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ADB

Policy Paper

PUBLIC

April 2022

Strategic Management of Policy-Based Lending, 2022–2024

Asian Development Bank

ABBREVIATIONS

ADB	–	Asian Development Bank
ADF	–	Asian Development Fund
CDF	–	contingent disaster financing
COVID-19	–	coronavirus disease
CPRO	–	COVID-19 Pandemic Response Option
DMC	–	developing member country
G20	–	Group of 20
PBL	–	policy-based lending
WPBF	–	work program and budget framework

NOTE

In this report, "$" refers to United States dollars.

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EXECUTIVE SUMMARY

Asian Development Bank's (ADB's) policy-based lending (PBL) plays a critical role in achieving lasting development impact in developing member countries (DMCs). Following the onset of the coronavirus disease (COVID-19) pandemic in early 2020, DMC demand for development financing through PBL has grown. As a result, ADB exceeded its institutional ceilings on PBL commitments in 2021.

To support DMCs achieve a green, resilient and inclusive recovery while ensuring ADB remains within a sustainable long-run financial trajectory, this paper proposes to replace ADB's regular PBL ceiling of 20.0% of sovereign operations on a 3-year rolling average basis, with a forward-looking ceiling of $18 billion in PBL commitments between 2022 to 2024.

To further enhance the development impact of PBL this paper also proposes measures to enhance PBL quality and impact, strengthen Board of Directors oversight of PBL operations and improve the contribution of PBL to ADB's Corporate Results Framework (CRF) including climate finance. Prior to end-2024, ADB will review its proposed approach and submit a recommendation for the future management of PBL operations for Board consideration.

I. INTRODUCTION

1. Since its inception in 1978, the role and design of policy-based lending (PBL) at the Asian Development Bank (ADB) and other international financial institutions (IFIs) has continued to evolve to reflect the changing context and understanding of international development. During this time, PBL has played an increasingly important role in achieving lasting development impact in developing member countries (DMCs). PBL helps to advance country-led structural reforms, such as promoting universal public health, supporting macroeconomic stabilization, strengthening fiscal and debt management, encouraging renewable energy generation, and helping to ensure economic recovery benefits to marginalized and vulnerable populations. PBL incentivizes reforms by helping governments address development financing gaps as reform objectives are achieved.

2. Following the onset of the coronavirus disease (COVID-19) pandemic in early 2020, demand for development financing has grown. In 2020 and early 2021, ADB met demand by establishing the COVID-19 Pandemic Response Option (CPRO), a tailored instrument for providing emergency countercyclical fiscal support.[1] Rather than medium-term structural policy reforms, CPRO supported immediate actions, which Governments could take to mitigate the worst impacts of the pandemic, with a focus on poor and vulnerable groups.[2] As many DMCs plan their economic recovery, their demand has shifted towards regular PBL to meet development financing needs and to accelerate reforms required to achieve a green, resilient, and inclusive recovery.

3. As a result of increased PBL demand, coupled with lower overall sovereign commitments, ADB exceeded its institutional ceilings on PBL commitments in 2021. In 2021, the ratio of regular PBL commitments[3] to sovereign operations on a 3-year rolling average basis rose to 23.6%, above ADB's 20.0% policy ceiling.[4] Likewise, the ratio of concessional assistance PBL commitments to concessional assistance sovereign operations on a 3-year rolling average basis rose to 24.7% in 2021, above ADB's 22.5% policy ceiling for concessional assistance.

4. This paper proposes measures to strategically manage policy-based lending operations between 2022 to 2024. These measures include suspending ADB's regular PBL ceiling of 20.0% of sovereign operations on a 3-year rolling average basis and replacing it with a forward-looking ceiling of $18 billion in PBL commitments between 2022 to 2024. To further enhance the development impact of PBL this paper also proposes measures to enhance PBL quality and impact, strengthen Board of Directors oversight of PBL operations and improve the contribution of PBL to ADB's Corporate Results Framework (CRF) targets including climate finance.

5. The proposal aims to enhance ADB's support to DMCs to help them achieve a green, resilient and inclusive recovery, promote improvements in PBL quality and impact while ensuring ADB remains within a sustainable long-run financial trajectory.

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[1] ADB. 2021. *Review of ADB's Comprehensive Response to the COVID-19 Pandemic*. Manila.

[2] As an emergency response tool, the COVID-19 Pandemic Response Option (CPRO) commitments are excluded from Asian Development Bank's (ADB) policy-based lending (PBL) ceilings, which apply only to regular PBL operations.

[3] Regular PBL commitments include stand-alone PBL, programmatic approaches, the policy-based component of sector development programs, and policy-based guarantees. Regular PBL commitments exclude ADB's crisis-response PBL (including the CPRO, Countercyclical Support Facility [CSF], special PBL [SPBL]), and regular ordinary capital resources (OCR) financed contingent disaster financing.

[4] ADB. 2021. *Work Program and Budget Framework, 2022–2024*. Manila.

II. ECONOMIC AND SOCIAL IMPACT OF THE COVID-19 PANDEMIC ON ASIA AND THE PACIFIC

6. **Economic and social impacts of COVID-19.** The COVID-19 pandemic, which commenced in early 2020 has created devastating economic impacts on Asia and the Pacific. Developing countries have lost an estimated $1.3 trillion–$2.0 trillion, equivalent to 5.7%–8.5% of what regional gross domestic product would have been without the pandemic.[5] Lost income earning opportunities for vulnerable or marginalized workers, including women, girls, and people with disability—will affect future income growth prospects even as economic growth recovers.

7. Resurgent COVID-19 outbreaks underscore that the pandemic is far from over. Outbreaks continue to reappear globally, partly because of the emergence and spread of coronavirus variants. Progress in vaccine rollouts varies considerably, with many developing economies continuing to face difficulties in expediting procurement and rolling out of their vaccination programs.

8. While economic growth is beginning to rebound in some DMCs, the socioeconomic scars—such as job losses and learning losses caused by enforced school closures—will take many years to address. In many DMCs, large fiscal stimulus packages are driving higher growth rates, while underlying economic activity and job creation remain weak. Downside risks to the economic outlook in developing Asia also remain significant, particularly in lower-income countries, small island developing states, and those classified as fragile and conflict-affected situations.

9. **Fiscal response to the pandemic.** The COVID-19 pandemic has caused a significant deterioration in public finances, adding to pre-existing strains from long-term structural challenges including population ageing, climate change, rising inequality, digitalization, and automation.[6] The size and composition of the fiscal response has varied across countries, reflecting differences in automatic stabilizers, pre-pandemic fiscal space, the severity of infections and policy preferences.[7]

10. Without large-scale fiscal interventions, the pandemic would have sharply reduced household and business incomes, caused greater labor market disruption and prolonged economic scarring through business and personal bankruptcies and higher unemployment. Across ADB's 41 DMCs, 36 recorded a deterioration in their fiscal balances between 2019 and 2021. For 16 of these DMCs fiscal deficits have increased by more than 5% of GDP with the most severe impacts being felt in lower and lower-middle income countries as well as small island developing states (SIDS), which have been particularly hard hit due to collapses in tourism revenues (Figure 1).

11. As a result of these rising fiscal imbalances, public borrowing has also increased sharply across the region. For lower and lower-middle income DMCs, 21 out of 24 have recorded increases in public borrowing since 2019 with a majority increasing their debt to GDP ratios by more than 10% of GDP. Upper-middle income and high income DMCs have also undertaken substantial increases in public borrowing but with a higher variance accounted for by the severity of impact on domestic resource mobilization and borrowing capacity. Tourism dependent

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[5] ADB estimates.
[6] OECD. 2021. *OECD Policy Responses to Coronavirus (COVID-19).* Tax and fiscal policies after the COVID-19 crisis report series. Paris.
[7] Reserve Bank of Australia. 2021. *The Global Fiscal Response to COVID-19*. Bulletin June 2021. Canberra.

economies such as Fiji, Maldives, and Thailand have been particularly hard-hit with public debt increased by 58.9% of GDP in Maldives, 37.9% of GDP in Fiji, and 17.0% of GDP in Thailand (Figure 2).

12. **Future development financing needs.** While progress has been made in addressing the COVID-19 pandemic, many DMCs continue to face significant threats. The emergence of highly mutated virus variants and a rise in infections globally indicate that the pandemic is far from over, with continued risk of economic slowdowns, including in major trading partners like People's Republic of China.[8] The World Bank has raised concerns about a "hard-landing" for poorer nations and has downgraded global growth projections amid continued COVID-19 flare-ups, diminished policy support, and lingering supply bottlenecks.[9] There are also significant downside risks to the current global and regional economic outlook, including new virus variants, unanchored inflation expectations, financial stress caused by rising interest rates as well as uncertain ramifications from escalating conflict due to the Russian Federation's invasion of Ukraine. The International Monetary Fund's (IMF) recently released World Economic Outlook update flags rising caseloads, a disrupted recovery and higher inflation as key risks to already moderating global growth projections.[10] All institutions have explicitly recognized the need for strong multilateral efforts to mitigate the ongoing impacts of the pandemic.

13. As DMC's transition unevenly from addressing the health and socio-economic impacts of the crisis towards longer-term recovery priorities, fiscal policy is likely to remain accommodative and require additional development financing. In many DMCs where economic activity remains constrained by containment measures, fiscal stimulus will continue to be needed to support vaccination programs, income subsidies, employment protection and social-safety net measures. In other DMCs, where growth is recovering more strongly, the emphasis of fiscal support will shift. This will entail a greater focus on public investment, particularly on green initiatives and decarbonization, health system strengthening to build resilience, incentives for consumption and private investment, and retraining programs for workers in those sectors that are expected to have been severely impacted during the pandemic.

14. In lower and lower-middle income DMCs, where debt servicing capacity is more constrained and additional domestic resource mobilization opportunities are limited, close attention will need to be given to the sustainability of fiscal imbalances. In these environments, additional fiscal support will need to be accompanied with appropriate sustainability measures such as re-introducing fiscal rules or committing to limiting future deficits and debt and enacting legislation that commits to deeper reforms of both expenditure and domestic resource mobilization.

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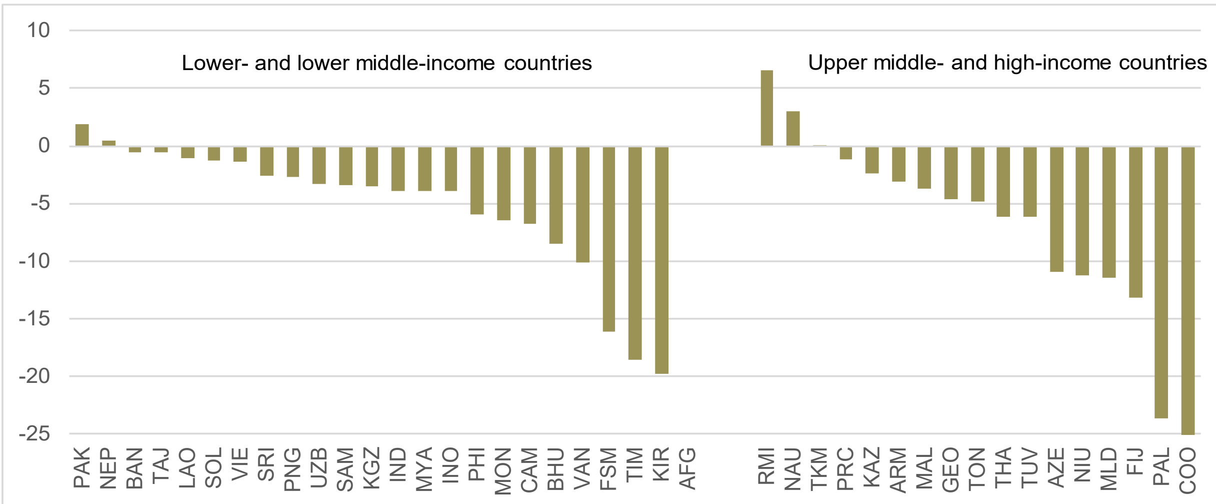
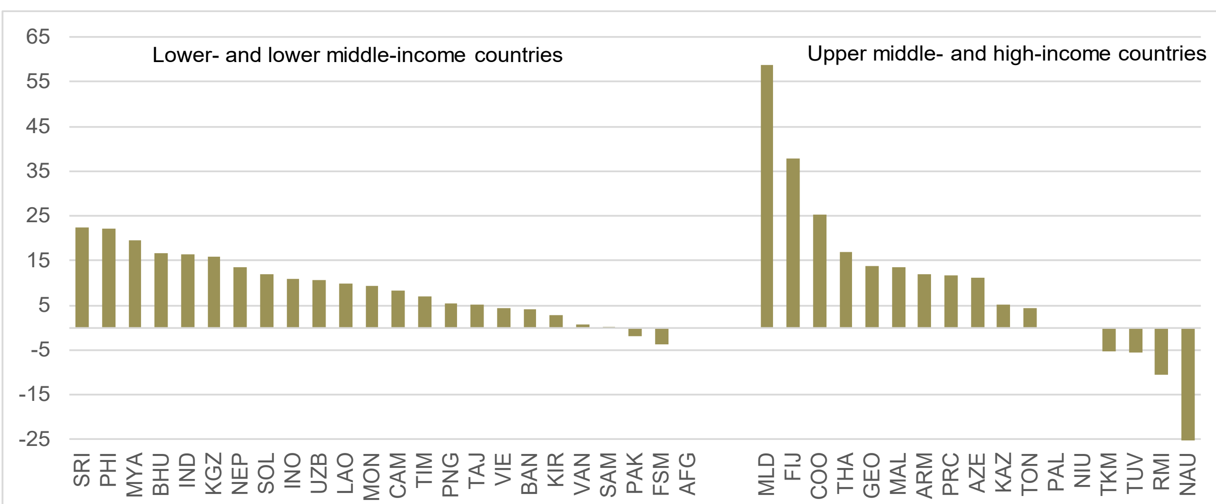
8 ADB. 2021. *Asian Development Outlook: Financing a Green and Inclusive Recovery*. Manila.
9 World Bank. 2022. *Global Economic Prospects.* Washington, DC.
10 International Monetary Fund (IMF). 2022. *World Economic Outlook: January 2022 Update.* Washington, DC.

Figure 1: Net Change in Fiscal Balance (2019 vs. 2021), % of GDP



AFG = Afghanistan, ARM = Armenia, AZE = Azerbaijan, BAN = Bangladesh, BHU = Bhutan, CAM = Cambodia, COO = Cook Islands, FIJ = Fiji, FSM = Federated States of Micronesia, GDP = gross domestic product, GEO = Georgia, IND = India, INO = Indonesia, KAZ = Kazakhstan, KGZ = Kyrgyz Republic, KIR = Kiribati, LAO = Lao People's Democratic Republic, MAL = Malaysia, MLD = Maldives, MON = Mongolia, MYA = Myanmar, NAU = Nauru, NEP = Nepal, PAK = Pakistan, PAL = Palau, NIU = Niue, PHI = Philippines, PNG = Papua New Guinea, PRC = People's Republic of China, RMI = Marshall Islands, SAM = Samoa, SOL = Solomon Islands, SRI = Sri Lanka, TAJ = Tajikistan, THA = Thailand, TIM = Timor-Leste, TKM = Turkmenistan, TON = Tonga, TUV = Tuvalu, UZB = Uzbekistan, VAN = Vanuatu, VIE = Viet Nam.
Source: ADB. 2021. *Asian Development Outlook: Financing a Green and Inclusive Recovery*. Manila.

Figure 2: Net Change in Public Debt (2019 vs. 2021), % of GDP



AFG = Afghanistan, ARM = Armenia, AZE = Azerbaijan, BAN = Bangladesh, BHU = Bhutan, CAM = Cambodia, COO = Cook Islands, FIJ = Fiji, FSM = Federated States of Micronesia, GDP = gross domestic product, GEO = Georgia, IND = India, INO = Indonesia, KAZ = Kazakhstan, KGZ = Kyrgyz Republic, KIR = Kiribati, LAO = Lao People's Democratic Republic, MAL = Malaysia, MLD = Maldives, MON = Mongolia, MYA = Myanmar, NAU = Nauru, NEP = Nepal, PAK = Pakistan, PAL = Palau, NIU = Niue, PHI = Philippines, PNG = Papua New Guinea, PRC = People's Republic of China, RMI = Marshall Islands, SAM = Samoa, SOL = Solomon Islands, SRI = Sri Lanka, TAJ = Tajikistan, THA = Thailand, TIM = Timor-Leste, TKM = Turkmenistan, TON = Tonga, TUV = Tuvalu, UZB = Uzbekistan, VAN = Vanuatu, VIE = Viet Nam.
Source: ADB. 2021. *Asian Development Outlook: Financing a Green and Inclusive Recovery*. Manila.

III. ADB'S POLICY-BASED LENDING TYPES AND CEILINGS

15. ADB has four PBL types: programmatic approach (a series of single-tranche PBL operations), stand-alone (usually configured into one or more tranches, generally referred to as multitranche), countercyclical support facility (CSF), and special PBL (SPBL). Programmatic approach and standalone are referred to as regular PBL with reform objectives typically identified as part of the country partnership strategy (CPS).[11] In contrast, SPBL and the CSF are referred to as crisis PBL, which cannot be anticipated and are typically not included as part of CPS' or country programming pipelines. In 2018, ADB introduced an option for regular PBLs to utilize a policy-based guarantee (PBG),[12] with contingent disaster financing (CDF) made available as a financing option for regular PBL in 2019.[13]

16. Regular PBL provides DMCs with financial resources to help meet government budget financing needs. The volume of support provided by ADB is determined based on the development financing needs of a country, including overall projected budgetary financing requirements, the availability of alternative financing, and debt sustainability at the macroeconomic level. Where relevant, the costs of adjustment directly related to the implementation of the envisaged reforms can be included as part of the rationale for loan size but it is not regarded as a prime determinant of loan size. Funds are provided contingent with the completion of an agreed set of policy actions to achieve substantive structural reforms that are specified in a policy design and monitoring framework (PDMF). PBL is distinct from and generally disburses more quickly than investment lending, as funds are made available to finance budget needs, and not tied to the procurement of goods and services under a specific project. Appendix 1 provides a summary of the evolution of the PBL modality since its inception in 1978.

17. Each PBL type is suited to different circumstances, and each maintains their own eligibility, due diligence, monitoring, and evaluation requirements along with tailored financial terms and conditions. Therefore, when considering the role of PBL in ADB operations it is critical to acknowledge the specific circumstances, macroeconomic situation, and reform environment to determine which type of PBL is appropriate.

18. A summary of the purpose and appropriate use of regular PBL includes:

(i) **Stand-alone policy-based lending.** Stand-alone PBL provides budget support and is packaged as a single or multitranche loan to support structural reforms over a short- to medium-term period (typically 1 to 3 years).

(ii) **Programmatic approach.** The programmatic approach is ADB's primary mode of PBL, which comprises a series of single tranche loans (subprograms) to support structural reforms over a medium-term period (typically 3 to 5 years).

(iii) **Policy-based guarantee.** PBG is a credit enhancement product that supports countries' access to commercial financing markets by using a partial credit guarantee, anchored on a set of policy conditions, as a financing instrument for sovereign borrowing, and is backed up by a sovereign counter-guarantee and indemnity.

(iv) **Contingent disaster financing.** CDF is designed as a contingent financing option, which provides quick-disbursing financing for DMCs impacted by disasters

[11] PBL can also avail of the precautionary financing option to make disbursement contingent on the occurrence of an economic or disaster-related crisis. PBL and investment loans can be combined into a sector development program.
[12] ADB. 2019. *Proposal for ADB's New Products and Modalities*. Manila.
[13] ADB. 2019. *Contingent Disaster Financing under Policy-based Lending in Response to Natural Hazards*. Manila.

triggered by natural hazards. Policy dialogue and agreed reforms to promote disaster resilience are completed before a disaster occurs, with disbursement made conditional on the satisfaction of pre-agreed disbursement condition(s) such as the declaration of a state of emergency.

19. A summary of the purpose and appropriate use of crisis PBL includes:

(i) **Special policy-based lending.** SPBL is designed to provide emergency balance of payments (BOP) support to a DMC in times of crisis as part of an international rescue effort led by the International Monetary Fund (IMF) and supported by other international financial institutions, including the World Bank.
(ii) **Countercyclical Support Facility.** The CSF provides budget support during an economic crisis, in conjunction with a DMC's fiscal stimulus package to restore growth. CSF lending currently has similar features to SPBL, such as accessibility for regular ordinary capital resources (OCR)-eligible or graduate countries.[14]

20. **Regular PBL ceilings.** Since the inception of program lending in 1978 (now referred to as PBL), ADB has adopted a policy of limiting the share of PBL in total sovereign lending. The original rationale for the introduction of a PBL lending ceiling was to ensure an appropriate mix of project and program lending in ADB operations.[15] ADB's regular and concessional assistance PBL ceilings are among the lowest for peer multi-lateral development banks, with both the African Development Bank (AfDB) and Inter-American Development Bank (IDB) allowing for additional flexibility in the application of their ceilings in response to the COVID-19 pandemic (table in para. 24).

21. Successive policy reviews have revised what has been considered an appropriate PBL lending ceiling (Appendix 1). Initially, the 1978 program lending policy adopted an ADB-wide program lending ceiling of 5.0% of overall anticipated ADB annual lending and a country ceiling of 10.0% of anticipated ADB annual lending. In 1983, the ADB-wide ceiling was increased to 7.5%, and the country ceiling to 20.0%. Individual country ceilings were abolished in 1987, and the ADB-wide ceiling was increased to 15.0%, in recognition of ADB's broader developmental role. A ceiling of 22.5% on program lending sourced from the ADF was also added in view of the increase in program lending from ADF sources. To provide flexibility, the ceiling on program lending was changed from an annual to a 3-year moving average basis, for both the Asian Development Fund (ADF) and OCR. With the introduction of the program cluster approach after the 1999 review, the ADB-wide program lending ceiling was increased from 15.0% to 20.0%. The ADF program lending ceiling was maintained at the same level, 22.5% of total ADF lending.[16] Neither ceiling has been changed since then.

22. The Review of ADB's Program Lending Policies (1999) outlined the importance of maintaining a degree of flexibility for ADB's PBL ceiling, noting that it should apply under 'normal circumstances' to allow ADB to cope with the changing needs of its DMCs. The review also notes that tying the volume of program lending (PBL) to the overall volume of lending could be disruptive unless there is some flexibility in its interpretation and indicates that the context, in which the ceiling is being applied should be an important consideration.

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[14] ADB. 1999. *Review of Program Lending Policies*. Manila. Pages ii and 32.
[15] ADB. 1978. *Program Lending*. Manila (confidential).
[16] ADB's contingent disaster financing (CDF) under PBL in response to natural hazards policy further stipulates that CDF operations financed by concessional ordinary capital resources, or the Asian Development Fund (ADF) shall remain within the 22.5% bank-wide cap, while CDF operations financed by regular ordinary capital resources shall fall outside the PBL cap of 20.0%.

23. The Review of Policy-Based Lending (2011) reconfirmed ADB's PBLs limits and the associated flexibilities established in the Review of ADB's Program Lending Policies (1999). In view of the more constrained availability and mobilization of concessional resources, ADB's 22.5% ceiling on a 3-year rolling average basis for concessional assistance PBL does not have the same flexibility and requires approval by ADF donors and the Board of Directors to breach the ceiling.

24. In 2020, ADB established the COVID-19 Pandemic Response Option (CPRO) under the CSF to facilitate critically needed fiscal stimulus for DMCs to better manage the immediate economic and financial shocks created by the pandemic.[17] At the same time, ADB also expanded the eligibility criteria for CDF operations to include health emergencies, in addition to the initial focus on disasters triggered by natural hazards. Throughout this timeline, ADB's crisis response PBLs (CSF, SPBL, and CPRO) and CDF financed from regular OCR have remained outside of ADB's PBL ceilings to ensure ADB maintains the flexibility to respond to emergency situations in its DMCs.

Peer Multilateral Development Banks' Limit on Policy-Based Lending Use (%)

Fund	ADB	AfDB	IDB	World Bank
Ordinary capital resources	20.0[a]	15.0[b]	30.0[c]	None
Concessional resources	22.5[d]	25.0[e]	30.0[c]	None[f]

ADB = Asian Development Bank, AfDB = African Development Bank, IDB = Inter-American Development Bank.

[a] Includes stand-alone policy-based loans (PBLs), loans under the programmatic approach, the policy-based component of sector development programs, and policy-based guarantees. Ratio is calculated against total sovereign commitments on a three-year rolling average basis. Source: 2021. Policy-Based Lending. *Operations Manual*. OM D4. Manila

[b] Refers to the Program-based operations (PBO) ceiling for AfDB's window (ordinary capital) and is fixed on an annual basis. AfDB's COVID-19 Response Facility paper approved on 21 April 2020, Annex 1 provides for flexibility in the application of its PBO ceilings citing that because of the expected costs and need for relief, the 15% PBO limit for AfDB countries and the 25% for AfDF countries may need to be exceeded to ensure that countries receive the assistance they need. Sources: 2020. *The African Development Bank Group's COVID-19 Rapid Response Facility (CRF)*. Abidjan.

[c] Resolution AG-8/20 (IDB's Governance Response to the COVID-19 Pandemic Outbreak Policy-Based Loans) adopted on 24 April 2020 increased from 30% to 40% the PBL approvals to be financed with IDB's ordinary capital resources and concessional ordinary capital resources until 31 December 2022. Calculated across four-year program cycles. Sources: 2021. *Review of the Implementation of the Debt Sustainability Framework and Enhanced Performance-Based Allocation, 2019–2020*. Washington, DC; 2020. Resolution AG-8/20: IDB Governance Response to the COVID-19 Pandemic Outbreak—Policy-Based Loans. Washington, DC.

[d] Includes concessional financing for stand-alone policy-based loans (PBLs), loans under the programmatic approach, and the policy-based component of sector development programs. Ratio is calculated against total concessional sovereign commitments on a three-year rolling average basis. Source: 2020. *Asian Development Fund 13 Donors' Report: Tackling the COVID-19 Pandemic and Building a Sustainable and Inclusive Recovery in line with Strategy 2030*. Manila.

[e] Based on the Fifteenth Replenishment of the African Development Fund (AfDF-15) dated 10 March 2020 and covers the three year period from 2020 to 2022. *ADF-15 Report: An Enabling Environment for Inclusive and Sustainable Growth and Transformation, Decent Jobs, and Greater Resilience*. Abidjan; 2012. *Bank Group Policy on Program-Based Operations*. Abidjan.

[f] A bank wide ceiling of 30% required during earlier IDA replenishments is not included under the IDA20 replenishment report covering the period 1 July 2022 to 30 June 2025. But for regional development policy financing, to ensure selective use of limited resources, IDA20 provides that overall allocations to development policy financing will be capped at 10% of the IDA Regional Window. Source: 2022. *IDA 20 Building Back Better from the Crisis: Towards a Green, Resilient and Inclusive Future*, Washington, D.C.

[17] ADB. 2020. *Comprehensive Response to the COVID-19 Pandemic*. Manila. While the CPRO was retired in July 2021 in line with commitments under the original COVID-19 response package, a review of ADB's COVID-19 response recommended that ADB draw on the lessons learned from the CPRO experience and consider updating the CSF policy to mainstream some of CPRO's successful or effective features into the CSF.

IV. POLICY-BASED LENDING OPERATIONS, 2019–2021

25. **PBL commitments, 2019–2021.** Following the onset of the COVID-19 pandemic in early 2020, the volume of PBL operations increased by 17.47% when compared with 2019 levels, with commitments of $3.95 billion in 2019 and $4.64 billion in 2020. As DMC demand for development financing grew rapidly in 2020, CPRO commitments reached $10.2 billion across 26 DMCs, with one more CPRO for $250 million committed in 2021. As an emergency response instrument, CPRO commitments are excluded from ADB's PBL ceilings, which apply only to regular PBL operations.

26. Following the retirement of the CPRO instrument in July 2021, DMCs' demand for PBL has increased to meet critical development financing needs arising from the COVID-19 pandemic. ADB worked closely with its DMCs to identify the reforms necessary to accelerate progress towards a green, resilient, and inclusive recovery. PBL commitments reached $4.61 billion in 2021, a slight decline from the $4.64 billion committed in 2020. Considering the extraordinary circumstances facing DMCs due to the COVID-19 pandemic, ADB was able to utilize the flexibility in its PBL ceiling to accommodate a higher share of PBL operations in 2021, exceeding its institutional ceiling with the ratio of PBL commitments to sovereign operations on a 3-year rolling average basis rose to 23.6% in 2021.

27. On a country-by-country basis, the majority of PBL commitments between 2019 and 2021 were provided to five DMCs, including Philippines (28% of total), Indonesia (23%), Pakistan (13%), Uzbekistan (6%) and India (5%). Cumulatively, these five DMCs comprised 74% of total PBL commitments between 2019 and 2021 with the remaining 26% of PBL commitments provided to 28 DMCs. Figure 3 presents Policy-Based Lending Commitments by DMC.

28. **Concessional assistance PBL commitments, 2019–2021.** Concessional assistance PBL commitments also moderated in 2020, as Group A and Group B DMCs utilized the CPRO instrument to meet their emergency financing needs arising because of the COVID-19 pandemic and as planned structural reforms necessary for regular PBL were delayed. CPRO commitments for concessional assistance countries reached $1.4 billion across 15 DMCs in 2020 while the volume of PBL financed by concessional assistance dropped from $1.3 billion in 2019 to $0.9 billion in 2020.

29. Following retirement of the CPRO instrument in 2021 commitments for PBL financed by concessional assistance declined further to around $0.7 billion in 2021. The drop in 2021 commitments was due to several reasons including: (i) prioritization of concessional assistance towards other COVID-19 response priorities in Group B blend DMCs, (ii) front-loading use of ADF 13 concessional resources into 2020 to support COVID-19 response programs, including CPRO; and (iii) delays in processing of concessional assistance PBL that led to the shifting of some commitments into planned 2022 operations.

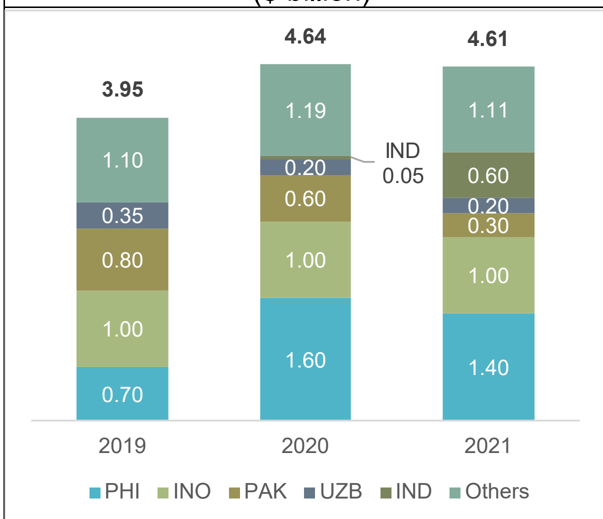
30. Although concessional assistance PBL commitments halved between 2019 and 2021, the ratio of concessional assistance PBL to sovereign operations on a 3-year rolling average basis continued to increase, rising from 16.2% in 2019 to 24.7% in 2021. Contributing to this rising ratio was lower total sovereign concessional assistance commitments, due to disrupted operations in several DMCs, and the graduation of Sri Lanka and Viet Nam to group C in 2019.[18]

[18] ADB placed on hold its assistance in Afghanistan effective 15 August 2021. ADB Statement on Afghanistan | Asian Development Bank (published on 10 November 2021). Manila.

31. Concessional assistance PBL commitments were also unusually low in 2018, contributing to a spike in the calculation of the 3-year-rolling average ratio in 2021 (Appendix 3). The 2021 ratio of 24.7% breached ADB's concessional assistance PBL ceiling of 22.5%. ADB sought and obtained ADF donor endorsement for exceeding the ceiling for 2019–2021 in October 2021, with subsequent Board of Directors approval in November 2021.[19]

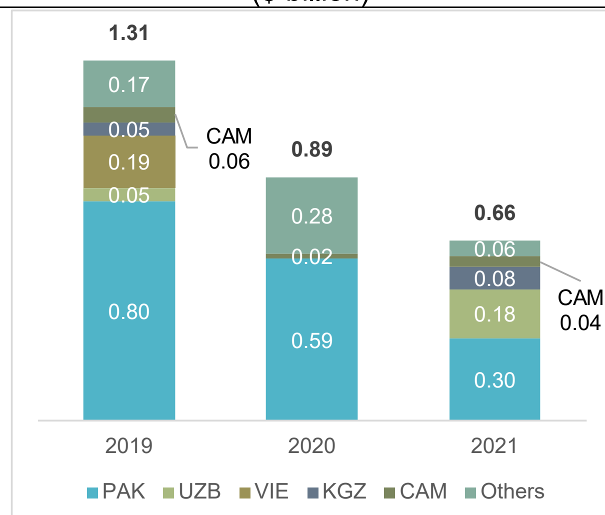
32. On a country-by-country basis, most concessional assistance PBL commitments between 2019 and 2021 were provided to four DMCs, including Pakistan (59% of total), Uzbekistan (8%), Cambodia (4%), and Nepal (4%). Cumulatively, these four DMCs comprised 75% of concessional assistance PBL commitments between 2019 and 2021 with the remaining 25% of PBL commitments provided to 17 DMCs. Figure 4 presents Concessional Assistance Policy-Based Lending Commitments by DMC.

Figure 3: Policy-Based Lending Commitments by Developing Member Country
($ billion)



IND = India, INO = Indonesia, PAK = Pakistan, PHI = Philippines, UZB = Uzbekistan.
Source: Asian Development Bank estimates.

Figure 4: Concessional Assistance Policy-Based Lending Commitments by Developing Member Country
($ billion)



CAM = Cambodia, KGZ = Kyrgyz Republic, PAK = Pakistan, UZB= Uzbekistan, VIE = Viet Nam.
Source: Asian Development Bank estimates.

[19] ADB. 2021. *Waiver of ADB's Concessional Assistance Policy-Based Lending Limits for 2019-2021*. Manila.

V. PROJECTED DEMAND FOR POLICY-BASED LENDING, 2022–2024

33. Projecting the future ratio of PBL commitments to sovereign commitments on a 3-year average basis is subject to a high degree of uncertainty due to several reasons. These include:

(i) approval and commitment of PBL operations requires the identification and completion of a substantive set of policy reforms. At early stages of program processing, when PBLs are included in program pipelines, the required timelines for completing agreed policy actions are uncertain, often requiring completion of activities across multiple Government agencies;
(ii) the size of PBL operations is determined by a DMC's development financing needs, which is subject to exogenous factors such as economic shocks, performance of domestic resource mobilization and the volume of budgetary assistance provided by other development partners. The volume of assistance requested by DMCs can therefore change as program processing is undertaken;
(iii) PBL operations are subject to a variety of stringent due diligence requirements, including demonstrating adequate debt sustainability with an assessment letter provided by the IMF. In cases where due diligence requirements are pending completion, planned PBL commitments may be postponed or delayed; and
(iv) projecting PBL ratios requires projections for ADB's total sovereign lending commitments, which also fluctuate year-on-year based on prevailing economic and DMC conditions. Regular project commitments have also become more unpredictable due to the challenges associated with project processing during the COVID-19 pandemic.[20] These challenges are particularly acute for concessional assistance commitments, which rely on a smaller number of concessional assistance recipients and are more prone to disrupted operations due to debt sustainability or political developments.

34. **Work Program and Budget Framework, 2022–2024 projections.** ADB's Work Program and Budget Framework (WPBF), 2022–2024 highlighted the potential for continued strong demand for PBL during 2022–2024. Based on indicative country pipelines submitted by regional departments in July 2021 WPBF, 2022–2024 projected $5.5 billion in PBL commitments in 2022, $4.9 billion in 2023, and $4.3 billion in 2024. Based on these projected commitments and sovereign project commitments, the ratio of PBL commitments to sovereign operations on a 3-year rolling average basis was projected to grow from 24.7% in 2021 to a peak of 24.8% in 2023, before dropping to 23.5% in 2024.

35. In contrast, demand for PBL financed by concessional assistance remained relatively modest in the pipelines submitted for WPBF, 2022–2024 with projected commitments of around $700 million projected for 2022 and 2023. Demand was then projected to drop in 2024, however, this was largely attributable to a heightened level of programming uncertainty in Group A and Group B DMCs in 2023 and 2024, due to the COVID-19 pandemic, as well as political developments. When combined with total concessional assistance sovereign project commitments, this level of operations was projected to support a return to compliance with the

[20] For example, in January 2021 ADB projected sovereign project commitments of approximately $15.5 billion for 2021. By November 2021, this number had been revised to approximately $8.2 billion due to changing DMC demand and, in some cases, delays in achieving project quality and readiness criteria prior to Board of Directors consideration.

prescribed concessional assistance ceiling, dropping to 19.2% in 2022 before dropping to 17.2% in 2023 and 14.4% in 2024.[21]

36. Appendix 2 presents actual and projected PBL commitments and their ratio to total ADB operations on a 3-year rolling average basis for total PBL, while Appendix 3 presents the same for concessional assistance PBL.

37. **Revised projections.** ADB's PBL pipelines are continually evolving to reflect changes in DMC demand and progress made in processing of individual operations. WPBF, 2022–2024 also emphasized the heightened uncertainty facing country programming due to the COVID-19 pandemic and the importance of continuously engaging clients to adjust work programs in response to changing circumstances. Subsequent country programming updates, the most recent of which took place in January 2022, have highlighted a potential further growth in demand for ADB's PBL operations beyond those indicated in WPBF, 2022–2024.

38. Based on indicative country pipelines submitted by regional departments in January 2022, DMCs have requested PBL commitments of $6.3 billion in 2022, $5.2 billion in 2023, and $6.4 billion in 2024. Based on these revised projected commitments coupled with existing sovereign project commitments, the ratio of PBL commitments to sovereign operations on a 3-year rolling average basis would be expected to grow from 23.6% in 2021 to a peak of 29.0% in 2024. Similarly, demand for PBL financed by concessional assistance has also grown. Based on recent requests for PBL assistance ADB projects demand of about $1.3 billion in concessional assistance PBL commitments in 2022, $0.7 billion in 2023, and $0.4 billion in 2024.[22] When combined with projected annual sovereign project commitments the annual percentage share of PBL on a 3-year rolling average basis would reach 24.5% in 2022, before moderating to 22.1% and 20.6% in 2023 and 2024, respectively.

39. On a country-by-country basis, requests for regular PBL continue to be concentrated in five large DMCs, including Philippines (22% of total), Indonesia (21%), India (12%), Pakistan (10%), and Kazakhstan (5%). Cumulatively, these five DMCs comprise 70% of projected PBL commitments between 2022 and 2024. Similarly, majority of concessional assistance PBL have been requested by a group of four DMCs with Pakistan (45% of total), Nepal (11%), Uzbekistan (9%), and Cambodia (9%) comprising 73% of concessional assistance PBL commitments between 2022 and 2024. Figure 5 and Figure 6 provide a summary of latest January 2022 projected PBL commitments for total PBL and concessional assistance PBL, respectively.

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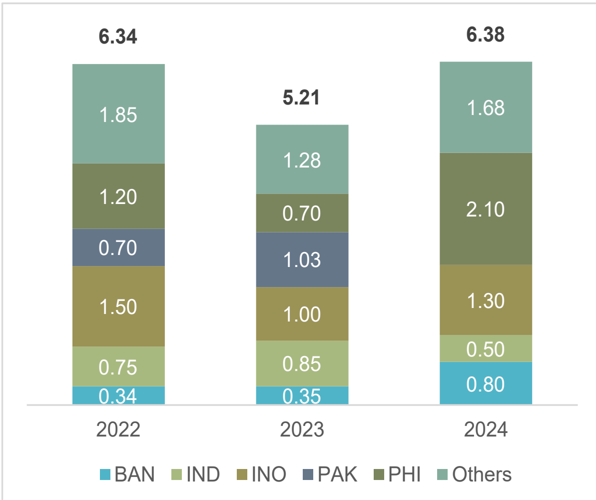
[21] The projections for 2023 to 2024 are indicative and subject to revisions based on factors such as the pace of economic recovery from the pandemic and changing DMC priorities.

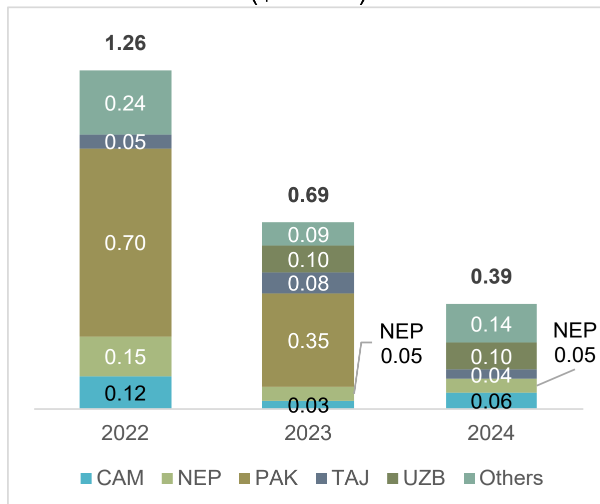
[22] Lower concessional assistance commitments in 2024 are partly attributable to a heightened level of programming uncertainty in group A and B DMCs because of the COVID-19 pandemic. Additional requests for PBL may be considered during the 2022 country programming exercise.

Figure 5: Indicative Requests for Policy-Based Lending Commitments by Developing Member Country
($ billion)



BAN = Bangladesh, IND = India, INO = Indonesia, PAK = Pakistan, PHI = Philippines.
Source: Asian Development Bank estimates.

Figure 6: Indicative Requests for Concessional Assistance Policy-Based Lending Commitments by Developing Member Country
($ billion)



CAM = Cambodia, NEP = Nepal, PAK = Pakistan, TAJ = Tajikistan, UZB = Uzbekistan.
Source: Asian Development Bank estimates.

VI. ENHANCING THE ROLE OF POLICY-BASED LENDING FOR CRISIS RESPONSE

40. DMCs face the dual challenge of delivering reforms and accessing sufficient development financing necessary for a green, inclusive, and sustainable recovery, while at the same time facing heightened risks of macroeconomic crisis. ADB's regular PBL should only be used to support DMCs, who are undertaking substantive structural reform programs. Regular PBL must be anchored on a comprehensive sector or thematic analysis that identifies structural constraints to sector development and support policy dialogue with government to address these constraints. The program resulting from the diagnostics and policy dialogue must have full government commitment, be consistent with ADB's country partnership strategy for the DMC and be closely coordinated with other major development agencies. Regular PBL is therefore not a suitable instrument for supporting DMCs, who are facing macroeconomic crisis, or to address emergency budget needs during and/or after these events.

41. To assist DMCs that are facing severe macroeconomic crisis, ADB should continue to utilize its tailored SPBL and CSF instruments to provide emergency balance-of-payments or counter-cyclical fiscal support.[23] Both instruments have due diligence and program monitoring requirements that enable ADB to partner with other international financial institutions to mobilize financing quickly, and to support actions, which are targeted at the direct impacts of the crisis (Figure 7). Lending through these crisis response instruments is highly flexible as they are not planned and do not form part of CPS discussions or indicative country pipeline and monitoring reports for a DMC. ADB should also encourage DMCs to leverage its CDF instrument, which allows for the rapid disbursement of budget support, based on the up-front completion of substantive policy reforms to improve resilience to disasters triggered by natural hazards.

[23] ADB. 2009. *Enhancing ADB's Response to the Global Economic Crisis—Establishing the Countercyclical Support Facility*. Manila.

42. ADB's Review of the Comprehensive Response to the COVID-19 Pandemic (2021) (footnote 1) highlighted several options to enhance the relevance and effectiveness of CSF. This includes: (i) expanding access to concessional-assistance only DMCs, which are among the most vulnerable to severe crisis events; (ii) revising access criteria to reflect a broader range of crisis events, including health emergencies, which tend to impact disproportionately vulnerable and marginalized populations, including women and girls; and (iii) strengthening the results-chain linkages between counter-cyclical fiscal programs and support for human development, vulnerable groups and social protection initiatives in design and monitoring frameworks (DMFs).

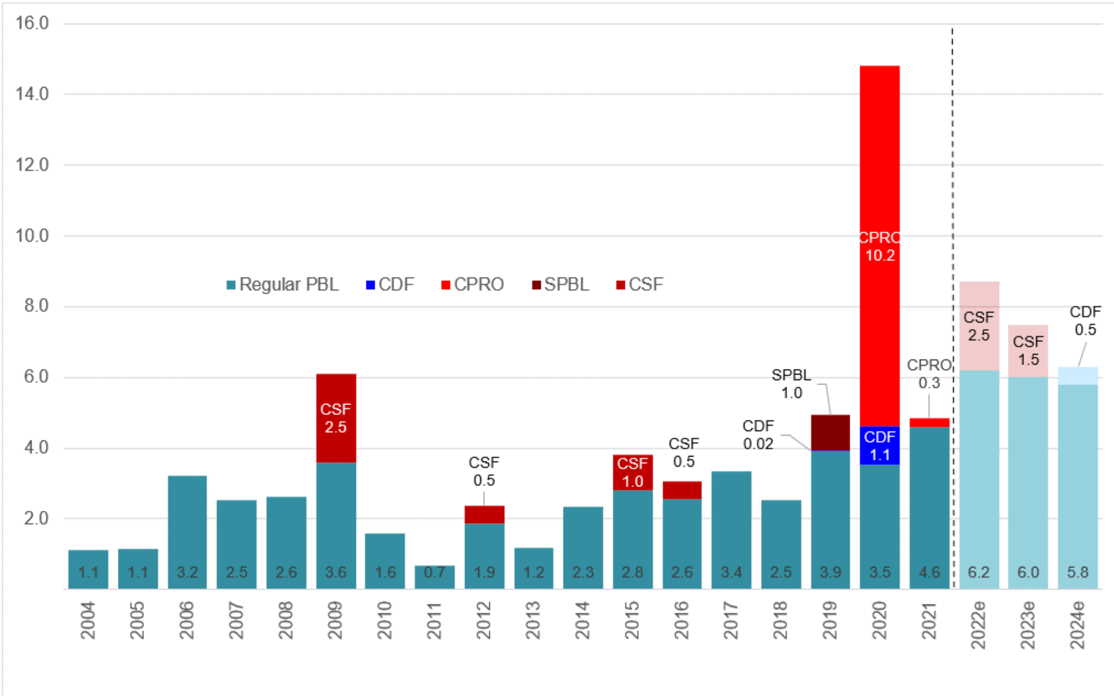
43. ADB will also take action to strengthen the relevance and efficiency of its CDF instrument, which currently does not cover health emergencies. While a special policy variation was approved by ADB's Board of Directors to cover health emergencies for the COVID-19 pandemic, that option has now lapsed, and the instrument is currently limited to disasters triggered by natural hazards.[24] There is also a need to address a lack of consistency in the treatment of CDF operations in relation to the PBL ceiling, with only CDF financed by concessional assistance included and CDF financed by regular OCR exempt from ceilings.[25] Further clarification is also needed on suitable disbursement triggers for health emergencies, which can be protracted and involve several waves of infection within one pandemic, including after an initial declaration of state of emergency is issued.

44. Due to the need for a comprehensive assessment of how crisis PBL fits into ADB's overall emergency response architecture, necessary reforms will be considered through a standalone proposal. It is critical however to ensure that the impact on ADB's risk bearing capacity of proposed revisions to regular PBL ceilings are considered in a comprehensive manner with the potential demand for a revised CSF instrument. Given its emergency nature, CSF is not programmed into ADB's operational pipelines, however, an initial demand assessment indicates the potential for up to $4 billion in CSF operations during 2022 and 2023 in response to the COVID-19 pandemic and emerging global economic pressures including the Russian Federation's invasion of Ukraine (Figure 7). The combined impact of both regular and crisis PBL proposals will therefore be considered when assessing potential impacts on ADB's financial sustainability and risk bearing capacity.

[24] The special policy variation expired on 31 December 2021.

[25] This results in unequal treatment of regular OCR- and concessional assistance-financed CDF for disaster and emergency assistance and can potentially limit CDF operations in concessional assistance DMCs.

Figure 7: Policy-Based Lending by Type
($ billion)



CDF = Contingent Disaster Financing, CPRO = COVID-19 Pandemic Response Option, CSF = Countercyclical Support Facility, PBL = policy-based lending, SPBL = special policy-based lending.
Note: 2004–2016 based on Approvals, 2017–2021 based on Commitments, 2022–2024 estimates. CSF volumes in 2022 and 2023 are a “high” utilization scenario based on latest economic outlook and DMC eligibility. Actual requests may vary. Regular PBL volumes from 2022 to 2024 are maximum allowed under revised PBL ceilings. Regular PBL commitments may be less, but not higher.
Source: Asian Development Bank.

VII. STRATEGIC MANAGEMENT OF POLICY-BASED LENDING, 2022–2024

45. ADB’s existing backward looking, 3-year rolling average, approach to calculating PBL ceilings creates a high level of uncertainty in planning appropriate PBL volumes with ceiling breaches typically not known until late in the calendar year. At this stage, it is less feasible to adjust or reprogram planned PBL commitments given the advanced stage of program processing by DMCs and ADB. The majority of PBL operations commence preparation 12 to 18 months prior to program approval with programmatic approaches also reaching agreement with DMCs on a series of subprograms over a 3-to-5-year time horizon. Disrupting or delaying commitment of ongoing programmatic approaches to meet ADB’s PBL ceilings would have detrimental impacts on both the effectiveness of ADB’s PBL operations, as well as client perceptions of ADB’s role as a reliable partner in supporting a medium-term program of structural reforms.

46. Given the challenges in using a backward looking PBL ratio, and the critical importance of giving DMCs clear guidance on the availability of development financing, a forward-looking strategic approach to managing ADB’s PBL volumes is proposed. Such an approach would allow ADB to better plan future PBL operations and maximize their impact. This approach will also help to mitigate the heightened uncertainty in project commitments due to the COVID-19 pandemic.

47. **Ceiling objectives.** In accordance with PBL policy requirements, when determining an appropriate volume of PBL commitments ADB should consider a variety of objectives. These include ensuring:

(i) DMCs have access to sufficient development financing to mitigate the direct impacts of COVID-19 and support a green, resilient, and inclusive recovery;
(ii) the quality and impact of ADB's PBL operations continues to be enhanced and is strongly aligned with ADB's corporate objectives;
(iii) an appropriate mix of ADB operations between policy-based and investment lending; and
(iv) ADB maintains adequate risk-bearing capacity.

48. **Proposed measures.** To achieve the above objectives the following measures are proposed for the period covering 2022–2024:

(i) replace ADB's PBL ceiling of 20.0% of sovereign operations on a 3-year rolling average basis, with a total PBL commitment volume of $18 billion across the three-year period;[26]
(ii) target a maximum PBL commitment volume of $6.2 billion in 2022, and a maximum PBL commitment volume of $5.8 billion in 2024, to support a gradual moderation in PBL commitments over the 3-year period. If PBL commitments do not reach $6.2 billion in 2022 or $6.0 billion in 2023 then the unused headroom may be committed in 2023 or 2024, provided that the total volume of PBL commitments across 2022–2024 does not exceed $18 billion;
(iii) strengthen Board of Directors oversight on PBL operations by (a) providing a detailed update on projected PBL operations during the annual Work Program and Budget Framework; (b) introducing analysis on the impact of PBL operations on capital utilization in ADB's quarterly risk monitoring report; (c) introducing information on sustainability of public debt into all PBL report and recommendations of the President (RRP);[27] and
(iv) improve the alignment of PBL operations with ADB's corporate results framework targets and introduce measures to strengthen quality and impact of PBL operations as described in Section VIII and Section IX.

49. Given the projected moderation in demand for concessional assistance PBL, no change in ADB's concessional assistance limit of 22.5% of concessional sovereign operations on a 3-year rolling average basis is proposed. ADB expects to return to compliance with this ceiling in 2022.

50. **Revised ceiling benefits.** Establishing the proposed forward-looking ceiling will allow ADB to provide critical development financing for DMCs economic recovery, while setting a firm anchor on regular PBL commitments consistent with ADB's objective of maintaining a sustainable

[26] The total PBL commitment volume of $18 billion is equal to 30% of sovereign commitments projected to be undertaken during Work Program and Budget Framework, 2022–2024. WPBF, 2022–2024 projects total sovereign commitments of $60.1 billion between 2022 to 2024. The total PBL commitment volume would apply to commitments for programmatic approaches, standalone PBL, and the PBL portion of sector development programs.

[27] To be introduced by end of Q3 2022. Where feasible, information on the sustainability of public debt should be based on the IMF assessment letter included as a linked document of the RRP or a recent IMF or World Bank assessment. If a relevant IMF or World Bank assessment is not available then reference may be made to ADB analysis, relevant government documents, or other reliable sources. All PBL RRPs should indicate whether the proposed program has been included into the latest Quarterly Risk Monitoring Report prepared by Office of Risk Management.

financial trajectory. The proposed ceiling will establish a higher level of certainty on available PBL commitment headroom that will support more predictable forward planning and preparation of PBL operations. The proposal will stabilize ADB's PBL ratio on a 3-year-average basis at around 30.0% of estimated sovereign operations between 2022 and 2024 (Figure 8), consistent with the level of PBL support provided by ADB during the Global Financial Crisis and its aftermath between 2006 to 2010 (Appendix 2).[28]

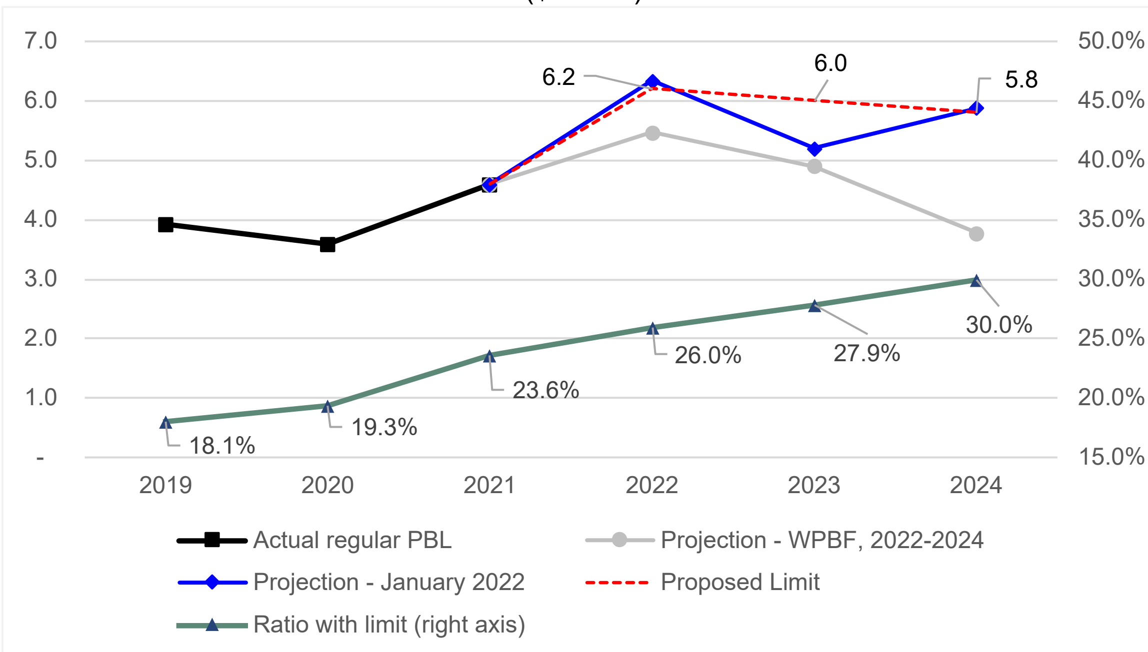
51. **Prioritization of PBL commitments.** Strategy, Policy and Partnerships Department (SPD) will be responsible for monitoring PBL commitment volumes, working in close collaboration with regional departments to minimize any potential disruption to country operations. In prioritizing PBL commitment headroom, preference will be given to:

(i) operations that demonstrate the highest levels of program quality and demonstrated DMC commitment towards supporting impactful reforms that accelerate progress towards a green, resilient and inclusive growth;
(ii) operations that support DMCs with more limited access to alternative sources of budget financing including low- and lower-middle income countries, small island developing states and fragile and conflict affected situations;
(iii) operations that are strongly aligned with ADB's corporate results framework objectives, including operations supporting ADB's climate finance objectives along with those that support a more inclusive recovery from the COVID-19 pandemic such as gender, health, education, and social protection; and
(iv) DMCs, which have utilized lower volumes of PBL commitments with the aim of ensuring equitable use of the PBL instrument across DMCs.

52. **Review timeline.** Prior to the conclusion of the 3-year forward-looking ceiling pilot period, ADB will review experiences and submit a recommendation for the future management of PBL for Board of Directors consideration.

[28] Given the backward-looking nature of ADB's existing PBL ceiling, it would likely require several years beyond 2024 before ADB would return to compliance with its existing regular PBL ceiling of 20% of sovereign operations on a 3-year rolling average basis.

Figure 8: Proposed Limits for Policy-Based Lending Commitments
($ billion)



PBL = policy-based lending, WPBF = Work Program and Budget Framework.
Note: Projections are calculated using WPBF, 2022–2024 program for total sovereign commitments with original and revised projections for PBL. Actual commitments may vary. Proposed limit is maximum PBL commitment volume allowed under proposed PBL ceilings. Actual amounts may be less, but not higher.
Source: Asian Development Bank estimates.

VIII. INCREASING CONTRIBUTION OF POLICY-BASED LENDING TO STRATEGY 2030 OBJECTIVES

53. ADB's PBL operations will play a critical role in supporting high-quality, government-led reform programs to recover from the COVID-19 pandemic, while being mindful of the appropriate sequencing and prioritization of reforms undertaken during periods of macroeconomic uncertainty. All PBL operations will be undertaken in close collaboration with development partners and the IMF and apply the Group of 20 principles on the effective coordination of budget support. ADB will actively seek out opportunities for cofinancing to expand impact, particularly for climate finance. ADB will support DMCs to deliver priority structural reforms that carefully balance the unprecedented economic scale and human toll of the COVID-19 pandemic while accelerating transition toward a green, resilient, and inclusive recovery (Box 1). When designing PBL operations across the 2022 to 2024 period, ADB will emphasize maximizing the contribution of PBL operations to Strategy 2030 and ADB's Corporate Results Framework (CRF) targets with particular attention to the priorities outlined below.[29]

[29] ADB. 2018. *Strategy 2030: Achieving a Prosperous, Inclusive, Resilient, and Sustainable Asia and the Pacific*. Manila.

Box 1: PBL's contribution towards DMCs green, resilient, and inclusive recovery		
Green recovery • A total of 38 operations supporting $2.8 billion in **climate finance** reforms. • 23 operations to support climate adaptation and nature-positive policy change across energy, transport, urban and water infrastructure, agriculture and rural development and disaster resilience. • 14 operations to support climate mitigation by restructuring power generation companies, improve distribution efficiency and promote renewable energy.	**Inclusive recovery** • 86% of PBLs by number (out of 118) will support lower and lower-middle income DMCs, including 21 ($848 million) for SIDS and FCAS. • 6 operations ($1.0 billion) to support strengthening of national health systems and 12 operations ($1.4 billion) in support for social protection. • 7 operations ($0.3 billion) to transform national education systems and address lost education and skills development.	**Resilient recovery** • 47 operations to strengthen fiscal management, domestic resource mobilization and debt sustainability along with 20 operations to support financial and private sector development. • 24 operations to advance implementation of **G20 quality infrastructure agenda** through urban and municipal infrastructure services (6 operations), more open and efficient trade policies (7 operations), strengthening sustainability of rural infrastructure (6 operations) and strengthening regulatory foundations for mass urban transport systems (5 operations). • 24 operations to boost regional connectivity and strengthen regional cooperation and integration.

Note: Data reflects latest projected PBL commintments for the perios 2022-2024 as of January 2022, of which there are 118 planned operations. Actual commitment numbers and volumes are subject to change.
Source: Asian Development Bank.

54. **Accelerating climate finance.** In line with ADB's ambition to reach $100 billion in climate finance by 2030, PBLs will expand their support for climate adaptation and mitigation and nature-positive structural reforms, where appropriate. In 2021, PBL contributed $607 million toward ADB's climate financing—17% of the total climate financing—up significantly from $209 million in 2019 and $417 million in 2020 (Figure 9).

55. To further promote the integration of climate adaptation and mitigation and nature-positive structural reforms into PBL operations, ADB will adopt a range of measures, including: (i) developing best practice guidance notes for implementing the joint multi-lateral development banks climate finance tracking methodologies; (ii) expanding staff training and development on climate-relevant and nature-positive policy reforms and the preparation of robust sector and thematic frameworks for climate reform; (iii) establishing additional technical assistance to provide knowledge and advisory resources for DMCs, which are developing climate-focused PBL programs; and (iv) developing new PBL programs that are directly linked to achievement of DMC's Paris Agreement objectives and Nationally-determined Contributions. These measures will support a continued expansion in PBL's contribution towards ADB's climate finance objectives with up to $1.3 billion in projected commitments expected in 2022, equal to 23% of ADB's projected climate financing for the year.[30] As future PBL programs reach more advanced stages of processing, these measures are also expected to boost the contribution of PBL operations to climate financing in 2023 and 2024.[31]

[30] Operations will include ADB's first dedicated climate change PBL in the Philippines; promoting the reduced use of carbon and energy efficiency in Cambodia, India, Pakistan, and Uzbekistan; strengthening financial resilience to climate events and enhancing fiscal frameworks for green investment in Bhutan, Cambodia, Indonesia, and the Philippines; and supporting climate-friendly agriculture and more sustainable land-use and irrigation practices in Georgia, the Kyrgyz Republic, the Philippines, and Tajikistan.
[31] Only those programs that can demonstrate clear and measurable impacts on advancing ADB's climate change mitigation and adaptation objectives should be proposed for consideration as supporting climate finance.

56. **Expanding financing for health and social protection.** Amid massive health system disruption caused by the COVID-19 pandemic, the need to maintain and improve essential health services is greater than ever. In addition to the Asia Pacific Vaccine Access Facility (APVAX), PBL operations have made a growing contribution towards ADB's health and social protection financing. In 2021, financing increased to $700 million for health system reform and $477 million for social protection (Figure 10). These operations have been used to increase ADB's support for health security and social protection, including income transfer programs to protect vulnerable groups; developing COVID-19 containment and mitigation strategies; and undertaking reforms necessary for upgrading over-burdened national health systems. ADB will give priority to using PBL for strengthening national health and social protection systems, and supporting universal health care, to build resilience against future health emergencies.

57. **Mainstreaming gender equity.** PBL will continue to make a significant contribution towards ADB's strong performance against its gender objectives, with approximately half of PBL operations supporting effective gender mainstreaming or gender equality and an average of 80% of operations having at least some gender elements (Figure 11). Between 2022 and 2024, ADB will seek to further strengthen the alignment of PBL operations with gender targets placing greater focus on the transformative gender agenda of Sustainable Development Goal 5 (achieve gender equality and empower all women and girls) and aiming for more projects categorized as gender equity theme, particularly given the disproportionate impacts of the pandemic on women and girls.

58. **Increasing education finance.** With several operations disrupted due to the COVID-19 pandemic, ADB's financing for education as a percentage of total financing fell below corporate targets in 2021—about 5%, compared to a 2024 target of 6%−10%. ADB will re-emphasize the important role PBL can play in expanding ADB's education sector support. It will focus on scaling up education technology and digital skills to ensure learning continuity, mitigating COVID-19 learning loss and inequality, and supporting skills and vocational training initiatives to meet emerging human capital needs. In total, PBL is projected to support around $300 million in education sector financing between 2022 and 2024 (Figure 12).

59. **Strengthening debt sustainability, fiscal management, and domestic resource mobilization.** Public sector management will continue to be a major focus of PBL operations (Figure 13). These operations will strengthen ADB's engagement on debt sustainability, fiscal reform, domestic resource mobilization and international tax cooperation, leveraging the knowledge and advisory services of the Asia-Pacific Tax Hub.[32] PBL operations will help DMCs develop capacity and share knowledge at the regional level and contribute to global initiatives in collaboration with other international organizations and sub-regional tax associations in the Asia and the Pacific region.

[32] Asia Pacific Tax Hub: Overview | Asian Development Bank (adb.org)

Figure 9: Policy-Based Lending Contribution to Climate Finance
($ million)

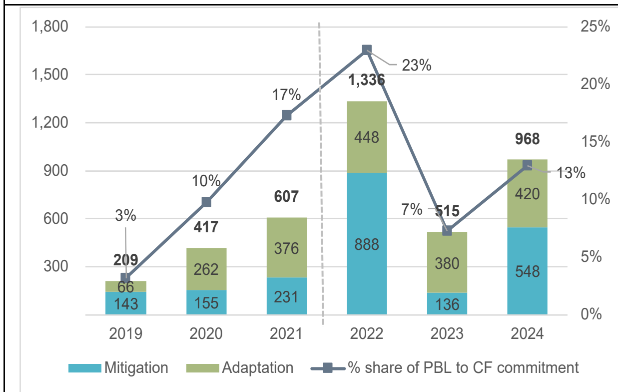


Figure 10: Policy-Based Lending Contribution to Health and Social Protection Financing
($ million)

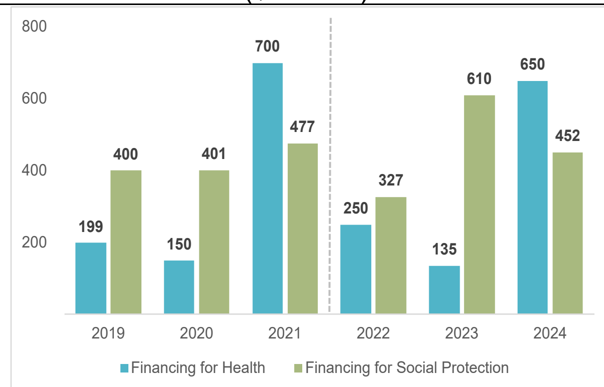
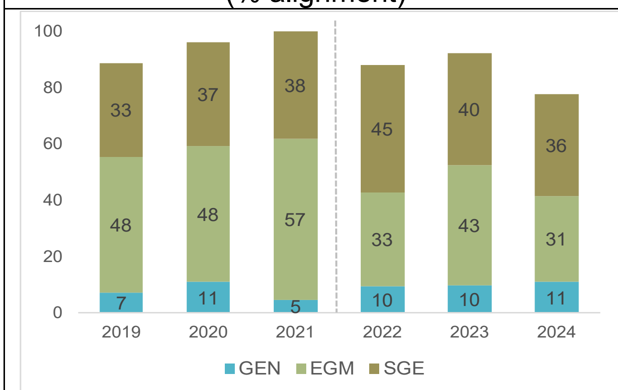
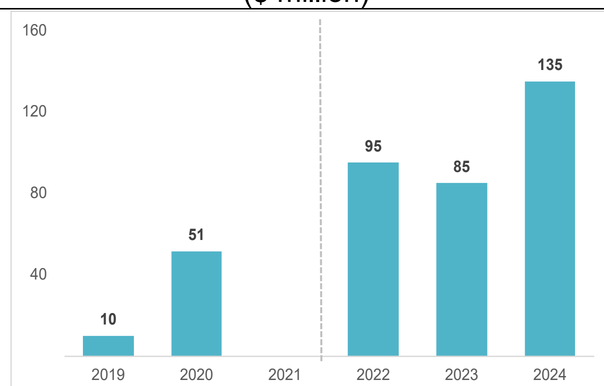


Figure 11: Alignment of Policy-Based Lending with Gender Equity
(% alignment)



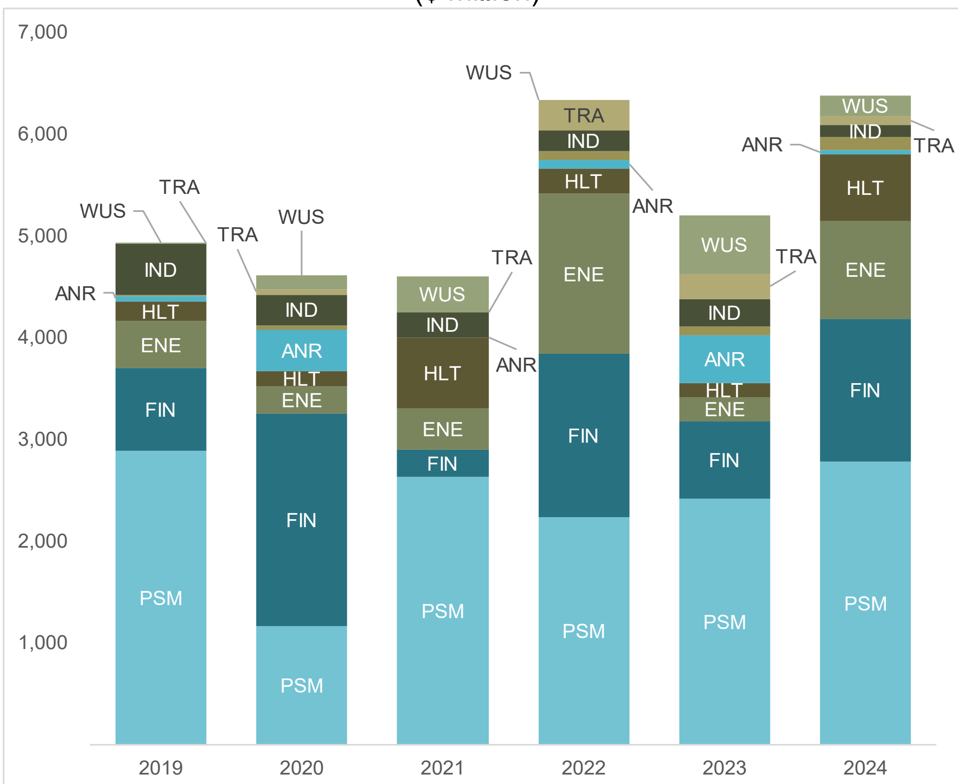
EGM = effective gender mainstreaming, GEN = gender equity, SGE = some gender elements.

Figure 12: Policy-Based Lending Contribution to Education Financing
($ million)



Note: Figures for 2019 to 2021 are actual commitments, while 2022 to 2024 are projections as of January 2022 and subject to change. Projections for PBL contribution towards climate finance, gender and social protection must meet tagging methodology criteria before being added to projected commitments. The contribution of PBL towards these thematic priorities in 2023 and 2024 are expected to increase closer to program approval as additional details are obtained regarding program impacts.
Source: Asian Development Bank.

Figure 13: Policy-Based Lending by Sector, 2019–2024
($ million)



ANR = Agriculture, natural resources and rural development, EDU = Education, ENE = Energy, FIN = Finance, HLT = Health, ICT = Information and communication technology, IND = Industry and trade, PSM = Public sector management, TRA = Transport, WUS = Water and other urban infrastructure and services.
Source: Asian Development Bank estimates.

IX. STRENGTHENING POLICY-BASED LENDING DESIGN QUALITY

60. ADB will continue to apply strict quality standards to all PBL operations and implement internal measures to improve program impact (Box 2). These will include (i) expanding staff training and knowledge sharing for program team leaders, (ii) utilizing ADB's updated policy design and monitoring framework to strengthen the analytical foundations and results-chain links of all PBL operations, (iii) strengthening ADB's value addition to government-led reform agendas through targeted technical assistance and staff-led policy advice leveraging ADB's workforce rebalancing initiative,[33] and (iv) continuing to rely on and enhance regional departments internal quality assurance mechanisms as the primary basis for ensuring PBLs are well designed and achieve their intended development impact.

61. All PBL operations will apply the budget support principles agreed at the Group of Twenty (G20) Italy Conference held in July 2021, which highlight the important role that MDBs must play in helping developing countries meet their financing requirements during periods of heightened macroeconomic vulnerability such as the COVID-19 pandemic. The G20 conference also reaffirmed the importance of strong MDB coordination when using budget support instruments to support country-led reform programs. ADB will continue to secure an assessment letter from the IMF analyzing the government's macroeconomic management and other policies before the

[33] ADB. 2021. *Workforce Rebalancing Framework*. Manila.

Board considers proposed PBL assistance. ADB will also work closely with IMF counterparts to determine the appropriateness of any crisis PBL and related regular PBL in the absence of an IMF program.[34] Similar engagement with other MDBs will also be adopted, as needed.

Box 2: Independent Evaluation of ADB's Policy-based Lending Impact and Performance (2018)

In 2018, the Independent Evaluation Department published an evaluation of Asian Development Bank’s (ADB) Policy-Based Lending (PBL) reviewing the performance of operations between 2008 and 2017. The development performance of PBL, measured by project success rates, doubled over 2008–2017, from 43% to 80%. This was due to five main factors. First, improved performance reflected greater use of programmatic approach (series of single tranche loans [subprograms]), which allows for greater ADB value-addition. Second, the reform focus of PBL shifted to public sector management, which accounted for a high proportion of PBL approvals. Third, conventional PBL was used to respond to crises. The balance between financial support and policy reform changes during crisis periods and, as a result, PBL tends to be used as a countercyclical facility. The success rate of these PBL operations was 93%, against 74% for non-crisis PBL. Fourth, the number of policy actions in PBL designs fell over the period. This indicates that PBL design is improving. ADB guidelines recommend restricting the actions to those critical to the removal of policy constraints on growth and poverty reduction. Fifth, the composition of PBL undertaken in countries with poorly performing programs in the total portfolio fell over the period.

The evaluation also highlighted several challenges with the PBL instrument including:

- Decision-making regarding the provision of a PBL that diverges from the International Monetary Fund (IMF) macroeconomic assessment may entail risks that require an independent assessment to be made independent of the regional department.
- PBL operations evaluated contained many process-oriented policy actions, the outcomes of which are not always clear. The practice of separating the policy matrix from the design and monitoring framework (DMF) makes the results less clear.
- The critical role of policy actions to the achievement of development outcomes was not sufficiently assessed at program completion. PBL requires independent additional scrutiny beyond the regional department.

To address these challenges, ADB has implemented a series of actions to strengthen the quality of its PBL operations including:

- Bolstering quality review mechanisms by expanding of training and knowledge sharing as well as establishment of PBL quality review focal points in Strategy, Policy and Partnerships Department.
- Enhancing and clarifying requirements for PBL operations through an updated Operations Manual providing, among others, a detailed guidance on close engagement with the IMF during program design.
- Making greater use of PBL in sectors where investment loans are also undertaken and ADB has experience with emphasis on energy and finance, and emerging pipelines in urban services and health.
- Formalizing the use of Contingent Disaster Financing (CDF) as an option under the PBL policy to strengthen resilience to disasters triggered by natural disasters.
- Strengthening the rationale and results chain linkages of all PBL operations through the adoption of policy design and monitoring framework.
- Strengthening medium-term planning of PBL operations by identifying priority areas of support in Country Partnership Strategies.

Source: IED. 2018. *Corporate Evaluation: Policy-Based Lending 2008–2017: Performance, Results, and Issues of Design*. Manila: ADB.

[34] ADB should involve IMF staff through regular and active policy dialogue during the preparation of CSF operations. Similar engagement with other international financial institutions should also be adopted, as needed.

62. Recognizing that the increased demand for PBL has put new pressures on ADB staff, including expansion into new thematic areas and sectors where PBL experience is more limited, ADB will also introduce an enhanced quality review mechanism for PBL proposals that are particularly challenging, novel, or of high-risk nature. A Policy-Based Lending Quality Review Committee (PBL-QRC) will be mobilized to provide enhanced review and technical support for qualifying proposals. The PBL-QRC will be chaired by Chief of Governance Thematic Group, Sustainable Development and Climate Change Department, and will comprise permanent members from SPD as well as experienced PBL mission leaders nominated by regional departments.

63. Criteria which will be used to screen proposals for the enhanced quality review mechanism include: (i) program size; (ii) strength of program rationale and PDMF; (iii) track record of ADB's PBL experience in the country or sector/subsector; (iv) degree of innovation or novelty including use of PBL types such as precautionary financing option or policy-based guarantee; and (v) other donors' involvement, particularly the IMF. SPD will function as secretariat to the PBL-QRC, including on coordination with processing teams to ensure fundamental issues are clearly understood and fully addressed. This approach will be piloted for an initial period of one year and will be reviewed following this period.

X. RECOMMENDATION

64. The President recommends that the Board approve the proposals as described in paras. 48 (i-iii), 51, and 52 of this paper.

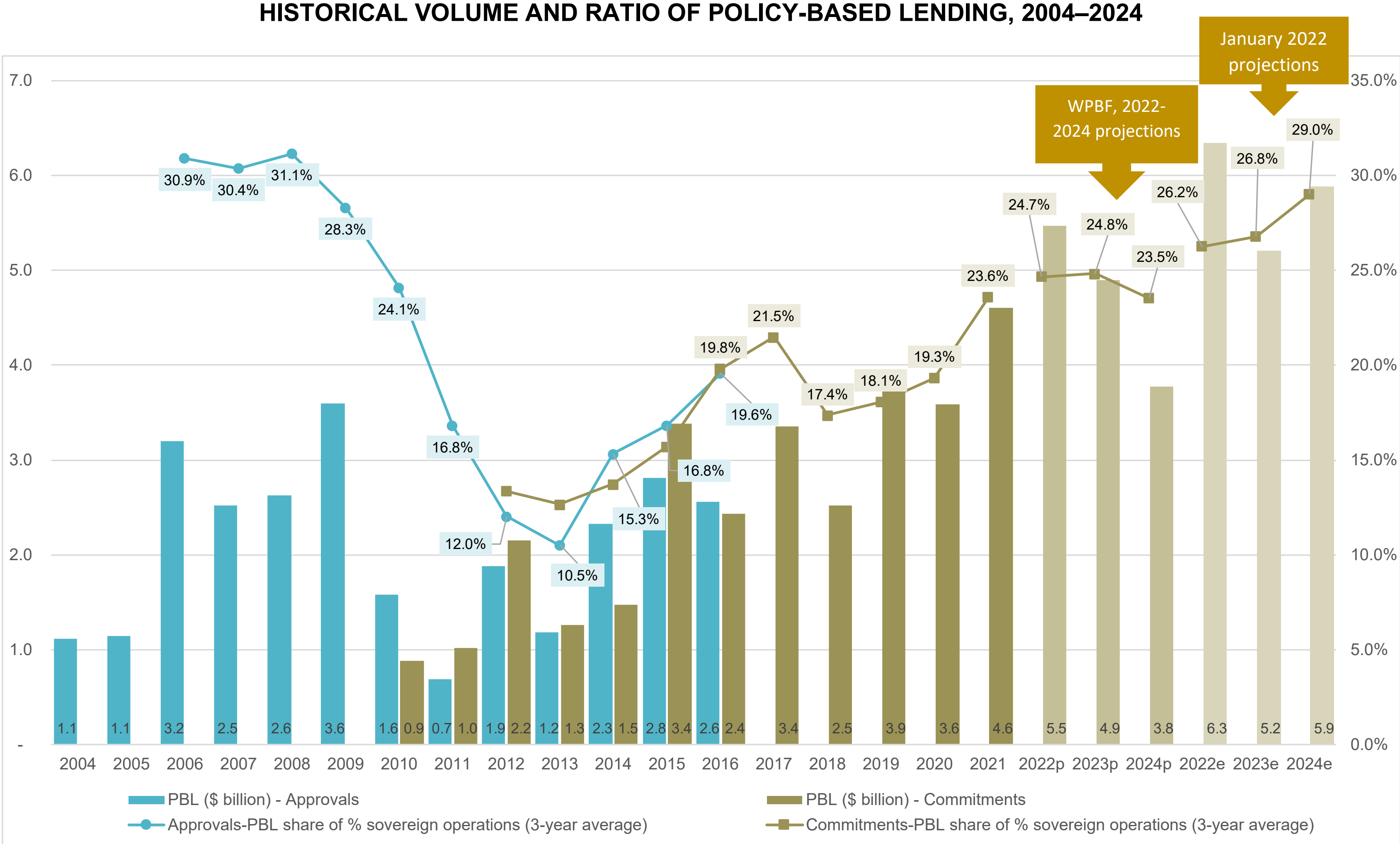
EVOLUTION OF ADB'S POLICY-BASED LENDING CEILINGS

1978:	Program lending (now policy-based lending [PBL]) introduced, primarily for balance of payments (BOP) support. Asian Development Bank (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 recognized its broader developmental role and a shift to sector policy reforms and institutional strengthening. BOP-related requirement abolished. Country ceiling abolished. ADB-wide ceiling increased to 15%.
1992:	Subceiling on Asian Development Fund (ADF) lending of 22.5% added in view of high incidence of program lending from ADF sources.
1996:	Sector development program introduced for targeted sector support.
1999:	Two new types of PBL, the program cluster approach (PCA) and the special program loan (SPL), introduced. ADB-wide ceiling increased to 20.0%; ADF ceiling remains 22.5% of total ADF lending.
2009:	A time-bound countercyclical budget support modality, the Countercyclical Support Facility (CSF), established for 2009–2010.
2011:	Programmatic budget support mainstreamed by: (i) renaming program lending as policy-based lending (PBL) and PCA as programmatic approach, (ii) removing the restriction on retroactive financing under PBL, and (iii) shifting the determination of overall loan size from adjustment costs to development financing needs. Crisis response capacity enhanced by: (i) mainstreaming the CSF and (ii) changing the pricing and terms of SPLs and renaming it as special policy-based loan (SPBL).
2016:	CSF's access criteria refined while financing and operational features of the mainstreamed 2011 CSF remain largely unchanged except that the consultation process with the Board was strengthened.
2018:	Policy-based guarantee (PBG) added as a credit enhancement product anchored on a set of policy conditions to support countries' access to commercial financing markets, with operations included in 20% ADB-wide PBL ceiling.
2019:	Contingent disaster financing (CDF) added to enhance resilience to natural disasters. CDF operations funded by regular ordinary capital resources excluded from 20% ceiling. CDF operations funded by concessional assistance remain within the 22.5% ceiling.
2020:	COVID-19 Pandemic Response Option (CPRO) introduced for a 15-month period and retired in July 2021. Policy design and monitoring framework (PDMF) adopted to enhance results-chain linkages for regular PBL.

Note: In 2017, the Board approved the application of PBL ceilings on a "commitment" basis. ADB. 2017. *Operational Adjustments and Change in Application of Existing ADB Policies Following the Introduction of Commitments as Performance Measurement*. Manila (confidential).

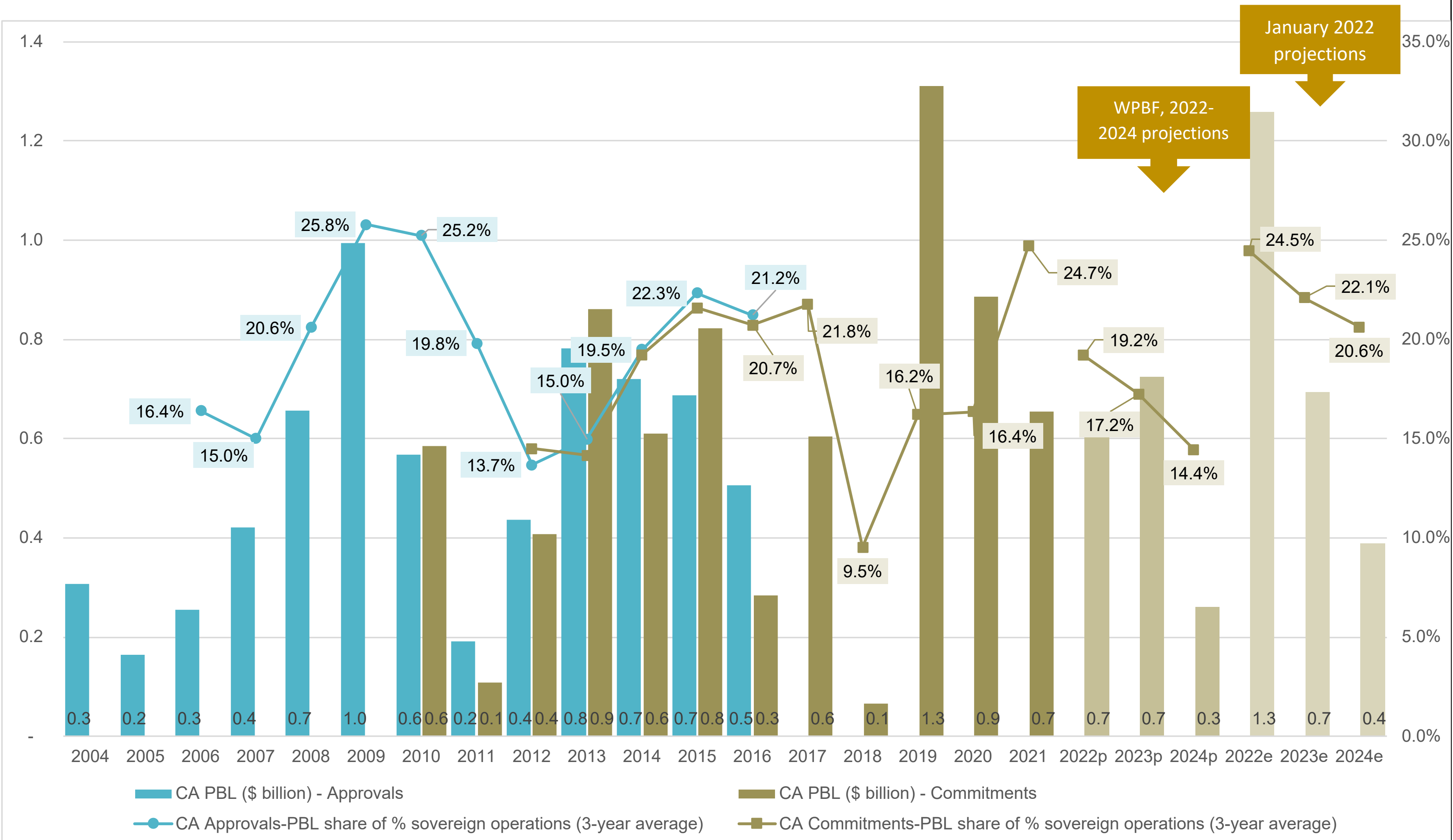
Source: Asian Development Bank.

HISTORICAL VOLUME AND RATIO OF POLICY-BASED LENDING, 2004–2024



PBL = policy-based lending.
Note: e = latest estimates as of January 2022, p = WPBF, 2022–2024 projections.
Source: Asian Development Bank calculations.

HISTORICAL VOLUME AND RATIO OF POLICY-BASED LENDING FINANCED BY CONCESSIONAL ASSISTANCE, 2004–2024



CA = concessional assistance, PBL = policy-based lending.
Note: e = latest estimates as of January 2022, p = WPBF, 2022–2024 projections.
Source: Asian Development Bank calculations.