious from the figure, the average composite rating for the large countries has been rising faster than that of the poorest countries. As a result, the ratio of performance ratings of the poorest countries to that of the large countries declined from 98% in 2001 to 88% in 2006.

Figure A3: Composite Country Performance Ratings by Country Group, 2001–2006



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

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

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

ALLOCATION CRITERIA IN THE INTERNATIONAL DEVELOPMENT ASSOCIATION POST-CONFLICT FRAMEWORK

Table A4.1: Considerations for the Initial IDA Allocation

Dimensions	Guidance Questions
Prospects of Peace	1. **Reconciliation:** Is a peace treaty in place? Have all the major parties signed it? Are insurgent groups still carrying out activities? Which accompanying efforts have been carried out to safeguard the peace treaty or cease-fire agreement? Is a mediation process in place and how effective is it?
	2. **Domestic security:** Have there been shootings over the past 6 months? Is movement of goods and people around the territory unhindered? To what extent does the security situation allow the preparation, implementation, and supervision of projects?
	3. **Impact of neighboring conflict:** To what extent does conflict in neighboring countries affect the internal conflict dynamics? How would stabilization impact the country's neighbors?
Needs	4. **Damage assessment:** What is the extent of destruction of social and economic infrastructure? What are the needs of conflict-affected groups? What is the estimated cost of a comprehensive emergency recovery and/or reconstruction program?
	5. **Absorptive capacity:** What level of government and donor resources can be effectively absorbed? If low, can capacity be quickly augmented? What are the main constraints to absorb development assistance?
	6. **Adequacy of available resources:** Is there a substantial unmet resource need in light of available government and donor resources? Are other donors making a substantial effort to ensure that the recovery program is fully funded? Would IDA engagement help mobilize donor resources? If IDA has a portfolio in the country, what level of resources can be redirected to support the recovery program?
Government Commitment to Sustainable Development	7. **Social and economic reform program:** Is the government intending to pursue social and economic policies that would contribute to sustainable and broad-based economic growth and poverty reduction? Which constraints could impede the implementation of the reform program?
	8. **Economic management:** Is the government putting in place adequate economic management functions, including fiduciary safeguards? Is the government committed to normalizing relations with donors and creditors, and has it encouraged official creditors to participate in an orderly arrears clearance process?
Moral Hazard Concerns	9. **Signaling impact of IDA involvement:** Could a resumption of IDA assistance undermine the domestic or regional commitment to peace? What role did the incumbent government play in the conflict? Could IDA assistance be perceived to "reward" one or more parties to the conflict?
	10. **Probability of misuse of IDA assistance:** Could IDA assistance fuel the conflict? To what degree should the fungibility of resources be considered a concern, either in the country or regionally?

IDA = International Development Association.
Source: IDA. 2004. *Aid Delivery in Conflict-Affected IDA Countries: The Role of the World Bank*. Washington, DC.

Table A4.2: Post-Conflict Performance Indicators

A. Security and Reconciliation
1. Public Security
2. Reconciliation
3. Disarmament, Demobilization, and Reintegration

B. Economic Recovery
4. Management of Inflation, External Debt, and Adequacy of the Budget
5. Trade Policy, Foreign Exchange, and Price Regimes
6. Management and Sustainability of Post-Conflict Reconstruction Program

C. Social Exclusion and Social Development
7. Reintegration of Displaced Populations
8. Education
9. Health

D. Public Sector Management and Institutions
10. Budgetary and Financial Management, and Efficiency of Revenue Mobilization
11. Reestablishing Public Administration and Rule-Based Governance
12. Transparency, Accountability, and Corruption in the Public Sector

Source: IDA. 2006. *Post Conflict Performance Indictors (PCPIs) 2006*. Washington, DC.

PROPOSED REVISIONS TO SUBREGIONAL POOL FUNDING CRITERIA

Criteria Under Revised PBA Policy	Proposed Modifications
A. Eligibility Criteria	
Country of record (i.e., the borrower or grantee) must have access to ADF.	No change.
Project cannot have component activities in a country with ADF arrears.	No change.
Project concept must demonstrate consistency with the Regional Cooperation Strategy, Operations Manual section on Regional Cooperation, national poverty reduction strategies, and country partnership strategies and country operations business plans.	No change.
Project benefits must include more than one country.	No change.
Country ownership is demonstrated through 20% of all project costs financed from combined national sources (which include government counterpart funds and any amount from its PBA). (i) Management can lower or waive this requirement for small countries. (ii) The requirement does not apply to projects that qualify for ADF IX grants.	Country ownership is demonstrated through partial financing from the country's PBA. Of the total ADF financing, two-thirds will come from the subregional pool and one-third from PBA. (i) The required contributions from the biennial PBA will be subject to a 20% ceiling, beyond which contribution from the country PBA will not be mandatory. The biennial allocation to be considered for the purpose of setting the ceilings would be net of any discount from the application of the ADF grant framework. (ii) The requirement applies regardless of whether the project is financed by ADF grant or ADF loan.
B. Prioritization Criteria	
Distribution of project benefits: Projects covering more countries are given higher priority.	No change.
Leveraging external resources: Projects with larger shares of external financing (ADF from PBA, official cofinancing, OCR, or private) are given higher priority.	Leveraging external resources: Projects with larger shares of external financing (ADF from PBA beyond the required amount, official cofinancing, OCR, or private) are given higher priority.
Supporting institutional and policy harmonization: Projects supporting deeper integration and lowering cross-border transactions costs are given preference.	No change.
Consolidating earlier gains: Projects that build on previous successful regional cooperation efforts are given priority.	No change.
No criteria.	Geographical distribution: Consideration will be given to ensure wide geographical distribution of subregional funds.

ADF = Asian Development Fund, OCR = ordinary capital resources, PBA = performance-based allocation.
Source: Asian Development Bank.