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**Overview of ADF IX at Midterm:
Development Effectiveness
through Change**

Asian Development Bank

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ABBREVIATIONS

ADB	–	Asian Development Bank
ADF	–	Asian Development Fund
CSP	–	country strategy and program
GACAP II	–	second governance and anticorruption action plan
IDA	–	International Development Association
Lao PDR	–	Lao People's Democratic Republic
MDB	–	multilateral development bank
MDG	–	Millennium Development Goal
MfDR	–	managing for development results
MTS II	–	second medium-term strategy
OCR	–	ordinary capital resources
OECD	–	Organisation for Economic Co-operation and Development
OED	–	Operations Evaluations Department
PBA	–	performance-based allocation
PCP	–	public communications policy
PRC	–	People's Republic of China
PRS	–	poverty reduction strategy
SDR	–	special drawing rights
TA	–	technical assistance
UNDP	–	United Nations Development Programme
UNESCAP	–	United Nations Economic and Social Commission for Asia and the Pacific
VP	–	vice president

NOTE

In this report, "\$" refers to US dollars.

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EXECUTIVE SUMMARY

The rapid economic growth in Asia and the Pacific has led to impressive progress in eliminating income poverty, yet the majority of the world's poor reside in the region. In Asian Development Fund (ADF) recipient countries alone nearly 110 million people live on less than \$1 a day, and over 420 million live on less than \$2 a day. Furthermore, the region has made much less progress on the non-income aspects of poverty. At least 19 of the 27 ADF recipients could fail to achieve even one fourth of the non-income Millennium Development Goals (MDGs).

The Asian Development Bank (ADB) continues to sharpen its strategic focus to respond to the evolving development challenges in the region. ADB made poverty reduction its central goal with the adoption of the poverty reduction strategy. The recent review led to a number of important changes in the strategy, and it specified a number of internal changes needed to boost ADB's organizational capabilities. Based on the revised strategy, ADB committed itself to 16 specific reforms during ADF IX negotiations, which form the core of the reform agenda. The commitments can be broadly classified as (i) mainstreaming managing for development results (MfDR); (ii) improving operational policies, strategies, and approaches; (iii) enhancing accountability and transparency; and (vi) strengthening internal governance and management systems.

MfDR is the underlying theme of the reform agenda guiding ADB toward greater development effectiveness. The vice presidents are leading the implementation of the action plan to mainstream MfDR within ADB. With the experience gained so far, ADB has developed results methodologies in a number of areas including country strategies, individual projects, internal policies, and staff workplans. Notably, all new country strategies and programs must be results-based, and 11 have been endorsed by the Board so far. The institutional results monitoring framework is harmonized with that of the International Development Association (IDA).

One of the main policies debated during ADF IX negotiations was the policy governing the allocation of ADF across countries. The resulting revised performance-based allocation policy strengthened the linkage between changes in country performance—especially in governance—and ADF lending, and it led to a country performance assessment system harmonized with IDA. The review of the governance and anticorruption policies resulted in ADB's adoption of an action plan focusing on public financial management, procurement, and anticorruption in the sectors where ADB is active in a country. In addition, ADB overhauled the strategic framework for its support to private sector development.

To be more responsive to the concerns of project-affected people, ADB adopted a new accountability mechanism. The new mechanism applies a dual-phased approach, with a consultation phase and a compliance review phase. To enhance its independence, the Operations Evaluation Department now reports directly to the Board. Steps have also been taken to better integrate evaluation findings into ADB's operations. After extensive external consultations, ADB adopted a new public communications policy. The policy has resulted in greater disclosure of project-related documents and a more systematic approach to external relations.

The main initiative to improve ADB's internal governance is the strengthening of the senior management team. ADB added a fourth vice president to oversee knowledge management and sustainable development, and it established the position of Managing Director General to coordinate among the management team. The President delegated greater

responsibility to the vice presidents for the effective functioning of the areas they supervise. The new human resources strategy aims to better align staff skills with ADB's strategic priorities. Performance and development plans were introduced to more clearly link rewards with staff performance. The independent review of the 2002 reorganization led to further adjustments in ADB's organizational structure. Finally, incentives are in place to encourage early identification of ADF loan savings to redirect them to higher priority activities, and steps have been taken to control year-end bunching of project approvals.

ADF IX resources will be fully utilized within the replenishment period. Compared with the sector distribution under ADF VIII, lending in ADF IX will generally support the priority I sectors in the second medium-term strategy (2006–2008)—such as road transport, water supply and sanitation, energy, and education. Although the health sector is priority II in the second medium-term strategy, the earmarked grants for HIV/AIDS and communicable diseases are driving an increase in support to this sector. The addition of ADF grants has helped support ADF countries with limited debt repayment capacity, and it is proposed to further harmonize the ADF grant framework with that of IDA 14. Evaluation results indicate an upward trend in the quality of ADF projects, though it is still too early to assess what impact MfDR has had in this regard. Donor responsiveness has made resource mobilization in ADF IX smooth so far.

The evolving development challenges in the region point to a continued need for concessional resources. In particular, the excess demand for ADF from several countries, the addition of new member countries, and the broader use of grants suggest robust demand for ADF resources through the next replenishment period. ADB has made considerable progress implementing the reform agenda, but much hard work remains. ADB reiterates its commitment to complete the agreed reforms during ADF IX and to continue implementation of the revised policies.

I. INTRODUCTION

1. Asia and the Pacific is the world's most dynamic region, consistently leading in terms of economic growth, yet the region is also home to the majority of the world's poor. Poverty has been persistent, but Asia is making progress. As the multilateral development institution dedicated to the region, the Asian Development Bank (ADB) is committed to working toward the elimination of this deprivation in all its forms. The Asian Development Fund (ADF) is helping to realize the vision of an Asia and Pacific region free from poverty. It provides concessional financing for development investments in the region's poorest countries. The recent addition of ADF grants has enhanced ADB's ability to meet the needs of countries heavily burdened by debt.

2. At the conclusion of the latest round of replenishment negotiations—ADF IX—donors endorsed a \$7.0 billion program for 2005–2008, including \$3.2 billion in new contributions. Discussions during the negotiations centered on ways to enhance ADB's effectiveness. In tandem with the review of ADB's poverty reduction strategy (PRS), ADB and ADF donors agreed on a number of priority reform measures for ADF IX. The resulting reform agenda presented in *ADF IX Donors' Report: Development Effectiveness for Poverty Reduction* (the Donors' Report)¹ aims to mainstream managing for development results (MfDR), improve operational policies, enhance accountability, and strengthen internal governance.

3. This overview report complements the detailed analysis of the standalone discussion papers prepared for the ADF IX midterm review. It first describes the state of poverty reduction efforts in the region (the external context) and the evolution of the corporate strategy and organizational development within ADB (the internal context). The overview then appraises ADB's progress on the reform agenda, accounts for the use of ADF resources, and highlights issues in ADF financial management.

II. DEVELOPMENT CONTEXT

A. Progress in Poverty Reduction in the Region and Continuing Challenges

4. Asia and the Pacific have made impressive progress in eliminating income poverty. The incidence of poverty using the \$1-per-day standard declined from 35% in 1990 to 19% in 2003. This means approximately 300 million people lifted themselves out of poverty in that period.² The reduction in the absolute number of people living below the poverty line has been more modest in ADF countries (66 million),³ but the drop in the poverty rate has been significant. Between 1990 and 2003, the poverty incidence for ADF recipients was cut from 32% to 16%. The reductions were largely attributable to robust economic growth. Over the past 5 years, growth in gross domestic product averaged 6.7% for the region as a whole—which is significantly higher than any other region of the world—and 5.3% for ADF recipients.⁴

¹ ADB. 2004. *ADF IX Donors' Report: Development Effectiveness for Poverty Reduction*. Manila.

² Poverty data are generally not available on an annual basis, and the timing of data collection varies considerably across countries. When 1990 and 2003 data were not available, the report used data available closest to those years.

³ This is primarily due to the fact that a large proportion of the region's poor (approximately 80%) live in India and the People's Republic of China, which are not ADF recipients.

⁴ The figures are the weighted-average growth rates for ADF countries using data from various years of the *Asian Development Outlook* (ADB. Manila).

5. Despite this progress, poverty still affects the lives of millions across the region. Nearly 110 million people live on less than \$1 a day in ADF countries, and over 420 million live on less than \$2 a day. The absolute number of poor is exacerbated by large-scale underemployment in many countries, with wages in rural areas and the urban informal sector insufficient to move beyond poverty. Unless growth and productivity gains are accelerated to absorb the rapidly growing workforce, these problems could worsen. Countries face significant challenges to ensure that growth is more inclusive and sustainable.

6. The region as a whole is on track to meet the Millennium Development Goals (MDGs) for income poverty,⁵ but the benefits of growth have not been spread evenly so sizable pockets of income poverty remain. Furthermore, the region has made much less progress on the non-income dimensions of poverty. As many as 27 of ADB's developing members could fail to achieve one fourth or more of the non-income MDGs, including 19 of the 27 ADF recipients (Figure 1).⁶ Areas of particular concern include health, access to water and sanitation, and the environment.

7. Recognizing the large number of people who remain below the poverty line and the region's moderate achievements in non-income poverty is an important reality check. Experience has shown that reducing income poverty is unlikely by itself to lead to adequate improvements in living standards. A more balanced approach is needed. In addition, sustaining economic growth to ensure further poverty reduction may prove difficult. The region's growth has been robust in recent years, but economic performance is expected to level off over the medium term. ADB forecasts the region's gross domestic product will grow by 7.7% in 2006, easing to 7.1% in 2007, supported by strong performances by the People's Republic of China (PRC) and India. If PRC and India are excluded, the rest of Asia is expected to grow more modestly, averaging 5.5% in 2006 and 5.1% in 2007. However, risks from economic and political uncertainties could undermine the realization of these forecasts. Should growth falter, governments will need to take additional steps to minimize adverse impacts, particularly on the poor.

8. Despite the recent success some countries have had attracting investment, the regions' overall investment rate of around 25% may not be sufficient to sustain the high rates of economic growth. It is estimated that East Asia alone requires investments of \$200 billion per year for infrastructure development and maintenance.⁷ Much of the region's population has no access to essential infrastructure: 36% of households have no electricity connection, 23% of the rural population have no access to all-season roads (31% in ADF countries), and 73% of the population have no telephone connection (90% in ADF countries).⁸ Access to water supply and sanitation is another infrastructure area where much needs to be done. Sustaining growth to reduce poverty depends on improving the region's investment climate. In most countries, business start-ups are time consuming and costly. Governance remains weak. Corruption, inefficiency, and poor capacity in public systems not only impede investment, they also add

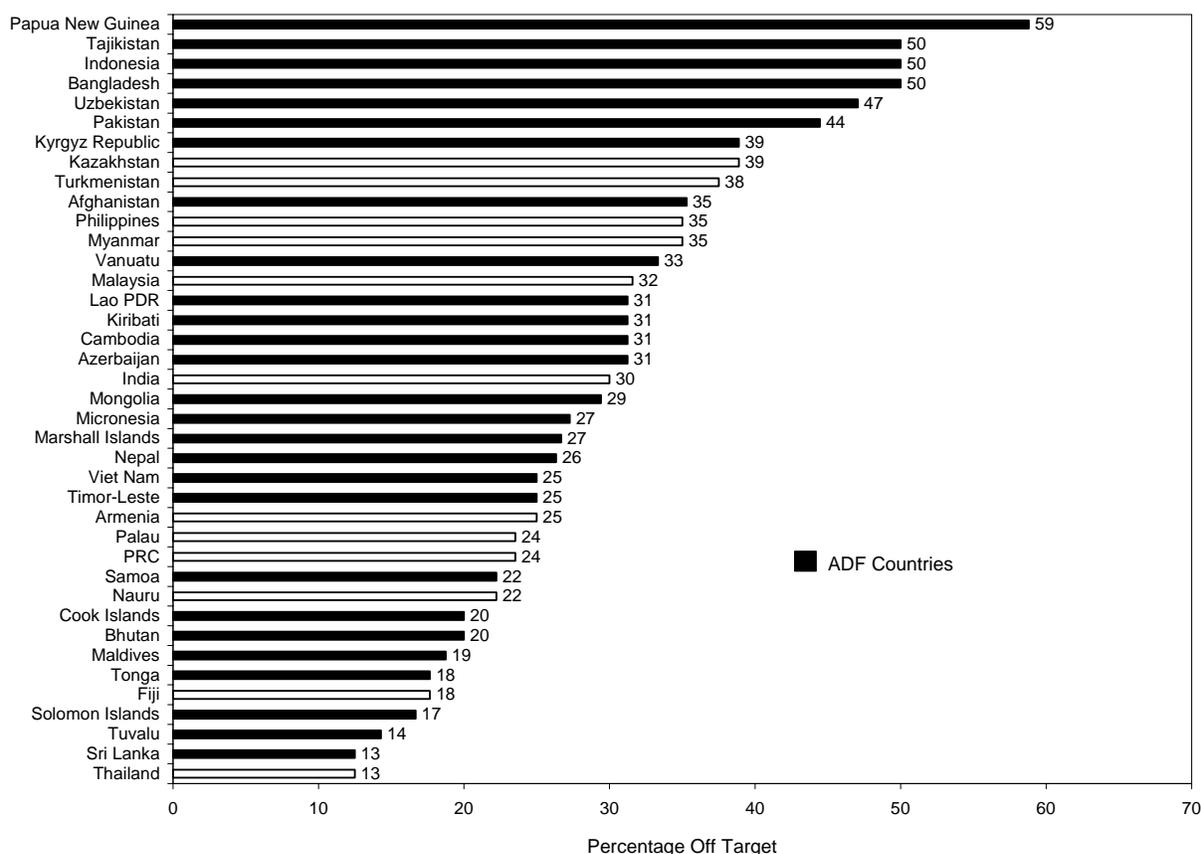
⁵ The income poverty target for the MDGs is to halve the proportion of people whose income is less than \$1 a day between 1990 and 2015.

⁶ UNESCAP, UNDP, and ADB. 2006. *The Millennium Development Goals: Progress in Asia and the Pacific 2006*. Data availability is a problem in many countries. While data was available for all countries for some indicators, others had coverage as low as 40% of countries reporting. Percentages calculated based on the indicators with available data in each country.

⁷ ADB, Japan Bank for International Cooperation, and World Bank. 2005. *Connecting East Asia: A New Framework for Infrastructure*. Washington, DC.

⁸ Data weaknesses on electricity connections make limiting the analysis to ADF countries difficult, though available data does suggest even less access to essential infrastructure in these countries.

Figure 1: Non-income Millennium Development Goals Off Target by Country



Source: UNESCAP, UNDP, and ADB.

large transaction costs to private economic activities, reduce the quality of life, contribute to income inequality, and weaken public social and economic programs.

B. ADB and Poverty Reduction

1. Strategic Framework for Poverty Reduction

9. ADB continues to sharpen its strategic agenda to respond to the evolving development challenges in the region. In 1999, ADB made poverty reduction its overarching goal with the adoption of the PRS.⁹ The strategy identified three pillars for development—pro-poor, sustainable economic growth; inclusive social development; and good governance—and four cross-cutting priorities—environmental sustainability, gender equality, good governance, and private sector development. The PRS was put into practice in the long-term strategic framework (2001–2015)¹⁰ that provided the broad principles and a series of medium-term strategies

⁹ ADB 1999. *Fighting Poverty in Asia and the Pacific: The Poverty Reduction Strategy of the Asian Development Bank*. Manila.

¹⁰ ADB. 2001. *Moving the Poverty Reduction Agenda Forward in Asia and the Pacific: The Long-Term Strategic Framework Of The Asian Development Bank (2001–2015)*. Manila

Box 1: Key Features of ADB's Second Medium-Term Strategy (2006–2008)

In May 2006, ADB adopted its second medium-term strategy (MTS II) under the long-term strategic framework for 2001–2015. To respond to the rapidly changing needs of its developing members and remain relevant in the region, MTS II urges ADB to prioritize the following areas for the 2006–2008 period:

- Catalyzing investment,
- Strengthening inclusiveness and the impact of growth on poverty reduction,
- Promoting regional cooperation and integration,
- Managing the environment, and
- Improving governance and preventing corruption.

MTS II also introduces adjustments to ADB's business model, including a more selective sector focus. Core sectors identified include road transport, energy, urban and rural infrastructure, education, and the financial sector.

The main elements of MTS II are relevant for countries with legitimate and orderly governance, generally peaceful conditions, and governments committed to improving public policy and delivery of public goods and services. A distinct strategic approach for weakly-performing countries is now being developed in a companion paper

Source: ADB. 2006. *Medium-Term Strategy II 2006–2008*. Manila.

guiding operations. The second medium-term strategy (MTS II), endorsed by ADB's Board of Directors (the Board) in March 2006, covers the remainder of the ADF IX period (Box 1).

10. ADB completed a comprehensive review of the PRS in 2004, revising its operational framework based on the results.¹¹ The revised PRS reaffirms the three strategic pillars, includes capacity development as a fifth thematic priority, and considers that greater country focus is a key to improve ADB's operational effectiveness. It requires higher-quality country strategies and programs (CSPs)¹² based on sharper results-orientation and improved country assessments. For this purpose, the revised PRS commits ADB to strengthening quality assurance mechanisms for CSPs and the analytical work supporting them. The strategy promotes greater harmonization and partnership with other development partners based on national poverty reduction strategies. The shift to a country-centered approach had an important implication for ADB operations. The PRS originally included a numerical target for so-called poverty interventions, but when programs are linked to national poverty reduction efforts, such targeting was considered unnecessary and was dropped. The renewed strategy also commits ADB to help countries achieve the non-income MDGs, and it specifies internal changes needed to boost the organization's capabilities. These actions, emphasized during ADF IX negotiations, form the core of the reform agenda.

11. In line with the MfDR initiative, ADB manages PRS implementation through a comprehensive results-based monitoring and evaluation system, which is harmonized with that

¹¹ ADB. 2004. *Review of the Asian Development Bank's Poverty Reduction Strategy*. Manila.

¹² The recent revision to the business processes on country strategies and programs included a change in the title of the document to "country partnership strategies." However, this report will maintain the old nomenclature to avoid confusion when referring back to the Donors' Report.

of the International Development Association (IDA).¹³ ADB's performance at the institutional level is assessed and reported annually based on the PRS's results framework.¹⁴ The framework is built around the results chain consisting of progress on the MDGs; improvements in the effectiveness of ADB operations; and improvements in operational quality, finance, knowledge, and partnerships. Country-level impact evaluations follow the country-specific results frameworks agreed in the CSP. Projects are evaluated using their design and monitoring frameworks in terms of their contributions to outcomes specified in the CSP.

12. Countries in the region span a broad range of economic development, and ADB is tailoring its approaches to respond better to their diverse needs. ADB's clients include middle-income countries that have some access to international capital markets, though not with sufficiently long maturities to fund public infrastructure investments. The recent review of ADB's operational approaches toward middle-income countries and borrowers from ordinary capital resources (OCR)¹⁵ will help ADB to be more responsive to their unique circumstances. In contrast, the region's weakly-performing countries need support to establish the basic governance foundations for the country and minimize their vulnerability to shocks, as a prerequisite for greater development assistance.

13. For ADF, the weakly-performing states are more relevant. ADB is fine-tuning an approach to them, basing it on the country performance assessments undertaken as part of the performance-based allocation (PBA) of ADF resources and taking conflict and post-conflict vulnerability into account.¹⁶ The assessments will help identify the underlying causes of weak performance, entry points for improvement, and areas that merit continued ADB support. Though based on the country performance assessments, a threshold will not be applied mechanically to categorize countries as weakly performing. ADB will be flexible, applying the approach to countries exhibiting evidence of weakness and vulnerability even as their performance improves.

14. The effective engagement of weakly-performing countries requires country ownership of the assistance program at all stages. Capacity development will be critical to strengthen the country's ability to absorb and manage external assistance. ADB will respond to this need by scaling up technical assistance (TA) and grant cofinancing for institutional development. In addition, ADB will seek opportunities for knowledge transfer from developing countries that have experienced the transition from weaker to higher-quality performance. Provision of ADB project financing (ADF loans or grants) will depend on the country context, with due regard to ADB's prudential and safeguard requirements. Given the unique challenges of weakly-performing countries, ADB will examine adjustments in its business processes, staff skills mix, and incentives to address their needs.

¹³ For more details, see the standalone report "Annual Poverty Reduction Reports: An Innovation in Institutional Level Monitoring of ADB's Efforts to Reduce Poverty."

¹⁴ During April–June 2006, ADB conducted the first independent survey of opinion leaders to gauge their perceptions of the its performance. The survey results form an important component of PRS monitoring and set the baselines for future surveys. Respondents considered ADB generally helpful and effective, but they clearly indicated a number of areas needing improvement. The survey report will be circulated to the Board in November 2006 and subsequently made public. (ADB. 2006. *ADB's Perception Survey: Multinational Survey of Opinion Leaders 2006*. Manila.)

¹⁵ ADB. 2006. *Enhancing Asian Development Bank Support to Middle-Income Countries and Borrowers from Ordinary Capital Resources*. Manila.

¹⁶ For more details, see the standalone report "Achieving Development Effectiveness in Weakly Performing Countries."

Box 2: Coordination and Harmonization in Bangladesh

In Bangladesh, the government and 11 development partners (led by ADB) are taking a sector-wide approach to the enhancement of primary education in the country. Rather than working independently, nearly \$640 million in financial support from the development partners are being pooled with the government's \$1.16 billion to provide the needed assistance more efficiently. The program for developing the primary education sector covers priority investments and a comprehensive reform framework. Taking a sector-wide approach has led to significant advances in harmonization efforts in the country including:

- Planning and budgeting—a single annual operation plan sets priorities and allocates resources
- Procurement—over 80% of expenditures use government procurement procedures
- Financial management
- Auditing—all procurement and financial management covered under common statutory audits and external audits
- Monitoring and evaluation—program uses a set of common indicators and baselines
- Reporting
- Reviewing

Harmonization is also seen in the formulation of the CSP for Bangladesh. ADB developed the results-based CSP jointly with the United Kingdom's Department for International Development, the government of Japan, and the World Bank. The four development partners prepared a common results framework, which they will jointly monitor. Further sector-wide approaches to projects are envisaged in the country strategy to deepen coordination. An example is the railway sector, which will be supported by multiple agencies and a recently approved multi-tranche financing facility from ADB.

Source: ADB staff.

15. During ADF IX negotiations, donors stressed the importance of harmonization and coordination to reduce transaction costs and increase development effectiveness. The revised PRS reflects this principle recognizing that partnerships are essential to make aid a more effective tool for poverty reduction. ADB has joined forces with the other multilateral development banks (MDBs), multilateral financial institutions, and bilateral partners to advance aid harmonization, as articulated in the Paris Declaration agreed in March 2005. In October 2006, ADB hosted the Asian Regional Forum on Aid Effectiveness, which provided a forum for developing countries and donors to share their experiences implementing the Paris Declaration. Partnerships are integrated into ADB operations in many ways at the country level. Joint activities include country strategy and program formulation, analytical work, project financing, portfolio reviews, and policy dialogue (Box 2).¹⁷

2. Commitment to Reform

16. On the adoption of the PRS in 1999, ADB began a process of internal reform to align itself more closely with its mission of poverty reduction. In 2002, ADB reorganized its structure and business processes, and it delegated greater authority and resources to the resident missions. During the ADF VIII midterm review and ADF IX negotiations, donors expressed

¹⁷ For more details, see the standalone report "Report on ADB Cooperation with Development Partners."

concerns about ADB operations that affect the management of ADF resources. In response, ADB made a number of commitments to high-priority reforms that became integral parts of the reform agenda launched in June 2004.

17. The reform agenda aims to significantly improve ADB's organizational capabilities to reduce poverty. MfDR is the underlying theme guiding ADB toward greater development effectiveness. Implementing the reform agenda will improve operational policies and strategies, introduce more competitive financing instruments, refine organizational processes and structures, reinforce knowledge sharing, and improve human resource management. The reforms agreed during ADF IX negotiations form a part of a more comprehensive set of reforms ADB is currently implementing to ensure its continued relevance.¹⁸

III. PROGRESS ON ADB'S REFORMS FOR DEVELOPMENT EFFECTIVENESS

18. ADB committed itself to fulfilling 16 specific reforms during the ADF IX period.¹⁹ The reforms build on the groundwork of the revised PRS. The commitments can be broadly classified as (i) mainstreaming MfDR; (ii) improving operational policies, strategies, and approaches; (iii) enhancing accountability and transparency; and (vi) strengthening internal governance and management systems. While implementation of the reforms has been slower than anticipated at the time of negotiations, ADB has advanced considerably. The following is an account of ADB's progress during the first 2 years of ADF IX, which is summarized in the Appendix.

A. Mainstreaming Managing for Development Results

1. Results Agenda as Key Priority

19. An action plan to incorporate MfDR into ADB operations was introduced during ADF IX negotiations. Building MfDR understanding and acceptance was critical in the initial implementation period since many staff viewed the agenda with skepticism perceiving it as donor-driven. ADB adopted an incremental approach that facilitated experimentation and learning. The action plan's implementation was reviewed after 18 months resulting in a revised MfDR action plan for 2006–2008 that was approved in August 2006.²⁰ The revised action plan will mainstream MfDR under the direct leadership of the vice presidents (VPs) by systematizing new results-based approaches and emphasizing staff learning at all levels. MfDR has become an institutional priority, and it is increasingly changing the way departments and offices are managed. For example, the South Asia Department has introduced innovative MfDR techniques—including a sectoral outcome tracking method—designed to better manage for results. Other departments are expected to take similar steps.

2. Development of Results Methodologies and Harmonization of Indicators

20. Over the past 2 years, ADB has developed results methodologies to assess and monitor performance at all levels including country strategies and programs, individual projects, corporate workplans, policies and strategies, and staff workplans. Business processes are being

¹⁸ See ADB. 2006. *Annual Progress Report on the Implementation of the Asian Development Bank's Reform Agenda*. Manila.

¹⁹ The reforms are listed in the Donors' Report, Section IV, Table 1.

²⁰ For more details on all aspects of mainstreaming MfDR into ADB operations, see the standalone paper "Managing for Development Results at the Asian Development Bank."

streamlined and made more flexible to focus on results. Some prominent initiatives include the new staff performance and development plans, results-oriented planning for preparing the work program and budget framework, institutional performance reporting through the annual PRS monitoring reports, results-based CSPs, and project design and monitoring frameworks.

21. ADB is becoming a results-based institution; however, experience with the change is mixed, which is true for the other MDBs as well. Results reporting tools at different levels can imply a sense of competing corporate agendas. Results methodologies tend to impose new reporting constraints and are often considered as additional features to meet new quality or business standards. Hence, MfDR is at risk of being regarded as one institutional priority among many rather than as a highly effective management technique. The mainstreaming phase requires a shift in emphasis from results measurement and reporting to results management and learning.

22. In line with harmonization efforts, ADB has adopted an institutional monitoring framework that is more consistent with that of other MDBs. The monitoring framework of the PRS now uses results indicators that are similar to those used by IDA. Harmonization has resulted in extending the monitoring indicators beyond the MDGs to include economic growth and the factors responsible for it. The MDBs have also initiated a common performance assessment system, and published its first annual report in April 2006. The system consolidates data on how the MDBs have implemented managing for development results and how they can improve their performances.

3. Results-Based Country Strategies and Programs

23. The revised PRS mandates that new CSPs must be results based, and the results approach to country programming is reflected in the new CSP business processes.²¹ New results-oriented tools have been mainstreamed in ADB operations through task-oriented training and guidance of staff. CSP results frameworks are now more closely linked to the goals of national strategies, and countries with new results-based strategies have more selective and focused pipelines than under their previous strategies. At the project level, the new results-based design and monitoring framework enhances design quality and participatory project preparation. It is also expected to improve the project monitoring system traditionally focused on performance in terms of delivery of inputs or completion of activities with less attention paid to outputs and outcomes.

24. While the impact of these new results-based approaches cannot be assessed at this early stage, an ADB staff panel has recently reviewed the quality-at-entry of CSPs and projects approved in the last 2 years (Box 3). The review showed ADB has made progress in making CSPs more results based, but it also highlighted a number of weaknesses. Looking beyond the quality-at-entry issues, results frameworks and performance indicators must be used to manage individual operations and country programs for outcomes if these tools are to be effective. According to the Operation Evaluation Department's (OED) assessment,²² project design and monitoring frameworks have improved in recent years, which will tighten the link between the goals of the country strategy and the work done in project interventions. At the same time, the

²¹ The results-based approach also applies to regional cooperation strategies and programs.

²² The standalone paper, "Report on the Independence of the Evaluation Function and Evaluation Results for ADF Operations," noted that the proportion of loan design and monitoring frameworks rated as satisfactory or better increased steadily from 32% in 2000 to 83% in 2005. The proportion of advisory TAs and regional TAs rated satisfactory rose from under 20% for both in 2000 to 64% for advisory TAs and 56% for regional TAs in 2005.

Box 3: Review of the Quality-at-Entry of ADB Projects and Country Strategies

As a commitment under the revised poverty reduction strategy, ADB undertook its first biennial assessment of quality-at-entry of public sector loan projects and CSPs. The review was designed to establish quality-at-entry standards for projects and country strategies, set baselines for future monitoring, and serve as a learning tool for staff. The study covered 6 CSPs and 31 loan projects approved in 2004 and 2005.

Country Strategies. The study notes progress in making CSPs more results-based and finds the CSP preparation process satisfactory. At the same time, the study urges ADB to improve sector and thematic diagnostics to identify more clearly binding constraints to development to guide the strategies and programs. It calls for more consistent use of past lessons to inform the strategy and program choices, and greater clarity about how the consultation undertaken influenced the strategic and program choices made. The discussion of risk and risk mitigation measures are found often too general. Of the 6 CSPs analyzed, 2 were rated as being satisfactory with the balance assessed as marginally satisfactory.

Projects. Overall, the study confirms ADB's strength in designing good projects, finding that most projects were well aligned with diagnostic findings on development constraints. The study commends the close attention given to poverty, social, and environmental aspects. Major weaknesses are noted in the implementation arrangements and schedule, the fiduciary aspects, and risk assessment. The study calls for better problem analysis, more adequate performance indicators, and more specific monitoring and evaluation arrangements. It also urges improvements in institutional and organizational capacity assessments and demonstration of ownership. Out of the 31 projects assessed, 25 were rated as satisfactory or better, and the remaining 6 as marginally satisfactory.

Source: ADB staff panel.

growing attention paid to short- and medium-term development outcomes may call for an expansion of the MfDR agenda to manage current portfolios. A retrofitting exercise—involving a systematic examination of ongoing operations in the light of recent development agendas in a country—could prove useful in a number of cases.

B. Improving Operational Policies, Strategies, and Approaches

1. Revised Performance-Based Allocation System

25. ADB introduced the PBA policy for ADF financing in March 2001 based on the principle that making country allocations based on strong performance maximizes the use of concessional resources for reducing poverty. In this way, the policy also creates incentives for countries to improve performance. Based on discussions during ADF IX negotiations, ADB developed a revised PBA policy that the Board approved in December 2004. The revised policy rationalized and considerably strengthened the PBA system. However, several issues have emerged from the implementation of the policy that will need to be addressed during the remaining period of ADF IX.²³

²³ For more details, see the standalone report "Implementation of the Performance-Based Allocation Policy—A Review."

26. One of the principal objectives of the revised PBA policy is to strengthen institutional arrangements and accountability. As mandated, ADB established a PBA focal point in the Strategy and Policy Department in early 2005. This unit, headed by the Director General, is now responsible for implementing all aspects of the policy, including managing the annual country performance assessments and the formula-based allocation of ADF based on them.

27. In line with the revised policy, ADB is harmonizing the PBA system with the World Bank's IDA and the African Development Bank's African Development Fund (which is also harmonized with IDA). A common country assessment questionnaire was adopted by all three MDBs, and the three MDBs regularly discuss implementation issues and share solutions. ADB and IDA have conducted joint training events for recipient country officials and civil society on specific aspects of the PBA system. ADB prepared annual country performance assessments in 2005 and 2006 using the common country questionnaire.

28. Based on the ADF IX negotiations, ADB has revised the formula to enhance the role of performance—especially governance—in determining allocations and to favor smaller countries. The most important outcome from implementing the revised PBA policy is the closer linkage between country performance and ADF allocations. With more transparent performance assessments and greater disclosure under the revised policy (the country assessment ratings for 2005 were made public in April 2006²⁴), country assessments also generate a database of performance indicators that can enhance policy dialogue with ADF borrowers when formulating the CSP. This information will complement the existing country diagnostics and sharpen the focus of ADB's assistance for policy reforms, governance, capacity development, and individual sector projects. However, this aspect needs to be further consolidated.

29. The application of the new formula resulted in increased allocations to better-performing countries, but shares have shifted from smaller to larger countries and from ADF-only borrowers to those with access to both ADF and OCR (so-called blend countries). The ADF-only countries' share of total ADF allocations, excluding Pacific countries and others receiving set aside amounts, declined from 24.3% in 2002–2004 (under the original PBA policy) to 22.0% during 2005–2006 and will fall further still to 18.1% in 2007–2008. This pattern is observed despite the small country bias built into the new formula. The shift is largely the result of the improved relative performance of blend countries and the removal of the “collar”²⁵ under the revised policy.

30. The transition to the new PBA system has generally been smooth, but experience gained to date points to a number of issues that donors and ADB need to address.²⁶ As noted, the share received by ADF-only countries has declined. Moreover, the new formula has resulted in greater volatility in allocations, particularly from changes in portfolio performance ratings. The need for effective engagement with weakly-performing countries—in light of the small allocations they receive based on their performance—needs to be addressed. Non-utilization of ADF allocations by some countries and its effect on overall ADF utilization needs further

²⁴ ADB. 2006. *2005 Annual Report on ADB's Country Performance Assessment Exercise*. (IN52-06). Manila. The report on the 2006 country performance assessments will be published in first quarter 2007.

²⁵ The “collar” refers to upper and lower bounds on the change in a country's allocation compared with its historical lending averages after the old PBA formula was applied. The intention was to smooth year-to-year adjustments in ADF lending levels to facilitate planning. The “collar” was discontinued under the revised PBA policy.

²⁶ The standalone report includes a number of other issues not reproduced in this report. Management will seek to address the issues within the framework of the current PBA policy, with any suggested policy changes to be discussed with the donors during negotiations for the next ADF replenishment.

Box 4: Second Governance and Anticorruption Action Plan

GACAP II aims to deliver results in the following key areas:

- Improve identification and management of governance, institutional, and corruption risks in country strategies and programs (at the time of formulation and during their midterm reviews) and in annual country portfolio review missions.
- Strengthen governance and anticorruption components in projects and in project designs.
- Strengthen program and project administration and portfolio management.
- Improve organizational structure, human resources, and access to expertise.

Source: ADB. 2006. *Second Governance and Anticorruption Action Plan (GACAP II)*. Manila.

attention. The use of country performance assessments in policy dialogue needs to be reinforced. Finally, joint country performance assessments with the World Bank should be considered, though managed in a way that does not dilute the institutional ownership of the assessments within ADB. While ADB will address these issues within the current PBA policy to the extent possible, the issues arising during implementation may merit a further review of the policy in the future.

2. Governance and Anticorruption Policies

31. ADB completed the review of the implementation of the governance and anticorruption policies in December 2005, which concluded that the policies had only been partially implemented.²⁷ ADB was unable to respond effectively to systemic governance and corruption issues, given the competing demands for its limited resources, because the policies covered such a wide range of topics. Moreover, ADB was unable to make sufficient investments to mitigate governance and corruption risks in the sectors where it is most active. Based on the review's findings and guided by MTS II, ADB prepared an action plan focused on governance and anticorruption needs at the sector level. Adopted in July 2006, the second governance and anticorruption action plan (GACAP II)²⁸ specifies the actions necessary to meet the requirements of ADB's policies (Box 4). The three development themes in the plan are public financial management, procurement, and anticorruption.

32. A key feature of the plan is integrating a risk-based approach to addressing the issues into CSPs and project designs. Collaborating with its development partners, engaging country officials, and drawing on existing studies, ADB will prepare country governance and sector diagnostics for of country strategies. ADB will use the analysis to assess public financial management, procurement, and corruption risks in the sectors and subnational governments where projects and programs are planned. Risk assessments will play a number of roles within a country program. First, they will pinpoint sector risks and help prepare mitigation strategies. Second, they will help to evaluate country systems and to what extent ADB can rely on them. Finally, they can help the governments prioritize actions to strengthen country systems to reduce risks in the future. As part of the analytical basis for the CSP, these assessments will be used to prepare a risk management plan that will be evaluated and updated during the CSP

²⁷ ADB. 2006. *Review of the Implementation of ADB's Governance and Anticorruption Policies: Findings and Recommendations*. Manila.

²⁸ ADB. 2006. *Second Governance and Anticorruption Action Plan*. Manila.

Box 5: Establishing a Common Framework for Combating Corruption

On 17 September 2006, the leaders of the MDBs and multilateral financial institutions issued a joint statement outlining the following actions to combat fraud and corruption:

- Agreement in principle on standardized definitions of fraudulent and corrupt practices for investigating such practices in activities financed by them.
- Agreement on common principles and guidelines for investigations.
- Agreement to strengthen the exchange of information, as appropriate and with due attention to confidentiality, in connection with investigations into fraudulent and corrupt practices.
- Agreement on general integrity due diligence principles relating to private sector lending and investment decisions.
- Agreement to explore further how compliance and enforcement actions taken by one institution can be supported by the others.

The leaders also agreed to continue to work together to assist their member countries in strengthening governance and combating corruption in cooperation with civil society, the private sector, and other stakeholders such as the media and judiciary.

Source: International Financial Institutions Anti-Corruption Task Force. 2006. *Uniform Framework for Preventing and Combating Fraud and Corruption*. Singapore.

midterm review. In addition, country portfolio review missions will routinely examine and report on country systems.

33. GACAP II requires special skills that will take time for ADB to acquire. As such, the implementation of the action plan will be phased with risk assessments undertaken in a limited number of countries to help develop methodology.²⁹ ADB will identify skill gaps in operations departments based on initial implementation and will consider options to respond. TA resources will be used initially to support the preparation of sector analyses, risk assessments, and risk management plans.³⁰

34. Beyond the specific requirements of GACAP II, improving governance and fighting corruption are areas where ADB will work closely with its development partners. This commitment is clearly demonstrated by the common framework for combating corruption recently signed by the heads of MDBs and multilateral financial institutions (Box 5). ADB will continue to support the joint anticorruption initiative with the OECD that commits 25 countries in the region to the Anticorruption Action Plan for Asia and the Pacific. Of the total lending volume planned for the ADF IX period, more than one fourth will finance projects with a governance theme.

²⁹ During the start-up phase, risk assessments and risk management plans will be prepared in two priority sectors in each of five new CSPs. Countries identified for initial implementation include Afghanistan, PRC, Samoa, and Sri Lanka.

³⁰ Approximately \$4 million in TA financing will be set aside for specific activities related to GACAP II in 2007. This amount is in addition to lending and non-lending operations to support governance and anticorruption initiatives already programmed.

3. Private Sector Development Strategy

35. Creating a vibrant private sector has been ADB's institutional priority, particularly since the adoption of the private sector development strategy in 2000.³¹ ADB reviewed its progress in implementing the strategy and found a number of internal weaknesses including a lack of strong leadership guiding the agenda, no specific targets or clear accountabilities for implementing the strategy, business processes and staff incentives not conducive to promoting private sector development, and poor coordination across departments. Based on the review's findings, ADB revised the strategic framework for supporting private sector development.³² The key features of the revised framework were incorporated into MTS II as part of the strategic priority to catalyze investment.

36. The revised strategic framework offers integrated, comprehensive solutions in three areas. First, ADB will improve and expand its support for policy reforms and institutional development to create an enabling environment for private sector development. Second, ADB will enhance its focus on developing of cost-effective public goods and services, and it will introduce innovative market-oriented approaches like public-private partnerships to finance them. Third, ADB will focus its direct private sector operations on transactions that promote larger, sustained flows of private capital into specific sectors or countries and on transactions that directly or indirectly enhance poverty reduction.

37. The implementation of the framework is being led by the operations VPs. In a joint memorandum in May 2006, the VPs stressed the importance of the CSP in defining ADB's role in supporting the development of a country's private sector, including private sector operations. The revised CSP processes strengthen this point by integrating private-sector development initiatives into the CSP and the sector road maps supporting it. The memorandum also defined the business processes for concept clearance of private-sector proposals and clarified the responsibilities for processing non-sovereign transactions.

38. ADB will continue to seek opportunities for private sector operations across the region, including diversifying its investments geographically. There have already been a number of private sector operations in ADF countries ranging from equity funds that target small- and medium-sized enterprises in the Pacific to the investment in the Nam Theun 2 Hydroelectric project in Lao PDR. Coordination across departments is improving, including the involvement of Private Sector Department staff in country teams preparing CSPs. As non-sovereign operations expand as envisaged under the framework, the Risk Management Unit will need to be strengthened to handle the increase in demand for project due diligence support. Staff skills generally will need to be augmented to prepare private-sector transactions and other operations promoting private-sector development.

C. Enhancing Accountability and Transparency

1. New Accountability Mechanism

39. The new accountability mechanism replaced the previous inspection function effective December 2003. Through it, ADB aims to strengthen its institutional transparency, be responsive to the concerns of project affected people, and improve project quality to enhance its

³¹ ADB. 2000. *Private Sector Development Strategy*. Manila.

³² ADB. 2006. *Private Sector Development: A Revised Strategic Framework*. Manila.

development effectiveness. The new mechanism applies a dual-phased approach: the consultation phase, through the Office of the Special Project Facilitator, and the compliance review phase, through the Compliance Review Panel. This system departs from previous inspection function in several ways. For example, under the new mechanism claimants are not required to cite specific violations of ADB's operational policies and procedures. Also, claims can be filed in any official or national language of ADB's developing member countries.

40. From the beginning of the new accountability mechanism to the end of the third quarter of 2006, the Special Project Facilitator has received seven complaints (six from ADF countries), a greater number than was received by the previous inspection function in a similar timeframe. The increase could be attributable to easier filing requirements and to greater awareness in civil society as a result of the mechanism's active outreach program. The complaints mainly concerned infrastructure projects and involved resettlement or environmental issues. Of the seven, the Special Project Facilitator determined that three were eligible and three were ineligible, while one is still being screened.

41. The complainants in two eligible complaints from the consultation phase also requested a compliance review. The Compliance Review Panel determined that one request was ineligible but that the other was eligible. Upon Board authorization, the panel carried out an investigation of the eligible complaint and issued its findings and recommendations. The Board approved these recommendations, and the panel is presently monitoring the implementation of the remedial actions. At the Board's direction, the panel is also monitoring the implementation of remedial actions on a project reviewed under the previous inspection function.

2. Independent Operations Evaluation Department

42. Beginning January 2004, OED began reporting directly to the Board through the Development Effectiveness Committee instead of Management thus increasing its independence.³³ The new institutional roles and responsibilities of OED, Management, and the Board have helped integrate lessons from evaluation findings into ADB products, services, policies, and approaches. OED introduced a 3-year evaluation work program based on extensive and transparent consultations across ADB to support this.

43. Progress has been made in the area of public disclosure. Once the Director General of OED approves a report, it is made public at the same time it is circulated to the Board and to Management. Also, the Development Effectiveness Committee's summaries of discussions and annual report to the Board are now on the ADB website as are all Management responses to OED reports.

44. OED broadened the focus of performance evaluations from projects to countries and to ADB policies and strategies. This has given the department greater impact as illustrated by the use of its evaluations in the formulation of MTS II's new operational model for sector selectivity and focus. ADB also now requires an independent country assistance program evaluation before a new CSP is proposed to the Board, though there is a need to better coordinate the timing of the evaluations with operations departments to avoid delays in CSP preparation.

³³ For more details, see the standalone paper "Report on the Independence of the Evaluation Function and Evaluation Results for ADF Operations."

45. Overall, OED independence has led to the higher visibility of evaluation results and greater attention to their findings. To improve development effectiveness, OED will emphasize proactive and more systematic sharing of knowledge and lessons from ADB's and other organizations' evaluation results.

3. Unified Public Communications Policy

46. In April 2005, ADB approved the public communications policy (PCP) that established a framework for proactive communications and information sharing with all stakeholders. ADB will engage more proactively with external audiences and make itself more widely known and better understood by its key constituencies. ADB is introducing a more systematic approach to external relations and outreach planning, and it has added a comprehensive communication skills development program.

47. The presumption is in favor of disclosure under the policy. The PCP mandates that all project-related documents normally produced during the project cycle be posted on the web. Documents addressing social or environmental issues and summarizing the proposed project design are disclosed before decisions are made so people who will be affected can influence the design. While the policy is not retroactive, it allows ADB to declassify older documents that would have been publicly available had they been created under the PCP. The result has been a wider range of operational documents released to the public. Less than 1% of all requests for operational documents have been denied, and 97% of all requests were fulfilled within the 30-day deadline. During the first year of implementation, there were no complaints that requests had been unreasonably denied. ADB has also improved access to operational information on its website. Initial feedback from nongovernment organizations and others is that they have greater access to more information from ADB as a result of the policy.

48. The Department of External Relations is leading the staff capacity development program to put the new requirements into practice, though more work is required to meet PCP disclosure deadlines. Staff members are spending somewhat more time communicating with government and private sector partners to convince them to disclose information at earlier stages than previously required.

49. The policy includes a results-based monitoring framework to gauge progress in implementation. A review of experience to date highlighted several issues requiring attention and action.³⁴ On the external relations side, there is a need to refine indicators and targets, to track progress in a more meaningful manner, and to promote more strategic institutional approaches to external relations. The Department of External Relations will continue to build staff capacity including in resident missions.

D. Strengthening Internal Governance and Management Systems

1. Strengthening the Senior Management Team

50. To strengthen the senior management team, the positions of VP for Knowledge Management and Sustainable Development and Managing Director General were established and filled. ADB enhanced the VPs' role by giving them greater responsibility—and accountability—for the effective functioning of the departments and offices they supervise.

³⁴ The first annual report is under preparation and will be submitted to the Board of Directors in November 2006.

Management committee meetings are regularly held for the VPs to advise the President. The President has delegated chairing management review meetings and private sector credit committee meetings to the operations VPs, giving them direct oversight of the development of all ADB investments. The VPs are also leading the initiative to improve ADB's portfolio management and the results-based design and monitoring of projects.³⁵ The VP for Finance and Administration chairs the quarterly meetings of the Asset and Liability Committee.

51. VPs now have increased authority over the allocation of TA resources and the approval of TAs. Previously, budgets for TA resources were allocated by department, with the VPs involved in the downstream approval process. Now VPs receive a block TA budget and are free to allocate resources across units, giving them substantial control over one of ADB's main business lines. Additionally, the VPs have been delegated the authority to approve smaller TAs.

52. The VPs provide guidance in formulating the work program and budget framework, which identifies business priorities for the upcoming 3-year period. In this process, they meet with the Board's Budget Review Committee to discuss strategic issues under their areas of responsibility. They also play a key role in defining the annual lending and disbursement targets. The VPs oversee budget submissions from their units and are directly involved in determining the allocation of professional staff positions within their groups as part of the annual budget exercise. In human resource management, the VPs ensure consistency of performance ratings for professional staff, especially for unsatisfactory performers, and make recommendations on the promotion of directors. Further, the President has delegated authority to the VP for Finance and Administration to approve a significant portion of personnel actions for professional staff below managerial level; and this VP chairs selection panels for directors, heads of resident missions and representative offices, and lead specialists.

53. The Managing Director General represents Management in meetings of the Board's Development Effectiveness Committee. In this role, this office coordinates the preparation of Management's responses to all OED reports and monitors the follow-up actions based on OED's recommendations. The Managing Director General also chairs the Reform Coordination Committee, facilitating effective implementation of the broader ADB reform agenda.

2. Human Resources Strategy

54. ADB adopted a new human resources strategy in October 2004 to enhance staff productivity.³⁶ The strategy aims to establish a transparent, merit-based human resource management system that supports ADB's strategic priorities. Under the strategy, ADB introduced a new performance management and rewards system (the performance and development plan). ADB has made progress delivering the strategy's outputs during the first 2 years of implementation.

55. ADB reviewed its learning and professional development program to identify better ways to meet ADB's business needs. ADB is formulating learning and development programs reflecting changing staff skill needs and supporting staff career progression. As ADB's technical talent is critical to its effectiveness, a nonmanagerial career path was introduced to reward and retain highly-valued technical experts. Previously, technical career paths would plateau at a

³⁵ For example, the VPs are taking the lead in coordinating and steering the implementation of ADB's project performance management system action plan adopted in 2004.

³⁶ For more details, see the standalone paper "Report on the Implementation of the New Human Resources Strategy."

lower level. The shift in sector focus under MTS II and the introduction of new business lines required an adjustment in the mix of staff skills. An enhanced separation program was completed in 2006 that provided ADB the flexibility to strategically adjust its workforce by reallocating existing resources and recruiting new staff in priority areas.

56. The performance and development plan provides an integrated approach to managing human resources by aligning results-based performance, desired behavioral standards, reward mechanisms, and support for professional development. This new system represents an important initial step towards a result-oriented culture. It also enables ADB to develop more mature and accountable managers. ADB has established a systematic process for identifying potential leaders, nurturing their development and succession into the senior echelon, and retaining their critical skills. The Assessment and Development Center will foster professional growth of ADB's potential leaders while also improving their current job performance and motivation.

57. For these initial steps ultimately to have their desired impact, ADB will respond to issues that arise and make adjustments as necessary during strategy implementation. ADB Management's ownership and active participation is the critical element for advancing the strategy and driving the necessary cultural change, and the Budget, Personnel and Management Systems Department will provide the necessary technical support. At the end of the implementation period, ADB will conduct a staff engagement survey to obtain feedback.

3. Independent Review of the Reorganization

58. In 2004, ADB commissioned an independent assessment of the 2002 reorganization to evaluate its impact. The final report was completed in November 2004 and suggested a set of options and recommendations covering strategic focus, sectoral strength and resources, quality assurance, and operational effectiveness. The options and recommendations involved structural, nonstructural, and functional changes.³⁷

59. Following the panel's recommendations, and as a prerequisite for piloting the new financial modalities, an independent Risk Management Unit was established directly under the President's office in July 2005. The unit is tasked with formulating policy and assessing credit risk in operations, assessing and assigning internal credit ratings to borrowing member countries and to individual public- or private-sector projects, and independently assessing the credit risk of transactions and working with project teams.

60. ADB reorganized the Regional and Sustainable Development Department in July 2005 to make it more effective in renewing key business areas, supporting quality enhancement and innovation of key sector operations, promoting sustainability and inclusiveness of investments, and managing knowledge. ADB also established the Office of Regional Economic Integration in April 2005 to provide strategic focus in regional cooperation and integration. The Office of External Relations was upgraded to a department to manage its expanded responsibilities in support of the PCP. In May 2006, ADB realigned the regional departments' country groupings to improve country focus, to correspond more closely with subregional initiatives, and to balance the workload among departments.

³⁷ Some actions, such as expanding the role of the VPs, overlap with other elements of the reform agenda and are not repeated here.

4. Mobilizing Resources and Addressing Bunching

61. Management has instituted a systematic process for reviewing ADF resource use. Treasurer, Controller's, and the Strategy and Policy departments provide regular reports to Management on the status of loan disbursements and cancellations highlighting issues for Management's guidance. The revised PBA policy includes a system to encourage operations departments to identify surplus resources quickly. The operations group retains all proceeds from loan savings and cancellations and can redirect them to priority projects. These funds are in addition to the limits determined by the PBA formula. As of 30 September 2006, \$310 million in loan funds were cancelled.

62. The new currency management framework for ADF, discussed in more detail in Section IV, streamlines ADB's internal currency practices and enhances currency risk management.³⁸ Furthermore, the revised policy on supplementary financing³⁹ allows more flexibility in obtaining additional funds in the case of cost overruns. Simplifying the process of obtaining supplementary financing reduces the need to commit scarce ADF resources to large project contingencies. This should reduce loan cancellations in the future.

63. Management has become more directly involved in the oversight and control of project scheduling to reduce bunching, setting priorities for projects based on readiness balanced with the needs of borrowing countries for timely approvals. To this end, Management ensures that project readiness filters are routinely applied. These efforts contributed to a reduction in the bunching rate of projects from 68% in 2004 to 51% in 2005, a figure comparable to that of other MDBs. For 2006, despite an increase in multi-tranche financing facility subprojects and some processing delays following the realignment of country groupings in the regional departments, bunching will be maintained at 52% by postponing Board consideration of 11 projects to the first quarter of 2007.

IV. ADF RESOURCES: DISTRIBUTION, IMPACT, AND FINANCIAL MANAGEMENT

A. Demand for ADF Financing

64. ADB's assistance program is country focused. CSPs are prepared in line with national development plans (usually poverty reduction strategies in ADF countries). Considerable background work and stakeholder consultations go into the preparation of a CSP. While this process pinpoints the priority sectors for ADB interventions, the maximum level of ADF resources that will be made available to a country is determined by the level of commitment authority and the outcome of the PBA process.

65. The demand for concessional resources is strong in ADF countries. The estimated resource availability—nearly \$6.9 billion excluding transfers to the TA special fund—should be fully utilized in ADF IX (Table 1). Some ADF countries have identified project financing needs beyond their indicative PBA limits, while others, due to capacity constraints or readily available grant financing, will not use all of the resources allocated to them. ADB is working with the latter group to identify suitable projects for financing, but in the event a country cannot utilize its allocation the funds will revert to the general pool to be allocated among the remaining countries

³⁸ ADB. 2005. *Asian Development Fund Currency Management Proposal*. Manila.

³⁹ ADB. 2005. *A Review of the Policy on Supplementary Financing: Addressing Challenges and Broader Needs*. Manila.

Table 1: Actual and Projected Approvals, ADF VIII and ADF IX

Regional Department	ADF VIII		ADF IX ^a									
	2001-04		2005		2006		2007		2008		2005-08	
	No.	\$ million	No.	\$ million	No.	\$ million	No.	\$ million	No.	\$ million	No.	\$ million
Central and West Asia	47	1,866	16	748	16	590	15	683	16	649	63	2,670
East Asia	9	136	1	10	3	46	2	32	3	47	9	135
Pacific	13	103	5	30	3	33	4	70	3	26	15	160
South Asia	52	1,785	12	412	12	544	13	511	11	403	48	1,870
Southeast Asia	51	1,743	13	422	17	480	16	508	13	582	59	1,992
Inter-regional					1	25					1	25
Total	172	5,633	47	1,622	52	1,718	50	1,804	46	1,707	195	6,852

ADF = Asian Development Fund.

^a Amounts include ADF grants, but exclude transfers to the TA special fund.

Source: Asian Development Bank estimates.

based on the PBA formula. For countries with an excess of demand for ADF financing, in the event that redistributed funds from countries underutilizing their allocations are insufficient, the excess will be financed through savings and cancellations whenever possible.

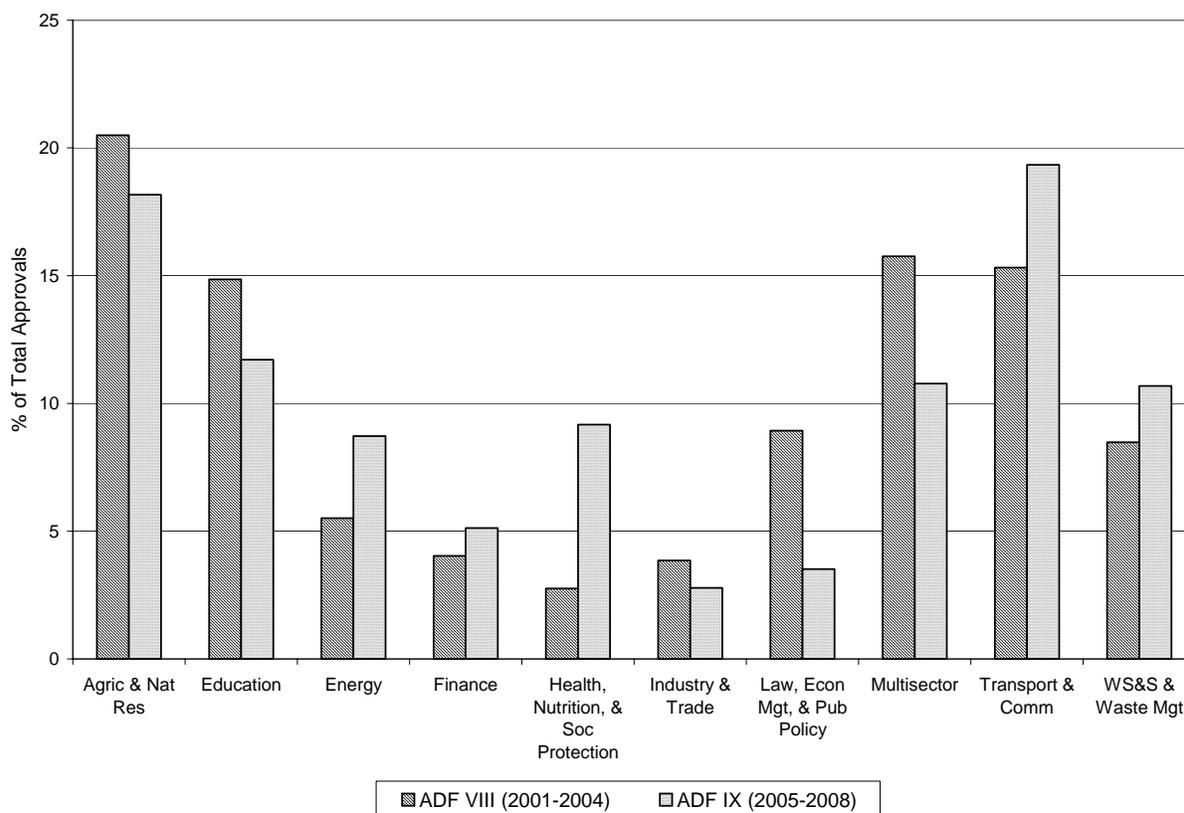
B. Resource Allocation and Uses

1. Use of Resources by Sector and Theme

66. There has been a noticeable shift in sector emphasis between ADF VIII and ADF IX. As Figure 2 shows, transport and communications will be the main sector under ADF IX—projected to account for 19% of all loan approvals—followed by agriculture and natural resources, the largest sector during ADF VIII.⁴⁰ Energy and water supply and sanitation also show strong gains, both of which are priority group I sectors in MTS II along with road transport. Transport and energy also benefit from strong demand for cross-border interventions in these sectors. While the share of support to education is dropping, it is still among the main areas for ADB support. The health sector also shows strong gains despite being a priority group II sector in MTS II. This is partly due to the availability of grants for HIV/AIDS and other communicable diseases under ADF IX.

67. Lending by theme is difficult to compare across ADF replenishment periods due to changes in the system following the PRS review, including the addition of the theme capacity development. However, during both periods, projects promoting economic growth made up the bulk of the support to ADF countries—71% will have economic growth as a theme during ADF IX—followed by inclusive social development and governance projects (Figure 3). Because these are the three pillars of the PRS and all projects must have at least one of these as a theme, this result is as expected. Crosscutting themes of gender and development,

⁴⁰ The sector shares are based on the volume of lending. Sector shares based on number of loans approved show a similar pattern of priorities, but the percentages change somewhat.

Figure 2: Actual and Projected Approvals by Sector, ADF VIII and ADF IX

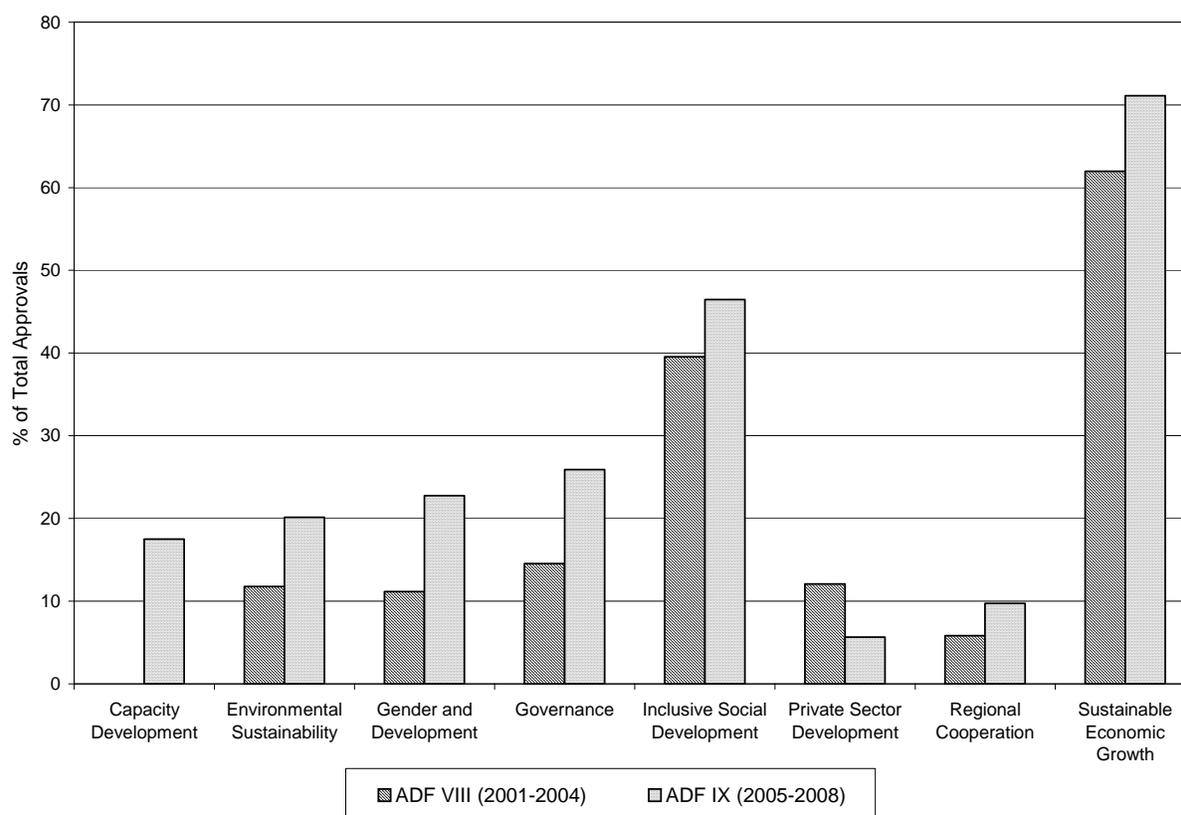
ADF = Asian Development Fund, WS&S = Water Supply and Sanitation.
Source: Asian Development Bank estimates.

environment, and governance also have strong showings with 20–25% of lending volumes supporting each of these areas.⁴¹

68. ADF IX donors allowed funds (up to 5% of the total) to be earmarked for subregional projects. The funds lent to a country from this pool are in addition to those lent using the PBA-formula. As such, formal criteria were developed in the revised PBA policy regarding project eligibility.⁴² The PBA focal point reviews concept papers for eligibility, and Management approves the final list of projects for financing under this facility. Subregional projects approved in 2005–2006 were mainly in transport and communications (70%) with health, nutrition, and social protection (22%) next highest as ADF grant financing for communicable disease projects was done through the subregional pool. The remaining projects were in energy. The list of subregional projects for 2007–2008 is currently being reviewed by the PBA focal point.

⁴¹ Some projects with gender components do not have gender as a thematic classification. All ADB loans require an initial poverty and social assessment, which includes gender analysis. If the initial assessment indicates the project has the potential to correct gender disparities or significantly mainstream gender concerns, a detailed gender assessment will be undertaken during project design to prepare a project-specific gender action plan.

⁴² The subregional set-aside funds were also a feature of ADF VIII, but new procedures were adopted beginning with the 2005 ADF program to ensure these resources were allocated transparently.

Figure 3: Actual and Projected Approvals by Theme, ADF VIII and ADF IX

ADF = Asian Development Fund.

Note: Up to three themes can be selected for a given project so the sum of the bars is greater than 100%. Capacity development was added as a theme during the ADF IX period.

Source: Asian Development Bank estimates.

69. While ADF disbursements averaged \$1.1 billion annually during ADF VIII, this is expected to increase to an annual average of \$1.5 billion in ADF IX. Disbursements were nearly \$1.25 billion in 2005 and the projections for 2006 show further increases. At the start of ADF VIII, the disbursement ratio (the ratio of total disbursements to the amount of funds available in a year) was 18.8%, but it fell to 15.0% in 2004. Through greater emphasis on portfolio management, incentives to redirect loan savings, and the application of project-readiness criteria; the disbursement ratio has begun to recover. It was 16.5% in 2005 and is expected to increase further in 2006.

2. Grants in ADF IX

70. The preceding section considered all ADF projects regardless of the terms of the financing; however, there are a number of issues that are specific to ADF IX grants.⁴³ Grants were introduced to ease the debt burden of the region's poorest countries, to meet the special needs of post-conflict countries, and to help contain HIV/AIDS and other communicable

⁴³ For details, see the standalone paper "Report on ADF IX Grant Framework and Proposal for Alignment with IDA 14 Grant Framework." The standalone paper includes a number of issues regarding harmonization with IDA for which donors' views are requested that are not repeated in the overview report.

Table 2: Grant Shares in ADF IX and IDA 14
(%)

Country	ADF IX	IDA14 (FY2006)	IDA 14 (FY2007)
Afghanistan	50	100	100
Bhutan	0	100	100
Cambodia	50	100	100
Kyrgyz Republic	50	100	100
Lao PDR	50	100	100
Mongolia	0	100	50
Nepal	50	50	100
Samoa	0	0	50
Solomon Islands	30	100	100
Sri Lanka ^a	15	50	50
Tajikistan	40	100	50
Timor-Leste ^b	40	100	60
Tonga ^a	0	100	100

ADF = Asian Development Fund, IDA = International Development Association, FY = fiscal year.

^a The country can access both ADF and ordinary capital resources.

^b The grant allocation for Timor-Leste under IDA 14 will fall to 30% in fiscal year 2008.

Note: Other ADF countries can only avail of ADF grants for projects addressing HIV/AIDS or other communicable diseases.

Sources: Asian Development Bank and International Development Association.

diseases. Donors agreed that up to 18% of total ADF resources (excluding an additional 3% of total ADF to be transferred to ADB's TA special fund) could be provided as grants to ADF countries. The framework allowed for grant shares of PBAs for selected countries and up to 2% of ADF resources earmarked for grant projects related to HIV/AIDS and other communicable diseases.

71. From 1 January 2005 to 30 September 2006, a total of \$406 million in grants have been approved. Afghanistan has been the largest grant recipient to date (\$140 million). Utilization of grants during the first 2 years of ADF IX is likely to be below the ceiling, about 85% of the \$630 million available. This is due in large part to start-up delays in implementing the new assistance modality, to ADF PBAs for grant-eligible countries being lower than expected, and to processing constraints in Nepal in 2005. However, the pace of utilization is picking up and expected to improve further. Looking at the number of grant approvals by sector during 2005 and 2006, most will be for agriculture and natural resources (25%) followed by health, nutrition, and social protection (22%) and transport and communications (22%). The sector distribution is somewhat skewed toward the health sector because of amount set aside for HIV/AIDS and communicable diseases.

72. Currently, the ADF grant framework is aligned with the IDA 13 framework. Subsequently, the IDA 14 replenishment was approved and included a revised grant framework that will be further refined in the upcoming IDA 14 midterm review. The IDA 14 framework links grant eligibility exclusively to a country's debt sustainability status. This has led to significant differences in grant eligibility levels across countries between ADF IX and IDA 14, as shown in Table 2. Grant eligible countries are subject to a reduction in their nominal IDA allocation (the so-called volume discount) so that the system is not seen to reward poor performers. ADB is coordinating closely with IDA to align the ADF grant framework with the revised IDA framework beginning in 2007. In the new IDA framework, a debt sustainability analysis prepared by the International Monetary Fund and the World Bank determines the level of grant eligibility. To

ensure ownership of the results within ADB, explicit arrangements with these institutions will need to be made for meaningful ADB involvement in the analysis.

3. Technical Assistance to ADF Countries

73. ADF donors' contributions to the TA special fund are an important part of ADB's overall TA program. The TA program—including the TA special fund, the Japan Special Fund, and bilateral trust funds managed by ADB—annually provides about \$220 million in support to all of ADB's developing members. While principal recipients of TA funds by volume have been the larger countries, the highest per capita allocations are made to lower-income countries such as Afghanistan, Cambodia and Nepal, and many Pacific economies. For 2005–2006, ADF countries will receive more than \$250 million in TA support from ADB (roughly \$100 million from the TA special fund), which is considerably more than the \$93 million in ADF funds transferred to date. About 45% of TA funds have been used to assist borrowers with sound project preparation, with the remainder used for capacity development and technical support in a variety of sectors. By sector, the priority for allocations has been agriculture and natural resources; health, nutrition, and social protection; and law, economic management, and public policy. Priorities for the rest of ADF IX will include a greater focus on the longer-term capacity development needs of weakly-performing countries, support for improved governance and anticorruption measures, and a sharper focus on MTS II priority sectors.

C. Trends in Project Performance

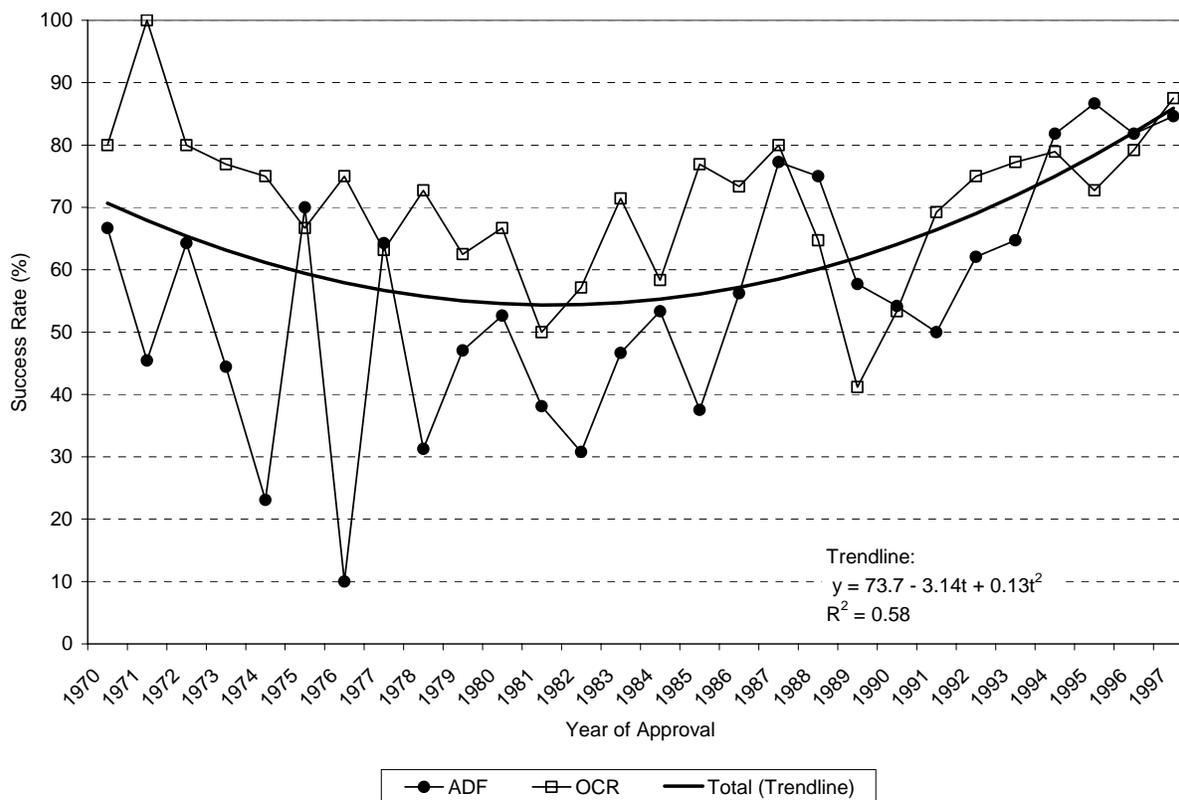
74. OED tracks the changes in project performance ratings over time and publishes the results annually.⁴⁴ As Figure 3 shows, ADF-funded projects approved in the 1970s and 1980s were rated considerably below contemporaneous OCR-funded projects. Since the early 1990s, the OCR and ADF success ratings converged, and both have improved markedly. Given the development challenges faced by ADF countries, this is a positive turn of events.

75. Average project success rates vary by country and sector. Statistically, sector is the major determinant of project success. Infrastructure projects are likely to be successful and agriculture projects are more likely to experience difficulties for both ADF- and OCR-funded projects. For most sectors, outcomes have been similar, but ADF-funded social infrastructure projects and lines of credit to government-owned development finance institutions have been less successful than projects funded by OCR. It is not surprising that OCR-funded projects are more often successful since ADF is allocated to poorer countries that often face daunting development challenges due to prevailing conditions and weak institutional capacities. What is encouraging is that more significant differences were not found between ADF and OCR success rates for projects approved in the 1990s. Projects approved after the turn of the millennium are still under implementation and have not been completed or rated.

76. Although project lending makes up the majority of ADB's financial assistance, program loans are an important tool to provide quick disbursements to cover the immediate adjustment costs of policy reforms. Program loans are a more common lending modality in ADF-only and blend countries than they are in OCR-only countries. Nearly three fourths of program loans rated (68 out of 92) were financed by ADF loans. This reflects the strong need for policy and institutional reform in countries that receive ADF. The analysis confirms that country factors

⁴⁴ The analysis is drawn from the standalone paper "Report on the Independence of the Evaluation Function and Evaluation Results for ADF Operations."

Figure 3: Trends in Project Ratings by Source of Funding



Note: Data includes ratings from both project performance evaluation reports and project completion reports.
Source: Asian Development Bank Operations Evaluations Department.

such as economic performance, development priorities, quality of governance, and strength of institutions contributed to the success rates of programs. Two thirds of OCR-funded programs were rated successful compared with 41% of ADF-funded programs. The data do indicate an improvement in success rates for program loans beginning in 1992 reflecting the positive effect of ADB's initiatives to improve quality in the 1990s, increased experience with the policy-based lending modality, and the revision of ADB's program lending policies in 1996.

D. Management of Financial Resources

1. Status of Resource Mobilization

77. After negotiations in Seoul, Korea, donors recommended a planned level of ADF IX operations of \$7.0 billion for the 4-year period 2005–2008 and additional resources of \$0.2 billion to cover forgone interest from the newly introduced ADF grant program. Donors pledged burden-shared contributions of \$3.2 billion. The balance was to be funded by reflows-based

resources of \$3.7 billion, the accelerated note encashment program that would generate an additional contribution of \$46 million, and other internal resources.⁴⁵

78. ADF IX became effective on 29 April 2005 when ADB received unqualified instruments of contributions from eight donors in a total amount exceeding the required 50% of the aggregate pledged. As of 30 September 2006, 27 out of 28 donors had submitted their instruments of contributions amounting to \$3.2 billion. This includes renewed support from Malaysia and a first-time contribution from PRC. Furthermore, Brunei Darussalam and Ireland have both pledged to contribute to ADF IX on becoming ADB members in 2006. As of 30 September 2006, total encashment of ADF IX promissory notes amounted to \$425 million of which \$93 million was transferred to the TA special fund.

79. With the additional resources mobilized from ADB's net income (\$80 million total transferred in 2005–2006), the accelerated note encashment program, additional donor contributions, and the reuse of loan savings; the ADF IX resource gap can be closed. If funds are generated as planned, total commitment authority for ADF IX loans and grants could reach \$7.3 billion. Efforts to improve ADF financial management continue with tangible results expected from redirecting resources from loan savings and cancellations, and from improving ADF asset and liability management under the new currency framework supported by the new financial projection system. The mobilization of resources has generally been smooth with few delays. ADB appreciates donor responsiveness to date and encourages continued timely provision of contributions—particularly the installment payment critical for new loan and grant commitment—to optimize the use of scarce concessional funds.

2. New Currency Management Framework

80. In October 2005, the Board approved a new currency management proposal for ADF, which simplified the system from one that required management of as many as 15 currencies to a full-fledged special drawing rights (SDR) approach.⁴⁶ ADF borrowers were informed of the salient features and benefits of the new system in a series of workshops conducted in the field starting in November 2005.⁴⁷ The new system, which improves the ADF lending product, was well received by the borrowers. Positive feedback includes (i) expected reductions in transaction costs, (ii) improved fit with their existing accounting systems, and (iii) greater ease of planning and streamlining their debt management.

81. Implementation of the new ADF currency management framework began in January 2006 and has thus far been problem free; however, full implementation of the new framework requires system enhancements and additional staff resources. For example, to meet the currency rebalancing requirement under the new framework, a comprehensive multi-currency projection model for ADF is needed. This model, currently under development, will be a tool for minimizing currency risks through asset and liability management by realigning non-SDR assets with SDR-denominated liabilities. Furthermore, the new system will (i) improve projections of

⁴⁵ For details, see the standalone paper "ADF IX: Mobilization and Use of Resources." The standalone paper includes two issues where donors' views are sought that are not repeated in the overview report, namely the discount rate to be used for calculating the credit to donors that join the accelerated note encashment program in the future and reducing Nauru's outstanding contribution to ADF VI.

⁴⁶ For details, see the standalone paper "New Currency Management Framework for ADF."

⁴⁷ To date, workshops have been held in five ADF countries, and presentation materials were distributed in two other countries during loan disbursement seminars.

ADF financial positions under multiple currency scenarios, (ii) support ADF lending and resource planning, and (iii) enhance ADF liquidity management.

82. With the introduction of the SDR-based framework, the existing portfolio investments from the accelerated note encashment program in non-SDR currencies will be unwound and converted to SDR currencies during the 2006 transition period. The converted liquidity and future cash inflows will be invested in SDR currencies with longer maturities. While the program credit agreed with each donor will not change, ADB proposes using the SDR composite discount rate to calculate the credit for new participants.

3. Financial Implications of ADF Grants

83. Forgone interest resulting from the introduction of grants under ADF IX will be financed through additional donor contributions, as agreed during negotiations. The \$200 million in additional contributions calculated at the conclusion of negotiations was based on an assumed total of \$1.26 billion in ADF grants (18% of \$7.0 billion planned operations). With the proposed alignment with the IDA 14 grant framework in January 2007, total grants are likely to exceed the amount calculated at the conclusion of negotiations by \$72 million. The associated interest forgone from the increase in grants is about \$15 million in nominal terms and \$7 million in net present value terms.⁴⁸ Donor contributions for this can be discussed during the next replenishment. The additional forgone principal (about \$72 million in nominal terms, \$28 million in net present value terms) will be financed in future replenishments as agreed by donors during ADF IX negotiations. Starting with ADF X, the new grant framework will likely lead to an increase in the share of grants in total ADF financing, thus necessitating additional contributions from donors to preserve financial integrity.

V. CONCLUSION

84. The Asia and Pacific region has made noteworthy advances toward the elimination of income poverty, yet the region still accounts for the majority of the poor in the world. Moreover, the non-income dimensions of poverty have proven more difficult to tackle than the income side. There are signs in many countries that progress to date has been insufficient to achieve the MDGs by 2015. This is particularly true in ADF countries. In addition, the levels of investment required to maintain the rapid growth needed to reduce poverty are enormous. Therefore, the demand for ADF will continue to be strong to the end of ADF IX and beyond.

85. ADB's work program and budget framework 2007–2009 indicates an operational program of \$6.85 billion for ADF IX, which slightly exceeds the level agreed at the conclusion of negotiations, net of transfer to TASF. This reflects ADB's prudent demand management and strict application of the PBA policy. However, there is demand for ADF resources beyond these operational levels, particularly from blend countries, and the addition of new ADB borrowing members Armenia and Palau (and the pending admittance of Georgia) will further bolster demand for concessional funds. Moreover, as ADB adopts the IDA 14 grant framework, debt constrained countries will be better placed to use their full allocation. Harmonizing with IDA 14 will also reduce future reflows into the pool, well beyond what was anticipated under the current

⁴⁸ Estimates of additional grants and foregone interest are based on the calculated 2007–2008 ADF allocations using the 2005 country performance assessments. The estimate will be refined as the 2006 PBA process is finalized and the ADF commitment authority is updated.

framework. While estimates of forward resource requirements need to be refined, the early indications suggest robust demand for ADF through the next replenishment period.

86. In the global development community, there has been a discernable shift in emphasis from monitoring the amount and distribution of assistance to demonstrating genuine development impacts. To keep pace with this change, ADF donors and ADB agreed on a number of reform measures to be undertaken during ADF IX to mainstream MfDR; improve operational policies, strategies, and approaches; enhance accountability and transparency; and strengthen internal governance and management systems. ADB has made a concerted effort to transform itself during the first 2 years of ADF IX.

87. Though ADB has made considerable progress, much hard work remains. Harmonizing results indicators is part of a broader agenda of donor harmonization that is still taking shape. Even items in which the deliverables agreed in the Donors' Report are completed, there are follow-up actions underway or planned. For example, although all new country strategies are results-based, this is a learning process and results frameworks are being updated and refined as ADB gains experience. Similarly, the review of the governance and anticorruption policies led to the development of GACAP II, the implementation of which will continue through the second half of ADF IX and beyond. ADB reiterates its commitment to complete the agreed reforms during ADF IX and to continue implementation of the revised policies.

STATUS OF REFORM AGENDA COMMITMENTS UNDER ADF IX

Area of Reform/ Commitments ^a	Key Actions Taken	Challenges/ Follow-Up Actions
Updated Institutional Strategy		
(4) Review of the Poverty Reduction Strategy (PRS)	The Board of Directors (the Board) approved the recommendations of the review of the PRS in July 2004. The revised PRS was published in December 2004.	The second annual report on the implementation of the revised PRS to be published in the fourth quarter of 2006.
Mainstreamed Managing for Development Results (MfDR)		
(3) Results Agenda as Key Priority	Results Management Unit established in the Strategy and Policy Department in February 2004. The President approved the revised MfDR action plan in August 2006.	Management guidance and leadership to implement the revised action plan.
(7) Development of Results Methodologies	Results reporting being institutionalized through the work program and budget framework, staff performance and development plans, and PRS monitoring. New design and monitoring framework introduced at the project level.	Development of a corporate performance assessment system.
(12) Harmonization of Results Indicators	The second annual report on the implementation of the revised PRS uses most of the International Development Association's (IDA) results indicators.	Continued coordination with IDA on results indicators.
(9) Results-Based Country Strategies and Programs (CSP)	Piloting of results-based CSPs completed. The Board endorsed 11 results-based CSPs as of 31 October 2006.	Continued attention to quality-at-entry of new CSPs. Institutionalize use of results tools to monitor the delivery of CSPs.
Improved Operational Policies, Strategies, and Approaches		
(6) Review of the Performance-Based Allocation (PBA) System	Board approved the revised PBA policy in December 2004.	Refine implementation of the PBA system, within the framework of the current policy, to address issues that have arisen during implementation.
(15) Review of Governance and Anticorruption Policies	Based on the review of the policies, ADB adopted the second governance and anticorruption action plan (GACAP II) in July 2006.	GACAP II to be implemented in a phased manner, initially in countries where new CSPs are being prepared.
(16) Review of Private Sector Development (PSD) Strategy	Based on the review of the strategy, the President approved the revised PSD strategic framework in February 2006.	Management guidance and leadership to implement the framework.
Enhanced Accountability and Transparency		
(1) New Accountability Mechanism	The Board approved the new accountability mechanism in May 2003. Compliance Review Panel reporting to the Board appointed in December 2003, and the Special Project Facilitator reporting to the President appointed in November 2003.	Compliance Review Panel and Special Project Facilitator to continue their activities in line with the policy.

Area of Reform/ Commitments ^a	Key Actions Taken	Challenges/ Follow-Up Actions
(2) Independent Operations Evaluation Department (OED)	OED reporting to the Board through its Development Effectiveness Committee as of 1 January 2004.	OED to implement its annual work programs, as approved by the Board.
(14) Unified Public Communications Policy (PCP)	Board approved the PCP in April 2005.	The first annual report on PCP implementation to be published in the fourth quarter of 2006.
Strengthened Internal Governance and Management Systems		
(5) Strengthening the Senior Management Team	Fourth vice president and Managing Director General added to the senior management team. The President delegated greater responsibility to the management team.	Management team to operate following the agreed division of responsibilities.
(8) Human Resources Strategy	The President approved the new human resources strategy in October 2004. Performance and development plans introduced to better align rewards with performance.	Budget, Personnel, and Management Systems Department to continue support for the implementation of the staff performance and development plan. Conduct a staff engagement survey at the end of the policy implementation period.
(13) Independent Review of the Reorganization	Based on the independent assessment, ADB established the independent Risk Management Unit, reorganized the Regional and Sustainable Development Department, established the Office of Regional Economic Integration, upgraded external relations from an office to a department, and realigned the country groupings of the regional departments.	Main recommendations of the independent assessment have been fully implemented.
(11) Reviewing and Mobilizing Resources	Revised PBA policy includes a system to encourage operations departments to identify surplus resources. \$310 million in cancelled loan funds were generated from 1 January 2004 to 30 September 2006.	Operations departments to continue to identify potential savings and to redirect them to higher priority activities, within the framework of the PBA policy.
(10) Addressing Bunching	Options to reduce bunching discussed in the May 2005 Management and Board retreat. Bunching rate dropped from 68% in 2004 to 51% in 2005, and is expected to be 52% in 2006.	Management to monitor bunching and take action, as necessary.

ADB = Asian Development Bank, ADF = Asian Development Fund, CSP = country strategy and program, GACAP II = second governance and anticorruption action plan, IDA = International Development Association, MfDR = managing for development results, OED = Operations Evaluation Department, PBA = performance-based allocation, PCP = Public Communications Policy, PSD = private sector development, PRS = Poverty Reduction Strategy.

^a Commitments are listed in the order they are discussed in the overview report. Numbers in parentheses indicate their ordering in the Donors' Report, Table 1, for ease of reference.