ADB

Special Evaluation Study

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Private Sector Development and Operations: Harnessing Synergies with the Public Sector

Operations Evaluation Department

Asian Development Bank

ABBREVIATIONS

ADB	–	Asian Development Bank
ADF	–	Asian Development Fund
AFTA	–	ASEAN Free Trade Area
ASEAN	–	Association of Southeast Asian Nations
BOT	–	build-operate-transfer
CAPE	–	country assistance program evaluation
CBP	–	country business plan
CEP	–	credit enhancement products
CFS	–	complementary financing scheme
CLASS	–	Comprehensive Loan Administration Servicing System
COSO	–	Central Operations Services Office
CPS	–	country partnership strategy
CSP	–	country strategy and program
DEC	–	Development Effectiveness Committee
DFI	–	Development Finance Institute
DFID	–	Department for International Development
DMC	–	developing member country
EBRD	–	European Bank for Reconstruction and Development
EIRR	–	economic internal rate of return
EVN	–	Electricity of Viet Nam
FDI	–	foreign direct investment
FIRR	–	financial internal rate of return
FSU	–	former Soviet Union
GCI	–	global competitiveness index
GDP	–	gross domestic product
GOCC	–	government-owned and -controlled corporation
HCMC	–	Ho Chi Minh City
ICT	–	information and communications technology
IEI	–	innovation and efficiency initiative
IFC	–	International Finance Corporation
IFI	–	International Finance Institution
IPP	–	independent power producer
LTSF	–	long-term strategic framework
MIC	–	middle-income country
MTS	–	medium-term strategy
MWSS	–	Metropolitan Water Systems Services
NAIA	–	Ninoy Aquino International Airport
NBFI	–	nonbank financial institution
NPL	–	nonperforming loan
OCO	–	Office of Cofinancing Operations
OCR	–	ordinary capital resources
OED	–	Operations Evaluation Department
OGC	–	Office General Counsel
PCG	–	partial credit guarantee
PCR	–	project completion report
PFI	–	private finance initiative
PIATCO	–	Philippine International Air Terminal Company
PPER	–	project performance evaluation report
PPP	–	public-private partnership

PRC	–	People's Republic of China
PRG	–	political risk guarantee
PRISM	–	private investment securities management system
PSA	–	private sector assessment
PSCC	–	private sector credit committee
PSCM	–	Capital Markets and Financial Sectors Division
PSD	–	private sector development
PSDS	–	private sector development strategy
PSIF	–	Private Sector Infrastructure Finance
PSO	–	private sector operations
PSOC	–	operations coordination unit
PSOD	–	Private Sector Operations Department
PSP	–	private sector participation
RMU	–	Risk Management Unit
RR	–	risk rating
RSDD	–	Regional Sustainable Development Department
SAPE	–	sector assistance program evaluation
SES	–	special evaluation study
SEZ	–	special economic zone
SIDBI	–	Small Industries Development Bank of India
SME	–	small and medium-sized enterprise
SOE	–	state-owned enterprise
SPD	–	Strategy and Policy Department
TA	–	technical assistance
UK	–	United Kingdom
VAT	–	value-added tax
VCF	–	venture capital fund
VFM	–	value for money
WTO	–	World Trade Organization

WEIGHTS AND MEASURES

km	–	kilometer
MW	–	megawatt

NOTE

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

Key Words

asian development bank, central asia, development impact, east asia, financial performance, financial sector, india, infrastructure, investment climate, pacific, performance evaluation, philippines, policy review, portfolio quality, private sector development, private sector operations, public-private partnership, south asia, viet nam

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Operations Evaluation Department, SS-74

GLOSSARY

Affermage	–	Concessionaire receives all the revenue and costs of the operation to service their costs before passing residual on to owners. Managers are provided with a relatively high degree of freedom to determine the commercial strategy.
Complementary financing scheme (CFS)	–	CFS (or B loan) is available for private sector projects in which the Asian Development Bank (ADB) is a direct participant by way of an A loan. CFS loans are a form of syndication, which are funded by commercial lenders with ADB acting as "lender of record." Although CFS loans do not provide cofinanciers with recourse to ADB, these loans enjoy the same privileges and immunities given to the ADB A loan.
Development impact	–	In accordance with the Operation Evaluation Department's guidelines for evaluating nonsovereign operations, development impact is evaluated according to (i) private sector development; (ii) business success; (iii) economic development; and (iv) environment, social, health, and safety performance.
Mezzanine finance	–	Mezzanine finance can be unsecured debt, or preference shares. This type of funding offers a higher return than debt due to higher levels of risk. However, returns are less than equity where returns are treated as residual payments. Mezzanine finance tends to be used when bank borrowing limits are reached and the firm cannot or will not issue more equity.
Partial risk guarantee	–	The partial risk guarantee covers part of a lender's outstanding debt service against specific political risks. ADB's Charter does not authorize coverage of equity risks. Risks potentially can cover issues such as breach of contract and currency inconvertibility.
Risk exposure	–	Risk exposure = probability of risk occurring x total loss if risk occurs.
Secured versus unsecured loans	–	The two main types of loans are secured loans and unsecured loans. For secured loans, the borrower pledges some sort of collateral. The bank may repossess the collateral if the loan is not repaid according to the terms agreed to when the loan was taken out. Unsecured loans do not require any collateral. Money is borrowed on the strength of the borrower's credit standing and ability to repay the loan using cash flows from the project or from an independent source.
Subordinated debt	–	Subordinated debt, a form of mezzanine finance, is a term used to describe debt that is unsecured or has a lesser priority than other debt claims on the same asset. If the party that issued the debt defaults on repayments, people holding subordinated debt get paid after the holders of the senior debt. A subordinated debt carries more risk than a normal debt, and earns a higher expected rate of return than senior debt due to the greater inherent risk.
Syndication	–	Syndication is the private placement of debt (or equity) securities to third parties. By employing debt syndication, several banks, investment firms, or other companies share the profits and diversify the risk of making a large loan. For ADB, syndications are used to transfer some or all of the risk associated with its loans and guarantees to its cofinancing partners, and include fronting (CFS), non-funded risk participations, and sell-down arrangements.
Underwriting	–	In banking, underwriting encompasses detailed credit analysis preceding the granting of a loan, based on credit information furnished by the borrower. Underwriting also can refer to buying corporate bonds, commercial paper, or government securities by a dealer bank for its own account, or for resale to other investors.

CONTENTS

The guidelines formally adopted by the Operations Evaluation Department (OED) on avoiding conflicts of interest in its independent evaluations were observed in the preparation of this report. Before joining OED, the director general of OED managed the Asian Development Bank's operation in the People's Republic of China for 11 years; the director, OED2, was responsible for country strategy and programming for Viet Nam (2003-2005); and the OED team leader responsible for preparing this evaluation was a private sector development specialist for Central Asia. Rolf Westling and Cherry Ann Santos, the consultants, might not necessarily agree with all of the views and conclusions presented in the study. To the knowledge of the management of OED, potential conflicts of interest of the persons preparing, reviewing, or approving this report were managed adequately.

EXECUTIVE SUMMARY

Introduction. Research confirms a strong link between poverty reduction, economic growth, improvements in the investment climate, and levels of private sector investment. In 2005, the Development Effectiveness Committee recommended that the Operations Evaluation Department (OED) assess the strategic direction and performance of the Asian Development Bank's (ADB) private sector development and investment operations. OED has prepared this Special Evaluation Study to determine: (i) the extent to which ADB is pursuing the correct objectives; (ii) whether the efficiency and effectiveness of its operations to support the private sector can be improved; and (iii) the extent ADB has been creating value in its private sector development activities.

Context of ADB's Private Sector Support. Over the last four decades, there has been a dramatic shift in the way multilateral development banks operate. In the mid 1960s, there was a lack of foreign currency capital in the Asia Pacific Region. Multilateral agencies such as ADB were established to mobilize this capital from members of the Organization for Economic Co-operation and Development and make it available through sovereign loans to developing member countries. There is now tens of trillions of dollars in funds available in international capital markets and regional banks. The main problem mobilizing funding in the Asia Pacific Region is finding investment opportunities of an acceptable quality that balance risks and rewards. Also, governments are withdrawing from direct provision of services and focusing on strengthening the policy and regulatory environment for private sector. These developments have meant that private sector is becoming an increasingly important client of ADB, and this is a trend that is expected to continue for the foreseeable future.

In many cases, money is no longer the core product being sought from ADB. Increasingly, what is being sought from ADB is support for building the enabling environment for the private sector (e.g., rule of law; access to finance; appropriate police/legal/regulatory frameworks) and lowering the risk associated with individual transactions through ADB's involvement. As a result, there has been a shift within ADB to create value for transactions by providing more intangible services such as private sector development, knowledge transfer and risk management. ADB is uniquely placed to provide this combination of services through its base in the region, and presence of public and private sector operations under one roof, creating a "one stop shop" for private sector development and commercial risk management services. Fully exploiting this potential comparative advantage requires development of strong synergies between the public and private sector parts of ADB.

ADB's Strategic Direction. Given these developments, the promotion of the private sector is an important strategic objective for ADB. It was one of three crosscutting themes identified in the *Long-Term Strategic Framework* for 2001–2015. ADB's Board of Directors approved the *Private Sector Development Strategy* in 2000 to improve the integration of ADB's public and private sector operations. The 2001 *Private Sector Operations: Strategic Directions and Review* recommended broadening the scope of private sector operations, increasing the level of resources, and establishing a Private Sector Operations Department (PSOD).

The *Private Sector Development Strategy* defines ADB's overarching framework for private sector operations. It has three strategic thrusts: (i) creating enabling conditions for the private sector and improving the investment climate, (ii) generating business opportunities by considering the scope for public-private partnerships in ADB projects, and (iii) catalyzing private investment through direct (equity and debt) and indirect (guarantees) financial participation in private sector projects. ADB's public sector operations were responsible for the first two strategic thrusts, whereas PSOD took the lead in directly catalyzing investment. ADB's country strategies were meant to identify private sector development bottlenecks and issues that needed to be addressed to facilitate public private partnerships. At the earliest stages of the country strategy development process, private sector commercial cofinancing options were to be considered as an alternative to the public sector as a means of funding prospective projects.

An important feature of the *Private Sector Development Strategy* was the need for regional departments to use ADB's country strategies to interlink public and private sector planning and operational activities. Country-specific Private Sector Assessments were required to be prepared to support that process. The evaluation found that, except in a few countries, private sector development road maps were not included in country strategies, and the Private Sector Assessments did not appear to have influenced significantly the preparation of country strategies. OED has prepared nine Country Assistance Program Evaluations since 2000. A review of these documents indicates that at the strategic level, ADB has failed to develop clear programs in the country strategies for the development of synergies between public sector and private sector operations. The vision of strong synergies between the public and private sides of ADB set out in the *Private Sector Development Strategy* remains unfulfilled.

While the general lack of synergy between public and private sector operations is disappointing, there have been some successes and progress is being made. ADB's experience in the power sector provides some examples of good practices that should be used in other sectors. ADB has supported the restructuring of the power sector in many countries. An important element of power sector reform is the creation of opportunities for private sector participation in areas such as generation. Although reforms in most countries have been slower than originally envisaged, progress is being made. Private sector investment in the power sector, including in projects supported by ADB, has increased in the Asia and Pacific region. PSOD financed energy projects have been successful. In some cases where problems arose with tariffs for private financed projects, ADB was able to use its access to policy makers to mitigate some of the negative financial consequences for its private sector clients through policy dialogue. In comparison to the energy sector, apart from India, where the government is scaling up private financing for airports and roads, progress on private sector participation in the transport and water sectors has been limited.

In the finance sector, country evaluation studies indicate that small and medium enterprise credit lines issued by government-owned development finance institutions have been a common feature of ADB's private sector enabling environment efforts. An analysis of OED's database on the performance of such institutions found that, excluding loans to Republic of Korea and Singapore, the success rate was a low 38%. The OED analysis concluded that generally ADB should not lend to government owned development finance institutions, and any exceptions would need to be strongly justified.

In regard to individual projects processed by PSOD, a review of OED's performance evaluation reports from 1992 through to 2006 indicated a highly satisfactory project success rate of 92%, which substantially exceeds the average success rate of evaluated public sector projects of 64%. The success rate for private sector projects exceeds the 80% standard that ADB uses as a benchmark defining satisfactory performance of projects. The OED evaluations of private sector projects highlighted a range of issues such as lack of coordination between public and private sector; lack of competition; tariff problems; need for foreign currency; difficulties with exit; and, more recently, resettlement issues. A review of project completion reports prepared by PSOD found a similar set of issues. Most of these issues are related to problems with the enabling environment and could only be resolved by policy dialogue undertaken by ADB's regional departments and the host country governments. Despite these problems, the overwhelming majority of PSOD's projects have been successful.

The ADB Task Force review of the *Private Sector Development Strategy* in 2006 reported on a wide range of problems implementing the strategy, including lack of focus in ADB's country strategies, weak screening and monitoring mechanisms at the strategic level, and lack of development performance standards. The Task Force made recommendations to address these issues. In response to these proposals, the Strategy and Policy Department prepared a new set of guidelines for producing country partnership strategies in 2007. These guidelines seek to reinforce the requirement that private sector alternatives be considered by regional departments when preparing country strategy programs based on sector road maps. While these changes are positive developments, the results of the evaluation suggest that, by themselves, such procedural changes alone may not be sufficient to develop strong public and private synergies within ADB. Organizational reforms within ADB may be needed if the rapid realization of these synergistic benefits does not materialize.

Private Sector Operations. ADB began its Private Sector Operations in 1983 and since 2003 the volume of PSOD transaction has grown substantially. Private sector transactions are now an important feature of ADB's operations, rising from 6% of ADB approvals in 2000 to 17% in 2006. A total of 22 private sector projects were approved in 2006 with a combined value of $1.42 billion, including a $455 million complementary financing scheme facility. In recent years, growth in private sector lending has been greatest in Bangladesh, India, Indonesia, the PRC, and Sri Lanka. The sector orientation has changed as opportunities in infrastructure have emerged. The share of infrastructure in ADB's private sector portfolio increased from 25% at the end of 1995 to 42% at the end of 2006. Power projects dominate ADB's private sector infrastructure portfolio. Most transactions have been in the form of senior debt (47%), equity (20%), and complimentary financing scheme instruments (21%). ADB has made virtually no use of subordinated debt instruments. The market demand for complimentary financing schemes (where ADB acts as lender of record for third party commercial lenders) and guarantees has been limited, although these are signs that demand appears to be recovering, at least for complimentary financing schemes.

PSOD's portfolio is profitable and quality appears to be satisfactory, although it is not yet rated by an independent third party such as Risk Management Unit. The capacity of the Risk Management Unit is still limited as it was only made independent in 2005. It is still in its initial period of operations and procedures and there is insufficient skilled staff to meet the volume of transactions. The Risk Management Unit requires further strengthening. PSOD has performed well in growing its portfolio in recent years in response to increasing demands throughout the Asia Pacific Region for non-sovereign support from ADB. While PSOD has been allocated additional budgetary resources and the number of staff has increased, these changes do not reflect growth in transaction volumes. In 2006, OED conducted a benchmarking review of PSOD relative to International Finance Corporation and European Bank for Reconstruction and Development, which confirmed that PSOD is significantly understaffed based on transaction volumes and the size of the portfolio. The limited human resources constrain PSOD's ability to increase the volume and development effectiveness of its transactions, particularly in small countries and in countries with challenging operating environments.

Evaluation of Private Sector Development and Operations. Following the criteria in ADB's *Guidelines for Preparing Performance Evaluation Reports on Nonsovereign Operations* approved in 2007 (the Guidelines), private sector development and operations was evaluated under four main criteria: (i) development impacts, (ii) ADB's investment profitability, (iii) ADB's effectiveness, and (iv) ADB's additionality (the extent to which it is creating value). The evaluation applies to both ADB's private sector development activities and PSOD transactions. Thus the evaluation ratings encompass both the activities of regional departments that took the lead on the enabling environment and PSOD which pursued transactions. The evaluation draws upon the results of a literature review, OED's general body of evaluation evidence, an assessment of ADB's processes to formulate country strategies a review of the PSOD portfolio and operations, and the findings of country studies in the Philippines, India and Viet Nam.

Private Sector Development and Operations was rated "**satisfactory**". Investment profitability and ADB's additionality were rated "satisfactory", while development outcomes were rated as being on the margin of "satisfactory". ADB's effectiveness was "partly satisfactory". The lower ratings reflect the fact that ADB has not realized its full potential to create synergies between its public and private sector operations, rather than systemic problems with the PSOD portfolio. ADB must strive hard to create these synergies to make full use of its potential to help mobilize private sector resources to support socio economic development and to create the jobs that are necessary to reduce poverty in the Asia and Pacific region.

Development Impact was evaluated using the following sub-criteria: (i) private sector development, based on "beyond company impacts" (i.e., impacts of regional department supported reforms on the enabling environment) and "direct company impacts" (i.e. impacts on private investments supported by PSOD); (ii) business performance; (iii) economic development; (iv) contribution to living standards; and (v) environmental sustainability.

Private Sector Development Impact was rated as "*satisfactory".* In the 2006 *Task Force Review* of the *Private Sector Development Strategy* was found to have not been successfully implemented and this evaluation confirms those findings, especially in regard to ADB's support for the creation of an enabling environment for the private sector. While the regional departments took the lead in this area, responsibility for this outcome rests with both the public and private sides of ADB. They have not worked together sufficiently to develop the synergies necessary to achieve a better development rating. The generality of the country private sector assessments and country strategies and lack of specific sector road maps and performance targets in the country strategies prepared by regional departments meant in many cases they were not operationally relevant for private sector development initiatives or private sector transactions. There was a general lack of coordination between the public and private sides of ADB. Apart from the power sector, where unbundling reforms pursued by regional departments created opportunities for private sector, a large proportion of public sector operations focused on sovereign loans designed to provide outputs in response to perceived market failures, rather than strengthening markets and creating entry points for PSOD transactions. Lack of feedback from PSOD to regional departments on critical enabling environment constraints did not provide a counterweight to this development. There was virtually no evidence that efforts were made early in the country strategy process to consider commercial financing options as an alternative to public funding. This was an explicit objective in the *Private Sector Development Strategy*.

More success has been apparent achieving positive direct company impacts in PSOD projects, which were rated as "*satisfactory*". The size of the PSOD portfolio has grown substantially in recent years and it has diversified operations to some frontier countries, rebalanced operations towards infrastructure projects, and created alliances with other agencies. Offsetting these results, the volume of PSOD operations is still low and concentrated in a small number of countries, relative to the International Finance Corporation. Weaknesses in the enabling environment, where reform was under the control of the regional departments, meant there has been a lack of progress diversifying into sectors such as roads and water due to a shortage of well designed concessions issued in competitive markets. There has been limited progress on the use of non traditional finance instruments such as complimentary finance scheme instruments and guarantees. Project evaluations and annual and quarterly PSOD reports confirm projects are profitable, deriving a *business success* rating of "*satisfactory*". Where available, self and independent project evaluation reports have indicated that, in general, the *social and environmental impacts* results of PSOD infrastructure projects were favorable, both leading to a "*satisfactory*" rating.

The second main evaluation criterion, *ADB's Investment Profitability* was rated "*satisfactory*" based on the good overall financial performance of the PSOD portfolio. Profitability is essential for an investment to be sustained, as well as to protect ADB's balance sheet. While the portfolio is profitable, there is need to ensure that quality is protected over the medium term. ADB's non-sovereign portfolio exposure at the end of 2006 to equity was 35.4%, which appears to be high for a bank. The portfolio exposure to the power sector was more than 40%, which exceeds the new 30% sector exposure limit adopted in 2007. Following the Asian financial crisis in 2000, 37% of the PSOD portfolio was rated as marginal or worse indicating that ADB should not be complacent when it comes to risk management, particularly now that the size of the PSOD portfolio is growing. Unexpected developments which are beyond ADB's control can affect the quality of the portfolio. While PSOD has informally applied a ceiling of 30% of the PSOD portfolio for equity, consideration should be given to determining whether explicit exposure limits should be adopted for types of funding modalities such as equity that are based on formal risk management principles.

The third evaluation criterion, *ADB's Effectiveness*, was rated "*partly satisfactory*". This result was due to partly satisfactory performance in (i) ADB's corporate project screening, appraisal, and structuring procedures, (ii) monitoring and supervising practices, and (iii) satisfactory performance in its role and contribution in supporting private sector.

In regard to screening, private sector investments could have been targeted more precisely to fit within clearly defined sector reform programs identified in country strategies. This result arose due to weaknesses in the planning process led by the regional departments and a lack of cooperation with PSOD which was meant to participate and help prioritize private sector development activities and sectors of intervention during the formulation of country strategies. The lack of full PSOD engagement at the country strategy and programming level meant that public sector-led country programming missions were not subjected to any significant internal pressure to consider alternative private sector modalities. ADB did not take any steps to introduce project appraisal techniques to assess the value for money arising from public versus private sector provision. These features, coupled with concerns about the uneven concentrations in the PSOD portfolio, lead to the conclusion that a defined business planning process would have helped the PSOD transactions better support ADB's private sector development objectives at a country level.

Between 1996 and 2005 there were a high number of project cancellations, especially in countries such as India. Problems arose due to factors such as ADB's high cost of funds and problems with regulatory approvals. This experience indicates that there may be issues with due diligence procedures. While these procedures do not appear to be resulting in projects with a high level of credit risks, the large number of cancellations undermines the efficiency and effectiveness of PSOD's operations. Some sponsors interviewed by OED voiced concerns about the lengthy turn around time ADB needed to complete all required internal procedures, document transactions, and reach financial close and disbursement. These problems appear to be arising due to the nature of ADB's business processes that largely reflect a public sector mentality and a lack of harmonization with other international finance institutions in areas such as safeguard policies.

There are concerns about structuring projects, both in terms of the type of assets that are selected by ADB and the financial structures that are provided. This problem is primarily due to ADB's lack of involvement in advisory work at the initial industry restructuring and project design stages, and preparation of bid documents. These activities have been the responsibility of the regional departments, and it has had the effect of dislocating PSOD's business process. Following the Asian financial crisis, it became apparent that concession agreements in sectors such as power, roads and water have sometimes allowed excessive levels of risks to be transferred to the private sector in areas such as tariff, traffic and currency movements. Project failures have effectively reduced the supply of private capital in these sectors. Because the enabling environment has not been improved in the road and water sectors, PSOD has had limited engagement in these sectors. Similar to infrastructure, PSOD does not have control over necessary entry points in the financial sector, that could strengthen targeting and delivery of its services. PSOD has not been provided with the mandate or the resources to introduce reforms to ensure property and financial rights are capable of being enforced and provide a catalyst for financial intermediation.

In regard to funding structures, high levels of equity, and limited use of subordinated debt and guarantees do not appear to be optimal structures. Hybrid forms of finance such as subordinated debt would help address the risk capital needs of clients without compromising ADB's exit options and the need to earn an acceptable return. A fundamental issue is the lack of use of complementary financing scheme and guarantee instruments that can be used to mobilize private resources by mitigating political and credit risks. Guarantee instruments can potentially utilize ADB's capital far more efficiently than conventional debt and equity to mobilize private investment. While PSOD must respond to the demands from its clients when structuring funding facilities the use of guarantees should be encouraged wherever possible. While PSOD is investigating ways of strengthening its guarantee capacity, there has been insufficient progress to date.

PSOD, and more generally ADB, have made progress developing sources of local currency finance. However, there continue to be concerns about pricing of ADB's private sector funding facilities as there is a lack of information on the costs of doing business. PSOD's financial instruments are priced exclusively by reference to the market. It is difficult to achieve an efficient result with this procedure as there is often a lack of market comparators, there are yield curve effects, and risk return effects. The lack of cost data means it is difficult to determine when prices are genuinely market based and financially sustainable for ADB.

Monitoring and supervision have suffered from weaknesses in the organization structure, which is an area that is largely beyond the control of PSOD and responsibility sits with ADB Management. The organization structure, where PSOD reports to Vice-President (Operations 1), does not facilitate effective and efficient project design and administration. The current arrangements introduce unnecessary geographic and administrative barriers and distort management incentives. The combination of project origination and project monitoring responsibilities within PSOD distorts incentives and despite an increase in staff, there is insufficient staff to perform its responsibilities. The lack of an in-country presence for PSOD in most resident missions undermines business development opportunities and places ADB at a competitive disadvantage vis-à-vis other multilateral agencies. PSOD's interface with the Office of Cofinancing Operations (OCO), which reports to a different Vice-President has been problematic.

PSOD would benefit from additional staff with skills in areas needed to define and monitor developmental and socioeconomic impacts of transactions, portfolio management, and management reporting capacity. Reporting systems do not provide a clear indication of development and financial performance or critical risks. Similar to public sector projects, virtually all the private sector project approval documents evaluated during the review period lacked performance indicators. Although PSOD introduced annual reports for monitoring projects in late 2005, only a small proportion of projects has been subject to a full review at this stage due to staff shortages and weakness' in portfolio management systems. Additional investment is required in information systems as the existing systems are manual in many cases, based on distributed systems, and are not secure, creating risks of errors and omissions.

Role and Contribution is concerned with the extent projects complied with ADB's strategies, policies and standards. The rating for this criterion was satisfactory. ADB's presence in transactions is clearly valued by private sector. PSOD was complimented by sponsors on a number of occasions on its efforts to establish standards of high corporate governance in both infrastructure and financial sector projects. In cases when projects encountered difficulties related to government actions, sponsors particularly appreciated ADB's ability to access senior decision makers, in the role of an honest broker, to help resolve the problem. In discussions with various sponsors, they valued the endorsement of project quality that arose through ADB participation, especially in areas such as social and environmental safeguards. At the same time, there was sometimes a lack of clarity in ADB's documentation about why PSOD was involved in particular transactions and the development results that were to be achieved. References to the country strategy for project justifications are often based on general statements such as a need to increase private sector participation in infrastructure, or strengthen financial intermediation. Reports and Recommendations of the President on project proposals present multiple objectives. There is also a lack of clarity on what is required from ADB's safeguard policies and standards which have been changing over time and are not harmonized with other international financial institutions or local government regulations.

The fourth evaluation criterion, *ADB's Additionality*, has been evaluated along two dimensions: (i) ADB's contribution to improving design and functioning of the private sector projects; and (ii) the extent ADB helped support the realization of the projects and mobilized private finance, either directly or indirectly. Additionality was present to a material degree in the majority of the ADB-supported private sector projects that were reviewed. However, a rating of "*satisfactory*" rather than "excellent" has been assigned to this criterion due to the lack of ADB involvement in project design. Given staff shortages, PSOD must largely respond to proposals submitted by project sponsors. Although there have been a few noteworthy exceptions, generally neither the public nor private sides of ADB are involved at the very early phase of the project cycle to identify and design transactions that maximize development impacts. Due to PSOD's limited capacity to pursue enabling environment reforms it operates in a reactive rather than proactive fashion. PSOD would benefit by scaling up its market presence in resident missions, and strengthening its access to technical assistance resources to initiate enabling environment reforms on its own account. In terms of supporting investment, sponsors provided encouraging feedback about the benefits of their involvement with ADB. Some sponsors considered ADB's involvement essential as a means of enhancing creditworthiness and catalyzing commercial funding. ADB's relatively long maturities and grace period were well suited to infrastructure financing. ADB participation provided an important means of ameliorating political risk, especially for tariffs in the power and energy sectors. While private sector projects demonstrate high leverage relative to public sector projects in terms of mobilizing $6.70 dollars of private investment over the period 1996 – 2006 per dollar of ADB funds invested or loaned, the level of resources mobilized to date seems modest relative to the potential.

Issues and Recommendations. Despite strong growth in the size of the PSOD portfolio, many DMCs are complaining that ADB is not responding adequately to this demand. In most countries in the Asia Pacific Region, the private sector's role in financing, managing, and delivering services has increased, particularly in sectors such as finance, energy, transport, and water utilities. Governments are shifting their operational focus to policy and regulatory functions. This trend requires changes in the scope of ADB's operations, as well as greater synergy between public and private sector operations. As discussed in the ADB's *Medium-Term Strategy II*, for 2006–2008, and the presentation of the Private Sector Development Strategy Task force to the Board in 2006, PSOD's role within the context of ADB's overall operations is expected to grow substantially over the next 5 years. The final report of the 2007 *Eminent Persons Group* confirmed this view. It highlighted the importance of economic growth, public private partnerships in infrastructure, and the need to strengthen financial intermediation. This vision requires changes in the roles, products, responsibilities, and organization structure; the level and type of resources; and ADB's organizational structure related to private sector operations. This type of change will not be straightforward. ADB has struggled to find ways of merging public and private sector operations since the early 1980s as it requires changes in culture, organization structures and strong leadership from Management. It is a particular challenge to graft a private sector culture into an organization like ADB that is dominated by a public sector culture. Many corporations involved in merger and acquisition activities have found that merging different corporate cultures is a difficult exercise. It is not surprising that ADB is no exception in this regard.

This evaluation is the first of four related studies. It will be followed by OED reviews of (i) investments in private equity funds, starting in 2007, (ii) private infrastructure portfolio in 2008, and (iii) the effectiveness of strategies for developing an enabling environment for the private sector in 2009. Together, these four evaluations will provide a comprehensive assessment of ADB's private sector operations, and its efforts to improve the business climate in DMCs. Within this context, this evaluation has found that at the corporate level, ADB needs to look at the organizational effectiveness to ensure optimal efficiency in its business procedures and delivery of services. At the departmental level, ADB needs to develop country level business plans within the framework of country partnership strategy for its private sector operations and medium term strategic plans. There are opportunities to further harmonize operations with other similar multilateral development agencies in developing/fine-tuning guidelines and practices for preparing country and departmental level business plans and implementing environment and social safeguard policies and procedures. ADB's aspirations for expanded private sector operations should be accompanied by the resources required to achieve this goal. The following key recommendations are put forward for Management consideration. Further details on these recommendations are presented in the main text of the report (Chapter V).

	Recommendation	Responsibility	Timing
1.	**Corporate Level:** (i) Assess the need for changes in organizational structure supporting Private Sector Operations and Private Sector Development activities such that the potential synergies of the public and private sectors working together are more effectively captured.	BPMSD with SPD, RDs, OCO, and PSOD after completion of the LTSF review	2009/10
	(ii) Establish a permanent unified credit committee that is supported by a permanent independent secretariat. Revise credit committee operations so that it considers risks and returns of transactions. Encourage a more direct and frank exchange of information by meeting on a regular basis, and review projects from concept clearance stage.	VPs and Managing Director General	2008
	(iii) Strengthen the Risk Management Unit in anticipation of a significant increase in non-sovereign lending.	VPs and Managing Director General	2008 and onwards
	(iv) Develop a corporate management plan covering a five year period that aligns resources with aspirations to expand private sector operations, including details on necessary administrative budget, technical assistance resources, staff skill mix, and strengthening supporting functions of risk management and commercial co-financing. Introduce balanced scorecard framework for assessing achievements in private sector operations, drawing on the experience of other similar multilateral development agencies.	PSOD, RDs, SPD, and BPMSD	2009
2.	**Department Level:** (i) Prepare country business plans for delivering private sector operations and private sector development related outputs in the country partnership strategy framework	PSOD and RDs	Beginning in 2008
	(ii) Develop and implement a medium term strategic plan, including new products for supporting private sector and non-sovereign clients, monitorable results indicators, and resource requirements.	PSOD and BPMSD	2008
	(iii) Prepare and implement integrity due diligence guidelines for private sector operations that form part of ADB's anticorruption policy framework encompassing various aspects of corruption, including fraud, money laundering, and financing for terrorism.	PSOD and OAGI	2008

ADB = Asian Development Bank; BPMSD = Budget, Personnel and Management Systems Department; LTSF = Long-Term Strategic Framework; OCO = Office of Cofinancing Operations; OAGI = Office of the Integrity Division; OED = Operations Evaluation Department; RD = Regional Department; RMU = Risk Management Unit; SPD = Strategy Policy Department; VP = Vice President.
Source: Operations Evaluation Department Staff Evaluation.

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I. INTRODUCTION

A. Background

1. The private sector is widely regarded as the engine of economic growth and job creation, and thus a major contributor, albeit indirectly, to poverty reduction in the Asia and Pacific region. The growing recognition of the important role of the private sector in reducing income poverty has led to strategic changes within international financial institutions, including the Asian Development Bank (ADB). International Financial Institutions (IFIs) realize that to provide better services to their clients and increase the probability of achieving development results, they must move away from providing funding to the private sector through state-owned development finance institutions, sharpen the focus of their private sector strategies on strengthening the enabling environment, and increase investments funded through their private sector operations (PSO).

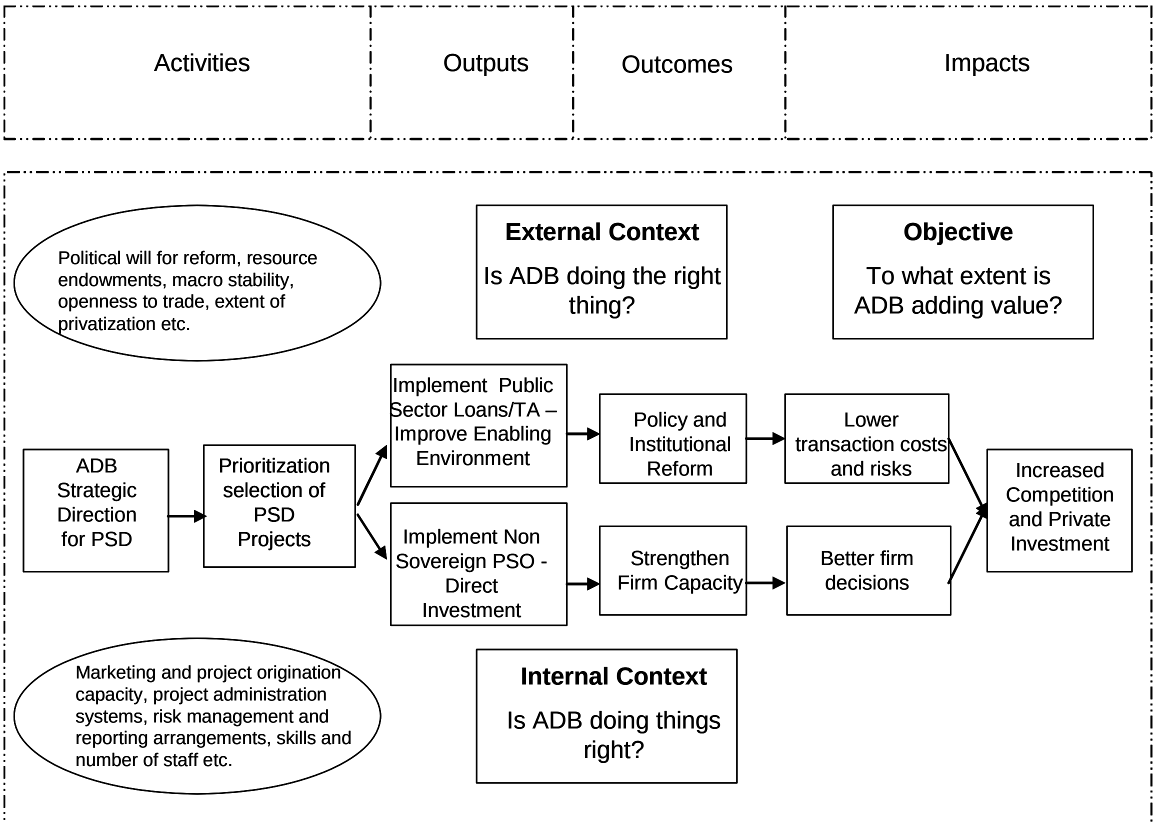
2. ADB designed its 2000 *Private Sector Development Strategy*[1] to help catalyze private investment. The growth of ADB's private sector transaction volumes has accelerated, especially since 2003, reaching $1.5 billion in 2006—more than five times the annual average level of approvals during the 1990s. For 2007, $1.87 billion in transactions are planned. The Development Effectiveness Committee recommended in 2005 that the Operations Evaluation Department (OED) assess the strategic direction and performance of private sector operations. This evaluation is the first of four related studies. It will be followed by reviews of (i) investments in private equity funds in 2007, (ii) the private infrastructure portfolio in 2008, and (iii) the effectiveness of strategies for developing an enabling environment for the private sector in 2009. Together, these four evaluations will provide a comprehensive assessment of ADB's private sector operations, and its efforts to improve the business climate.

B. Study Objectives, Scope, and Methodology

3. The Private Sector Development Strategy was meant to help realize ADB's pro poor growth objectives and catalyze private sector development (PSD) and private sector investment. To capture the effects of this strategy, operations were evaluated over the period 1995 to 2005, five years before and five years after the policy was adopted. This evaluation is designed to determine: (i) the extent ADB is producing the right outputs in its enabling environment and related investments activities to achieve private sector development outcomes; (ii) whether there are opportunities to improve the efficiency and effectiveness of its operations; and (iii) the degree to which ADB's private sector activities are adding value. The conceptual framework for the evaluation is illustrated in Figure 1.

[1] ADB. 2000. *Private Sector Development Strategy*. Manila.

Figure 1: Conceptual Evaluation Framework



ADB = Asian Development Bank; PSD = Private Sector Development; TA = technical assistance
Source: Operations Evaluation Department.

4. This conceptual framework forms the basis of the OED's Guidelines *for Preparing Performance Evaluation Reports on Non-sovereign Operations* (the Guidelines).[2] The way the evaluation issues map onto the criteria and sub-criteria defined in the Guidelines is presented in Table 1.

[2] The Guidelines are based on the harmonized *Good Practice Standards for Evaluation of Private Sector Investment Operations* prepared by the Multilateral Development Bank-Evaluation Cooperation Group and were approved in 2006. Available: http://www.ADB.org.

Table 1: Evaluation Framework and the OED Evaluation Guidelines

Key Questions of the SES:	**Evaluation Criteria based on the Guidelines:**
Is ADB doing the right thing?	Development impact: • Sustainable private sector development • Business performance • Economic development • Contribution to living standards and environmental sustainability
Is ADB doing things right?	ADB's investment profitability, measured by returns from projects ADB's operational effectiveness: • At entry screening, appraisal and structuring work • Monitoring and supervision quality • Role and contribution
Is ADB adding value?	ADB's additionality in terms of improving design and functioning of private sector operations and finance mobilization

Source: Evaluation Approach Paper, Operations Evaluation Department.

C. Report Structure

5. Chapter II provides the context for the evaluation. The findings of a broad-based literature review are presented, identifying trends in private sector investment in ADB's developing member countries (DMC) and important issues. The objectives of ADB's overall assistance program are presented to help clarify the scope of private sector development activities generally.

6. Chapter III reviews trends in ADB's technical assistance (TA) and public sector lending programs, and levels of private sector development activities. ADB's process for coordinating policy dialogue, and preparing private sector assessments and country strategies, is reviewed. Issues that have emerged from previous ADB evaluation studies at the country, sector, project, and thematic levels are discussed. The operations of the Private Sector Operations Department (PSOD) within ADB is reviewed, identifying strategic objectives, trends in approvals, geographic and sector coverage, use of various financial instruments, and portfolio quality. Organization structure, level and type of resources, and reporting and risk management systems are reviewed.

7. Chapter IV appraises ADB's private sector development program, investments and loans, using the four private sector evaluation criteria: (i) development impacts; (ii) ADB's investment profitability; (iii) ADB's effectiveness; and (iv) ADB's additionality. Chapter V summarizes the issues arising from the analysis and provides recommendations for strengthening ADB's operations to help develop the private sector in the future. The detailed findings of the literature review, project evaluation reports, country case studies and the operational review of PSOD undertaken by OED in 2006 are presented in the appendixes.

II. CONTEXT OF SUPPORT FOR THE PRIVATE SECTOR

A. Assessment of Trends in Private Sector Development

1. Background

8. A literature review (Appendix 1) found that over the past decade important shifts have occurred in the views on the best ways for IFIs to support (i) economic development, especially in middle-income countries; and (ii) the private sector. Poverty reduction became the primary objective of many IFIs. The important role that economic growth, job creation, and private sector participation play in reducing poverty has been increasingly recognized.

9. In the mid-1990s, the World Bank presented evidence on the substantial costs that state-owned enterprises (SOEs) impose on countries due to poor incentives, monopoly powers, and preferential access to finance that crowded out private sector. Further, it highlighted the importance of privatization as a means of supporting economic growth.[3] Subsequent studies[4] found that aid in the form of money has a material impact only if it is provided in the context of good institutions and economic policies. Studies[5] have confirmed the central role that the private sector plays in supporting growth, generating jobs and tax revenue to fund the provision of essential public goods. Evidence demonstrated strong links between poverty reduction, economic growth, and private sector development.[6] Studies found that countries with higher levels of private sector investment experience higher rates of growth.[7] In 2006, a British report confirmed the validity and importance of these objectives, and published findings showing the high correlation between growth and poverty reduction. The report noted the private sector is a key driver of growth by creating jobs and higher wages. A vibrant private sector increases national savings, enhances the national tax base, allows higher public spending on basic services such as health and education, strengthens civil society, and encourages broader participation in national development.[8]

10. The encouragement of private investment from foreign and domestic sources has been an important feature of development since the early 1990s. In the 1990s, foreign direct investment (FDI) in infrastructure projects with private participation grew dramatically—in Latin America, sub-Saharan Africa, and Asia and the Pacific. Private investment in projects totaled almost $500 billion from 1990 to 1998, peaking in 1996 and 1997.[9] Developing countries benefited from project finance as a means of financing mining, oil, and gas projects. The use of project finance applications was broadened in the 1990s to include infrastructure, particularly power and telecommunications projects, and a small number of water, sewerage, and transport projects. The type of private participation varied by region. In Latin America and Central Asia, divestiture, often accompanied by market structure and regulatory reforms, was the preferred option. In contrast, new project investments were more common in East and South Asia—for

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3 World Bank. 1995. *Bureaucrats in Business. The Economics and Politics of Government Ownership*. Washington, DC.
4 World Bank. 1998. *Assessing Aid—What Works, What Doesn't, and Why.* Washington, DC.
5 Dollar D. and A. Kraay. 2001. *Growth Is Good for the Poor*. World Bank Development Research Group mimeograph. Washington, DC.
6 United Nations Development Program. 2004. *Unleashing Entrepreneurship.* Commission on the Private Sector and Development. New York.
7 Bouton, L. and S. Mariusz. 2000. Trends in Private Investment in Developing Countries: Statistics for 1978–1998. *Discussion Paper 21*. International Finance Corporation. Washington, DC.
8 House of Commons, International Development Committee. *Private Sector Development, Fourth Report of Session 2005-06, Volume 1.* London.
9 PPI Project Database in Roger, N. 1999. Recent Trends in Private Participation in Infrastructure. *Private Sector Viewpoint Note No. 196*. World Bank. Washington DC.

example, pursuing independent power producers—without associated market reforms to stimulate competition.

Box 1: Private Sector Participation and Poverty Reduction

Privatization has been a common modality used to promote economic growth and poverty reduction. However, critics often have argued that restructuring and movements to cost recovery unfairly affect the poor. Conversely, proponents of reform have argued that resources need to be freed up and used efficiently to allow them to contribute to job creation, tax payments, and economic growth. Similarly, improvements in cost recovery will enhance service delivery and access to critical services, and targeted payments can support the poor. A recent review of privatization experience found the major infrastructure privatizations in Latin America generally increased access to power, telephone, and water services, particularly for the poor. Privatization freed up 1–2% of gross domestic product, providing governments with 5–10% additional revenue. On the other hand, privatization generally was carried out without considering its potential to reduce inequality. Reform focused mainly on reducing the burden of losses to the state, and on attracting new investment. In the transition and Asian economies, the experience has been more mixed, and distributional debates typically focus on infrastructure. In many cases, independent, accountable regulatory regimes were lacking. Evidence indicates that better regulatory regimes—in law and in practice—produce better distributional outcomes of privatization. A practical implication of this finding is that selling governments should spend more time upfront creating and reinforcing regulatory capacity, taking into account the distributional implications of privatization.

A recent Asian Development Bank (ADB) publication examined ways that public-private partnership (PPP) financing modalities can work for the poor. Governments first need to create the appropriate enabling environment for PPPs to work, and then ensure that pro-poor benefits of infrastructure provision are put in place. PPPs can range from service and management contracts to privatization, with many variations in between. Using ADB's experience, the paper suggests four key steps to make PPPs work for the poor: (i) integrate PPPs into the government's poverty reduction strategies, interpret these strategies as forms of "market research", and use them as "marketing opportunities"; (ii) build poverty considerations into the policy setting and process by establishing a PPP framework that includes universal service obligation payments to private providers for delivery of noncommercial services, competitive service delivery, and careful pro-poor tariff policy design (e.g., lifeline tariffs); (iii) put in place pro-poor regulatory designs and enforcement mechanisms; and (iv) design a financing structure that does not asymmetrically allocate financial risks that can weigh heavily on the poor.

[a] Center for Global Development. 2005. *Privatization Reality Check: Distributional Effects in Developing Countries*, N. Birdsall and J. Nellis. Washington, DC: Center for Global Development.
[b] Panggabean, A. T. P. 2006. Expanding Access to Basic Services in Asia and the Pacific Region: Public-Private Partnerships for Poverty Reduction. *ERD Working Paper Series No 87*. Manila: ADB November 2006.
Source: Operations Evaluation Department staff compilation.

11. In addition to providing finance for capital-intensive infrastructure, FDI is an important source of technology, innovation, and international links.[10] FDI has been a major source of capital in East Asian countries such as the People's Republic of China (PRC) and Viet Nam, where it has been encouraged through the creation of special economic zones. While FDI has many benefits, it is a volatile source of funding. Exchange rate risks are created when foreign loans are used to finance projects that generate revenues in domestic currencies. Following the macroeconomic turbulence of the Asian financial crisis, the availability of private infrastructure financing declined dramatically. It is still recovering almost a decade after the event.

12. Delays in the recovery of FDI flows in DMCs have been coupled with an increasing recognition of the value of mobilizing local private resources to support development. Studies[11]

[10] World Economic Forum. 2000. *Building on the Monterey Consensus: The Untapped Potential of Development Finance Institutions to Catalyze Private Investment*. New York.
[11] De Soto, H. 2000. *The Mystery of Capital: Why Capital Triumphs in the West and Fails Everywhere Else*. New York, Basic Books.

indicate the potential value of land and other domestic forms of property held by small and medium enterprises is substantial. These assets provide a far larger pool of resources to finance investment than official development assistance. Studies have found that domestic competition and productivity are potentially more important drivers of growth than investment alone.[12]

13. Traditional official development modalities, such as public sector credit lines for small and medium enterprises (SMEs), often have experienced problems because of inappropriate incentives for lenders and borrowers. Loans can be politically motivated and directed to noncommercial operations. Many state-owned development finance institutions have weak project appraisal and credit risk management systems. Credit lines were often denominated in foreign currency, while SME receipts were in local currency. Frequently, these constraints resulted in high levels of nonperforming loans and poor financial performance of the financial institutions.[13] Similar issues arose with direct public sector provision of monopoly infrastructure, including utilities, due to (i) conflicts of interest between regulatory and commercial functions, (ii) tariffs that are below the cost of providing services, (iii) inefficient operations, (iv) poor maintenance, (v) lack of staff incentives, and (vi) limited access to finance. Lack of competition also can lead to problems with corruption.[14] Many public providers are financially distressed and lack resources to meet demands for expanding access.[15] Because of these issues, development priorities shifted toward helping create or strengthen competitive markets and improve the investment climate to support local investment, rather than directly providing foreign funding support to SMEs through state-owned financial institutions or state-owned and operated infrastructure.

14. Despite the potential offered by market liberalization, coupled with improved access to FDI and local private capital, the persistent shortage of funding for private SMEs and a gap in infrastructure investment have continued in many developing economies. Investment climate studies show that SMEs consistently rate access to finance as a major constraint. For infrastructure, efforts to encourage private investment in telecommunications, power generation, and ports have yielded some success. However, limited investment by private sector in roads and water continues. The UN Millennium Project estimated the current financing gap for businesses at $73 billion per year in low-income countries and $10 billion per year in middle-income countries.[16] A joint 2005 study by ADB[17], Japan Bank for International Cooperation, and World Bank estimated the infrastructure investment needs in 21 developing countries in East Asia at $200 billion per year over the next 5 years, with the PRC accounting for 80% of this total. Financing at these levels is beyond the capacities of governments. Private sector capital must be mobilized.

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[12] World Bank Economic Review. 2000. *It's Not Factor Accumulation: Stylized Facts and Growth Models*. Washington, DC.

[13] OED evaluations have found that the success rates of loans to government owned development finance institutions have been low relative to other sectors. These findings raised questions about whether ADB should continue to finance such loans as most government-owned financial institutions would not meet the criteria specified in Section D of ADB's operations manual.

[14] Moran, T.H. 2007. *Harnessing Foreign Direct Investment: Policies for Developed and Developing Countries.* Washington, DC: Center for Global Development.

[15] World Bank. 2005. *Infrastructure Development: The roles of public and private sectors, World Bank Group's approach to supporting investments in infrastructure*. Washington, DC.

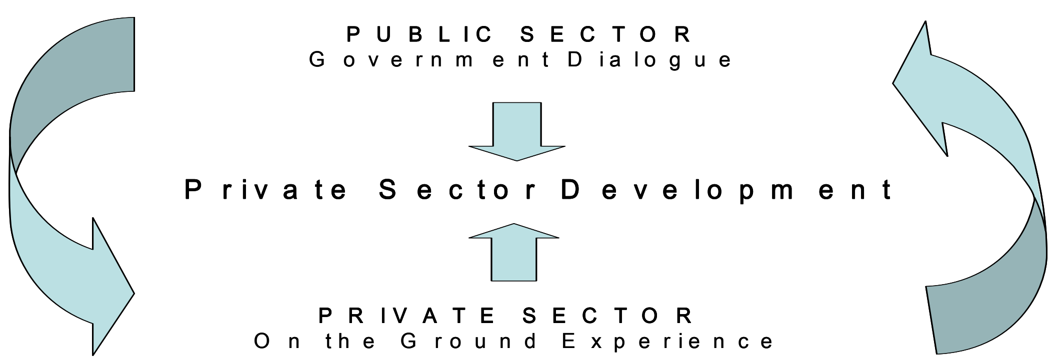
[16] World Economic Forum. 2006. *Building on the Monterey Consensus: The Untapped Potential of Development Finance Institutions to Catalyze Private Investment.* New York.

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

15. While there continues to be serious levels of underinvestment within DMCs, it is apparent this result is not arising due to a shortage of capital in the region. Over the last four decades, there has been a dramatic shift in the way multilateral development banks operate. In the mid 1960s, there was a lack of foreign currency capital in the Asia Pacific Region. Multilateral agencies such as ADB were established to mobilize this capital from members of the Organisation for Economic Co-operation and Development and make it available through sovereign loans to developing member countries. There is now tens of trillions of dollars in funds available in international capital markets and regional banks. The main problem mobilizing funding in the Asia Pacific Region is finding investment opportunities of an acceptable quality that balance risks and rewards. Also, governments are withdrawing from direct provision of services and focusing on strengthening the policy and regulatory environment for private sector. These developments have meant that private sector is becoming an increasingly important client of ADB, and this is a trend that is expected to continue for the foreseeable future.

16. In many cases, money is no longer the core product being sought from ADB. Increasingly, what is being sought from ADB is support for building the enabling environment for the private sector (e.g., rule of law; access to finance; appropriate police/legal/regulatory frameworks) and lowering the risk associated with individual transactions through ADB's involvement. As a result, there has been a shift within ADB to create value for transactions by providing more intangible services such as private sector development, knowledge transfer and risk management. ADB is uniquely placed to provide this combination of services through its base in the region, and presence of public and private sector operations under one roof, creating a "one stop shop" for private sector development and commercial risk management services. Fully exploiting this potential comparative advantage requires development strong synergies between the public and private sector parts of ADB.

Figure 2: Public Sector Strategy and Operations within ADB



Source: Private Sector Operations Department.

B. Objectives of ADB's Private Sector Development Assistance

1. ADB Strategies

17. In line with market trends, ADB's strategies have assigned an important role to the private sector since the late 1990s. Apart from a stable and predictable macroeconomic environment, DMCs need policies, regulations, and institutional capacity that support competitive private investment. While scaling up the number and volume of private sector investments, ADB has sought to strengthen its internal planning processes to address more effectively the multitude of factors that affect the business environment.

18. ADB prepared its first formal private sector strategy paper in 1985.[18] Despite gradual growth throughout the 1990s, private sector operations remained modest in size, with limited internal and external market recognition. Following the Asian financial crisis, the need to mobilize private capital to help build the foundation for economic recovery became apparent. ADB began to recognize private sector development as a strategic priority. In 1999, ADB approved its poverty reduction strategy,[19] which acknowledged the importance of a strong and dynamic private sector for achieving long-term, rapid economic growth and reducing poverty.

19. Promotion of the private sector was one of three crosscutting themes in the *Long-Term Strategic Framework* for 2001–2015. A *Medium-Term Strategy* for 2001–2005 was prepared to implement the long-term strategy. In 2000, ADB prepared the *Private Sector Development Strategy*[20]. Under that strategy, ADB's public sector operations were to increase their orientation toward private sector development, and private sector operations would focus more on development impact. In 2001, a *Review of the Strategic Direction and Operations*[21] of ADB's direct private investment activities recommended the scope of private sector operations be broadened, the level of resources increased, and that a PSOD be established.

20. In 2006, ADB concluded a review of the *Private Sector Development Strategy*,[22] which found that demand for private sector development in the Asia and Pacific region was increasing with the rise of globalization and international integration. A central challenge for ADB was transforming itself from an institution focused broadly on public sector lending into a more regionally focused and agile institution that could meet its overall objective of poverty reduction. Actions to help ADB achieve these objectives included: (i) using more rigorous diagnostic analysis that supported a series of strategic, sequenced interventions based on sector road maps, supported by changes to ADB's policies and procedures to screen and monitor projects; (ii) revising the organization structure; (iii) increasing the level of private sector-related skills in ADB; and (iv) clarifying reporting arrangements. The roles of the Office of Co-financing Operations (OCO) and the Risk Management Unit (RMU) were to be strengthened.

21. The *Medium-Term Strategy II*, approved for 2006–2008,[23] identified five corporate priorities, one of which is catalyzing investment. Private sector operations were upgraded to be a core business activity. In July 2006, ADB's *Strategy for Middle-income Countries* reconfirmed

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[18] ADB. 2005. *Strategy for the Bank's Assistance for Private Sector Development.* Manila.
[19] ADB. 1999. *Fighting Poverty in Asia and the Pacific–The Poverty Reduction Strategy of the Asian Development Bank.* Manila (R179-99).
[20] ADB. 2000. *Private Sector Development Strategy*. Manila.
[21] ADB. 2001. *Private Sector Operations: Strategic Directions and Review*. Manila.
[22] ADB. 2006. *Private Sector Development: A Revised Strategic Framework.* Manila.
[23] ADB. 2006. *Medium-Term Strategy II, 2006–2008*. Manila.

the importance of strengthening PSOD.[24] For much of the past decade, while public sector lending has been stagnant, the demand for private sector operations has been rising. ADB needs to be able to service this demand.

22. The final report of the Eminent Persons Group, issued in April 2007,[25] highlighted the importance of economic growth, public-private partnerships in infrastructure, and the need to strengthen financial intermediation in the Asia Pacific Region.

III. COUNTRY STRATEGIES AND ASSISTANCE

A. Strategic Objectives

23. The *Private Sector Development Strategy* (2000), which defines the framework for ADB's private sector operations, has three strategic thrusts: (i) creating enabling conditions for the private sector and improving the investment climate, (ii) generating business opportunities by considering the scope for private sector participation in ADB projects, and (iii) catalyzing private investment through direct (equity and debt) and indirect (guarantees) financial participation in private sector projects. ADB's public sector operations were responsible for the first two strategic thrusts, whereas PSOD took the lead in directly catalyzing investment. PSOD would support the formulation of the development goals in ADB's country strategy by helping to identify private sector development bottlenecks, as well as issues that needed to be addressed to facilitate private sector participation. The strategy anticipated private sector alternatives and commercial cofinancing alternatives to prospective public sector projects or parts of such projects would be considered at the earliest stages of the development of ADB's country strategies and program.

24. An important feature of the *Private Sector Development Strategy* was the use of ADB's country strategies to link public and private sector planning and operational activities. The country-specific private sector development strategies were to be based on private sector assessments. Their preparations became a formal requirement following the reorganization of ADB on regional lines and introduction of ADB's New Business Processes on 1 January 2002. Country strategies were to be implemented using a balanced scorecard and a set of development indicators. Private sector operations would benefit from a country strategy in which the public sector regional departments would try to improve the business environment. Private Sector Development Specialists were to be recruited and placed in the regional departments to provide advice on private sector development from a public policy perspective. Investment officers in PSOD were responsible for representing the private sector view in country strategy formulation based on their hands-on experience.

B. Public Sector Operations

1. Technical Assistance and Public Sector Lending

25. Public sector operations encompass the provision of technical assistance (TA) and sovereign guaranteed loans. Many of these activities are directly or indirectly supportive of the private sector. TA is used to support a broad array of policy, advisory, and capacity building services. Almost 25% of TA over the period 1996-2006 was allocated to law, economic and

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

[25] ADB. 2007. *Towards a New Asian Development Bank In a New Asia, Report of the Eminent Persons Group to the President of the Asian Development Bank*. Manila.

public policy reforms, all of which should have had positive implications for private sector development. Various public sector loans were designed to (i) strengthen the policy, legal and regulatory environment in the financial sector to improve the efficiency of financial intermediation for banks, non-bank financial institutions, and the capital markets; (ii) remove infrastructure bottlenecks to reduce the cost of transport and provide more reliable supplies of electricity and water; (iii) address externalities associated with air and water pollution; (iv) support policy reforms to improve governance; and (v) improve education and health to strengthen the workforce.

26. All of these types of interventions should have helped to improve the enabling environment for the private sector, although evidence indicates that private sector development was often not a priority. In terms of thematic classification, 9.4% of the public sector loans in 2006 were targeted directly at private sector development reforms. This figure is volatile, being only 3.5% in 2005. Offsetting this result, there are conceptual problems with ADB's loan classification system. Project classifications do not fully capture the indirect private sector development support provided by interventions funded by sovereign loans. For example, programs that support state owned enterprise reforms, governance reforms, privatization, and sector unbundling, all have important indirect private sector development impacts. These types of loans would not generally be recorded as private sector development related interventions in the classification system.

27. To understand what level of public sector operations was dedicated to creating enabling conditions for the private sector and creating investment opportunities for PSOD in accordance with the *Private Sector Development Strategy*, it is necessary to review the individual country level private sector assessments, country strategies and loans and TA programs.

2. Private Sector Assessments

28. The *Private Sector Development Strategy* included a requirement that country-specific private sector development strategies be produced as part of the preparation of ADB's country strategies. Guidelines for Private Sector Assessments were produced in 2003.[26] These documents were designed to be the primary means to develop ADB's private sector strategies and to guide operations at the country level. The guidelines indicated that a private sector development road map would be integrated with the country strategy sector road maps. Private Sector Assessments would be prepared prior to finalizing country strategies discussed with the government, and treated as supplementary appendices of the country strategies that could be obtained on request. In practice, consultation with governments was often limited to a presentation of the related research without any follow up discussion on how changes might be implemented. The assessments were primarily treated as internal ADB documents. OED was able to locate only 14 Private Sector Assessment documents that were published and in the public domain via ADB's web portal (Table 2).

[26] ADB. 2003. *Private Sector Assessment Reference Guide.* Manila.

Table 2: Availability and Scope of Private Sector Assessments

Country	Year	Scope					
		Macro Economy and Competition	Privatization and Property Rights	Infrastructure Public-Private Partnerships	FDI Reform	SME Reform	Access to Finance
PRC	2003	Yes	No	Yes	Yes	Yes	Yes
India	2003	Yes	No	Yes	Yes	Yes	Yes
Cambodia	2003	Yes	Yes	Yes	Yes	Yes	Yes
Vanuatu	2003	Yes	Yes	Yes	Yes	Yes	Yes
Papua New Guinea	2003	Yes	Yes	Yes	Yes	Yes	Yes
Marshall Islands	2003	Yes	Yes	Yes	Yes	Yes	Yes
Samoa	2003	Yes	Yes	Yes	Yes	Yes	Yes
Pacific Islands	2004	Yes	Yes	Yes	Yes	Yes	Yes
Mongolia	2004	Yes	Yes	Yes	Yes	Yes	Yes
Viet Nam	2005	Yes	No	Yes	Yes	Yes	Yes
Uzbekistan	2005	No	Yes	No	Yes	Yes	Yes
Philippines	2005	Yes	Yes	Yes	Yes	Yes	Yes
Solomon Islands	2005	Yes	Yes	Yes	Yes	Yes	Yes
Fiji Islands	2006	Yes	Yes	Yes	Yes	Yes	Yes

FDI = foreign direct investment, PRC = People's Republic of China; SME = small and medium-sized enterprise.
Source: www.adb.org (While Private Sector Assessments were prepared for Viet Nam in 2002 and Indonesia in 2004, they were not published and placed in the public domain.)

29. Half of the Private Sector Assessments that were published were issued in 2003. Six of the 14 Private Sector Assessments were prepared for small Pacific island economies, where the potential for private sector investments in absolute terms is limited. Five additional assessments were only published in 2005 and 2006. Private Sector Assessments are not available for some DMCs in which ADB had substantial operations (e.g., Bangladesh, Lao People's Democratic Republic, Nepal, Pakistan, and Sri Lanka). Only one Private Sector Assessment was available for a Central Asian country (Uzbekistan). Despite the provision of guidelines, the structure of the reports varied widely, although typically the scope encompassed the six main aspects (Table 2) of private sector development. This is not surprising, given the complexity of the subject. Constraints are dynamic and difficult to measure, and ADB instruments have varying degrees of influence on objectives. The main weaknesses were a lack of precise data and the generality of the recommendations. In many cases the lack of road maps meant it was not clear what resource requirements were envisaged, when events should occur, or who was responsible.

3. Country Strategies and Programs

30. Country strategies[27] are the primary mechanism for defining public sector advisory and lending activities. Table 3 provides a summary of country strategies prepared since 2000, and the extent to which they explicitly referred to Private Sector Assessments and private sector road maps. In most cases the Private Sector Assessments did not appear to play any material role in the country strategies. Assessments were mentioned in only five of the 20 country strategies (Cambodia, Papua New Guinea, the PRC, Uzbekistan, and Viet Nam). With the exception of Papua New Guinea, private sector development road maps were not included in the country strategies. The public sector side of ADB prepared the Private Sector Assessments, typically by the governance and finance division concerned, often with little input from other public sector divisions or PSOD. The level of discussion on private sector development and the amounts of public sector assistance identified in the country strategies that would support the development of the private sector was quite high in some cases (e.g., India). However, the assistance to support the necessary reforms identified in the country strategies was absent from project and TA pipelines.

31. In many cases, project descriptions indicate that private sector development-related projects were concerned primarily with constructing state-owned facilities or state-guaranteed credit lines to provide services and funding to the private sector. Few examples were found of specific reforms to the enabling environment to support sustained private sector investment in areas such as competition policy, privatization, or definition of property rights. Similarly, there were limited cases where entry points were created for PSOD transactions. The overall conclusion is that Private Sector Assessments were not used effectively to position ADB strategically to support the development of the private sector in a particular country, or to create synergies between the public and private sector sides of ADB.

Table 3: Country Strategies and Private Sector Development, 2000–2006

Country	Country Strategy Period	Reference to Private Sector Assessments in the Country Strategy	Private Sector Road Map/ Strategy in the Country Strategy	No. of Projects/TAs with Private Sector Development Orientation	Public Sector Funding ($ million) with Private Sector Development Orientation	Sectors with References to Private Sector
Philippines	2000–2002	No	No	2	175	Finance (Capital Market), Transport
Afghanistan	2000–2002	No	No	—	—	—
Viet Nam	2002–2004	Yes (2001)	No	2	135	Finance (SMEs)
Maldives	2002–2004	No	No	—	—	—
Lao PDR	2002–2004	No	No	4	75	Agriculture, Finance, and Communications
	2003–2005	No	No	7	115	Agriculture, Transport, Power, Communications, and Finance
Pakistan	2003–2005	No	No	4	650	Finance (SMEs, Infrastructure),Energy

[27] Country strategies were known as country operational strategies and country assistance plans before January 2002, country strategies and programs from 2002 to 2006, and currently as county partnership strategy.

Country	Country Strategy Period	Reference to Private Sector Assessments in the Country Strategy	Private Sector Road Map/ Strategy in the Country Strategy	No. of Projects/TAs with Private Sector Development Orientation	Public Sector Funding ($ million) with Private Sector Development Orientation	Sectors with References to Private Sector
Indonesia	2003–2005	No	No	10	990	Energy, Transport, Social, Trade, Governance
India	2003–2006	No	No	23	5,210	Agriculture, Finance, Energy, Transport, Governance, Regional Cooperation
Kyrgyz Republic	2004–2006	No	No	3	35	Trade, Education, Finance (capital markets)
Kazakhstan	2004–2006	No	No	4	190	Agriculture, Transport, Water
PRC	2004–2006	Yes	No	8	—	Agriculture, Finance, Energy, Transport, Urban Services
Tajikistan	2004–2006	No	No	1	15	Agriculture
Sri Lanka	2004–2006	No	No	4	290	Industry, Transport, Finance (SMEs)
Cambodia	2005–2009	Yes (2003)	No	2	25	Agriculture, Finance
Nepal	2005–2009	No	No	0	0	Agriculture, Finance
Bangladesh	2006–2010	No	No	1	315	Energy
Uzbekistan	2006–2010	Yes (2005)	No	1	30	Agriculture
Indonesia	2006–2009	No	No	8	2,437	Agriculture, Education, Law & Economic Mgt, Transport, Finance
PNG[a]	2006–2010	Yes (2003)	Yes	—	—	—

— = not available, Lao PDR = Lao People's Democratic Republic, PNG = Papua New Guinea, PRC = the People's Republic of China, SME = small and medium-sized enterprise, TA = technical assistance.

[a] The Country Strategy Program has only one nonlending project for a energy project with a private sector theme (as shown in concept paper), amounting to $500,000.

Source: Asian Development Bank records.

4. Private Sector Development

a. Country Assessments

32. OED has produced nine country assistance program evaluations (CAPEs) since 2000 (see Box 2). A review of these documents indicates a number of common themes related to private sector operations: (i) the country programs did not have a clear strategy that positioned ADB to have a strategic impact in this area; (ii) the public and private sector sides of the ADB did not work together effectively to develop niches and create synergies; (iii) while the regional departments undertook some activities to improve the enabling environment, these efforts were scattered across sectors, not systematic, and generally unrelated to PSOD; (iv) ADB's success in improving the business climate was mixed; and (iv) ADB's indirect contributions to generating business opportunities by considering the scope for private sector participation was largely absent from the country strategies.

Box 2: Country Assistance Programs Evaluations

The 2002 Mongolia[a] country assistance program evaluation (CAPE) found that the Asian Development Bank (ADB) had supported privatization, trade liberalization and competition reforms, and sector restructuring and unbundling (e.g., power, telecommunications, airports, and air navigational aids). Further, the CAPE found ADB had provided extensive technical assistance (TA) support to reform the financial sector. While private sector development support was quite extensive, coordination was a problem due to a lack of guidance on how thematic assessments should be incorporated in programs. The Papua New Guinea [b] and Bangladesh[c] CAPEs found the main form of private sector development assistance had been credit lines for small and medium-sized enterprises (SME), and both programs had been unsuccessful. There had been limited progress in Bangladesh on privatization and there was an intention in the future to strengthen banks. The Cambodia[d] CAPE noted TA had been provided to strengthen the tourism industry, and that the private sector assessment examined strategic options to facilitate SME development. The Nepal CAPE[e] indicated private sector development should become a future ADB priority.

The CAPE for Bhutan[f] indicated that private sector development initiatives needed to be based on a more practical approach, where support is targeted at improving SME access to finance and ways are considered to strengthen data collection, especially in the informal sector. The Indonesia CAPE[g] found that ADB's public sector assistance for private sector development had been directed toward privatization and financial sector reform to help resolve nonperforming loans that had arisen because of the Asian financial crisis. The CAPE noted that further work was required to address enabling environment issues, and recommended the next country strategy identify ways to catalyze private sector investment through regulatory and governance reforms and an increase in the number of ADB's private sector transactions, which had ceased following the Asian financial crisis. An increase in private transactions could be achieved by using risk mitigation instruments and local currency bonds more often.

The Uzbekistan CAPE[h] concluded that, while the country operational strategy identified many possibilities for private sector development, prioritization and specificity on what ADB would seek to achieve were lacking. The country strategy implied that assistance would be limited to ADB-funded private sector transactions. The Uzbekistan private sector assessment had concluded that major impediments to growth of the private sector related to undeveloped financial markets and directed lending through state-owned banks had crowded out the private sector. ADB's private sector support in Uzbekistan had consisted primarily of the provision of credit lines to SMEs, plus a revolving credit facility in the education sector to support the private production of textbooks. Some of these sovereign guaranteed credit lines were not successful, with only 22% repaid as agreed in the original loan agreements, 45% rescheduled, and 25% written off, with the balance being frozen. SME borrowers did not repay loans due to a combination of factors, such as adverse foreign exchange movements and operational problems. ADB had not financed any nonsovereign transactions in Uzbekistan.

The Lao People's Democratic Republic CAPE[i] concluded that ADB's private sector development strategies needed to be strengthened at the sector level, and should encompass both issues within a sector and related factors such as the impact of trade liberalization and access to finance. Private sector development was linked primarily to financial sector assistance targeted at SMEs. Programs focused on strengthening monetary policy; bank regulation and operations; and underlying financial drivers such as land registration and bankruptcy provisions. These programs had limited impact, and were rated partly successful.

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[a] ADB. 2002. *Country Assistance Program Evaluation, Mongolia*. Manila.
[b] ADB. 2003. *Country Assistance Program Evaluation, Papua New Guinea.* Manila.
[c] ADB. 2003. *Country Assistance Program Evaluation, Bangladesh*. Manila.
[d] ADB. 2004. *Country Assistance Program Evaluation, Cambodia.* Manila.
[e] ADB. 2004. *Country Assistance Program Evaluation, Nepal.* Manila.
[f] ADB. 2004. *Country Assistance Program Evaluation for Bhutan.* Manila.
[g] ADB. 2005. Country Assistance Program Evaluation for Indonesia. Manila.
[h] ADB. 2006. *Country Assistance Program Evaluation for Uzbekistan*. Manila.
[i] ADB. 2006. *Country Assistance Program Evaluation for Lao PDR*. Manila.

b. Sector Assessments

1) Power and Energy

33. While the general lack of synergy between public and private sector operations is disappointing, there have been some successes and progress is being made. ADB's experience in the power sector provides some examples of good practices that should be used in other sectors. In 2006, OED evaluated[28] the achievements of ADB's *Energy Policy Review (2*000). Among other things, ADB operations in the energy sector were designed to support: (i) unbundling public sector monopolies; (ii) supporting hydrocarbon and power sector restructuring; (iii) reforming energy pricing policies, tariffs, and energy management; and (iv) strengthen sector governance. The evaluation found: (i) significant progress had been achieved across the Asia and Pacific region unbundling the power sector, a critical first step in creating an enabling environment for the private sector; (ii) restructuring the power sector was often more difficult, and required more time than originally envisaged; (iii) ADB contributed positively to sector reforms in several countries (e.g., Bangladesh, India, Pakistan, Philippines); (iv) after the Asian financial crisis, the availability of project finance from international commercial banks declined due to efforts of some DMCs to renegotiate power purchase agreements and concerns about risks of currency mismatches; (v) despite a decline in international project financing, the level of interest from local private investors and financial institutions has increased; and (vi) ADB's lending priorities have shifted, with nonsovereign lending for generation supplanting public sector lending, which shifted into providing loans for transmission and distribution systems.

34. The *Evaluation of ADB's Energy Policy* concluded: (i) ADB-funded projects and programs in the power sector have enjoyed a considerable degree of success; (ii) the work of the public side of ADB in supporting power sector reform helped to create business opportunities for the private sector; (iii) in many countries, the private sector responded to these new opportunities by investing in the power sector; and (iv) while ADB's nonsovereign power projects have been successful, other private sector energy-related investments have experienced difficulties. These problems included allegations of corruption, particularly in cases of noncompetitively bid concessions, and difficulties with tariff adjustments, especially when the currency had experienced large fluctuations.

35. OED has evaluated ADB operations in the energy sectors in Bangladesh,[29] India,[30] and Philippines.[31] Overall, while the programs were generally successful in unbundling and establishing independent regulators, progress on privatization was slower than expected, especially in transmission and distribution. In the Philippines, the restructuring program and establishment of independent regulators took longer than expected to complete, and some of the bidding processes to privatize assets failed. While the private sector financed many of the independent power producer generation projects in the late 1980s and early 1990s, these concessions were awarded through negotiation rather than transparent competitive bidding procedures. This practice raised concerns in some quarters about the possibility of corruption. The long-term nature of the contracts has delayed sector restructuring to introduce competition,

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[28] ADB. 2007. *Evaluation of ADB Energy Policy 2000 Review*. Manila. (forthcoming)

[29] ADB. 2003. *Sector Assistance Program Evaluation of Asian Development Bank Assistance to Bangladesh Power Sector*. Manila.

[30] ADB. 2007. Sector Assistance Program Evaluation of Asian Development Bank Assistance to Indian Energy Sector, Manila (ongoing).

[31] ADB. 2005. *Sector Assistance Program Evaluation of Asian Development Bank Assistance to Philippines Power Sector*. Manila.

and created substantial stranded costs that contribute to the financial burden of consumers. The Philippines has honored its contracts with independent power producers, although they are a major contributor to the high cost of power in the country.

36. OED has examined several private sector power and energy projects in Bangladesh, the PRC, and Sri Lanka, and they were all found to be successful. However, some of these projects encountered difficulties. For example, in one transaction, ADB could not fulfill its role as a catalyst for further build-operate-transfer projects, because: (i) it lacked a system-wide technical due diligence program, and (ii) the availability of local financing and generation capacity changed. Subsequent to construction, the public sector purchaser threatened to renege on the tariff, and ADB played a key role negotiating with the government on behalf of cofinanciers and mitigating political risks associated with the project. The quality of ADB's due diligence in more recent nonsovereign projects in the energy sector has improved, particularly in generation and fuel transmission-related projects. Despite issues of this nature, the energy policy evaluation found the benefits of ADB's involvement in private sector power projects had extended far beyond its financial contribution. ADB's involvement had supported progress on reform, given confidence to other investors, encouraged the adoption of best practice, and provided important demonstration and risk mitigation effects.

Box 3: Strategies for Mitigating Risks of Corruption

The Operations Evaluation Department's (OED) *Energy Policy Review*[a] discussed the potential for corruption in the power sector, and concluded the Asian Development Bank (ADB) can help to address problems of this type by improving governance in sector operations. The introduction of competition can harness the power of markets to promote good governance. The regulator, in its capacity as an independent legal authority that balances the needs of the consumers and the viability of the suppliers, has a critical role to play in enhancing accountability and limiting risks of corruption. For private sector infrastructure projects the greatest risks of corruption occur at the time of award of concession bids, and then possibly through the tariff adjustment mechanism. These risks can be managed by creating an enabling environment with a transparent process leading to contract award and regulatory functions that are subject to public scrutiny and independent audit.

On a wider scale, ADB addresses corruption through its *Policy on Anticorruption* and associated integrity principles and guidelines that all staff are expected to follow, irrespective of whether they work in the public or private sector. Identical provisions apply to sovereign and nonsovereign loans. The Integrity Division has been established within ADB's Office of the Auditor General to enforce these corruption principles. To date, no cases of corruption associated with nonsovereign loans and investments have been reported.

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[a] ADB. 2007. *Evaluation of ADB Energy Policy 2000 Review*. Manila.

2) Transport

37. Compared to power and energy, ADB has been less successful catalyzing private sector participation in the transport sector, although some progress has been made in the Philippines (Box 4). India has made the most progress developing transport related public-private partnership programs. In other countries, such as Pakistan and the PRC, where OED has prepared transport sector assistance program evaluations (SAPEs), ADB has supported few or no non-sovereign transactions in the transport sectors in these countries. This result is broadly consistent with worldwide experience. While private sector investments have been substantial in airports and seaports—transport modes where ADB has limited to no involvement in most countries—few private transactions have been seen in roads and railways, the modes that dominate ADB's public sector transport portfolio.

Box 4: Manila North Tollways Corporation

In October 2000, the Asian Development Bank (ADB) approved a loan of $45 million without government guarantee, and a $25 million loan under the complementary financing scheme (CFS) for the Manila North Tollways Corporation (MNTC), a special purpose vehicle established to rehabilitate, expand, and operate 83.7 kilometers of the North Luzon Expressway and other related tollways. The sponsors for the project were (i) First Philippine Infrastructure Development Corporation; (ii) Egis Projects S.A., France; and (iii) state-owned Philippine National Construction Corporation, which has exclusive rights to develop road concessions. The Toll Regulatory Board approved the investment proposal in 1996, and MNTC was formed in 1997. Lenders were ADB, International Finance Corporation (IFC), Export Finance and Insurance Corporation, and commercial banks under cover provided by ADB, Compagnie Francaise d'Assurance pour le Commerce Exteriur, Multilateral Investment Guarantee Corporation, and a commercial bank letter of credit.

The project was carried out on a rehabilitate-operate-transfer basis, and the construction contract was competitively bid internationally. The agreement covers Phase 1 and there are two additional phases envisaged, but they did not form part of the project. The project was classified as environmental Category B, as impacts were limited because it was an expansion of an existing road and noise and pollution effects could be mitigated. The project had relatively few social impacts, as most land was already in government possession. The project started operations in February 2005, and financial performance has been in accordance with expectations.

The loans were based on market-derived margins that were acceptable given the risks attached to the project. ADB's operational effectiveness was high, as it was the coordinating bank, leading the technical, financial, and legal due diligence. ADB also conducted contract negotiations under what proved to be difficult conditions. IFC's extensive global experience with tollway projects helped ensure the financing facility was designed well. Traffic risks were mitigated by the shortage of alternative routes and available data on existing traffic flows. Tariff risks were addressed through provisions in the agreement to make automatic tariff adjustments independent of any administrative or public hearing processes. Local currency risk was addressed partially through the tariff mechanism, and some of the debt was intended to be refinanced locally once construction was complete. Overall, the level of ADB additionality was rated excellent.

Source: Operations Evaluation Department Staff compilation.

38. OED's transport SAPE in India[32] focused on roads and railways. The evaluation concluded that transport investment needs substantially exceed the fiscal capacity of the national and state governments. Creating an enabling environment for private investment in the transport sector, particularly for roads, has been a key strategic objective for ADB. Private sector participation has been growing in the Indian road sector. ADB's public sector operations have supported this development by promoting both public private partnerships projects and private sector participation in rehabilitation and maintenance. ADB encouraged private sector involvement by providing sovereign guaranteed funding assistance to private and state owned development banks for on-lending to private sector infrastructure such as roads.

39. A Private Sector Infrastructure Facility was designed by ADB to help support public private partnership schemes in India. An OED evaluation[33] of this project identified a range of issues limiting effectiveness of the facility including: lack of realistic traffic forecasts; resistance to tolls; inappropriate models for public private partnerships; a lack of domestic and international private sector interest; and poorly designed financial structures. One of the participating state owned development banks became insolvent. It proved difficult to find viable projects. Loans were denominated in foreign currency while revenues were in domestic currency, creating a mismatch that reduced demand for these funds.

[32] ADB. 2007. Sector Assistance Program Evaluation of the Transport Sector in India. Manila.
[33] ADB. 2006. *Project Performance Evaluation Report on the Private Sector Infrastructure Facility in India.* Manila.

40. Overall, the Indian transport sector evaluation found the government had moved to address issues undermining the effectiveness of private sector participation in infrastructure by establishing: (i) annuity based public private partnerships contracts; and (ii) a viability gap funding scheme. These mechanisms will help avoid problems with inappropriate allocations of risks to the private sector such as traffic flows and foreign currency movements. The government no longer intends to guarantee facilities such as the Private Sector Infrastructure Facility and the focus will be on non sovereign guaranteed public private partnerships that will be used to finance future roads. Private sector participation has not been a feature of ADB's railway operations in India.

41. In comparison to India, Pakistan is only starting to consider ways of stimulating private sector participation in the transport sector. An OED evaluation of ADB's operations in Pakistan's road sector[34] found that to date private sector participation had been limited to consultancy and construction contracting, and greater private sector involvement was needed as investment requirements exceed the fiscal capacity of the government. Constraints that need to be addressed include the inability of the private sector to obtain long term local finance, political constraints imposing tolls, and lack of capacity within government to design, procure and administer public private partnerships.

42. The findings of the evaluation of ADB's operations in the PRC transport sector[35] were similar to those in Pakistan. While identification of alternative financing mechanisms, including private sector, was a sector priority, private sector participation was limited. The PRC had financed most of its road development programs (70%) by borrowing debt at the local government level, secured against projected toll revenues. Only 1–5% of the financing for expressways was sourced from the private sector, despite significant private sector interest in the first half of the 1990s. ADB's attempts to formulate public private partnership road projects in the PRC were not successful due to problems forecasting traffic volumes. For this reason, the government decided to bear construction and start-up traffic flow risks by financing initial stages of development, and then leasing or securitizing the completed expressways. In line with this model, two publicly financed ADB road projects were part of a package of expressways securitized in the capital markets, and two early local railways financed by ADB were listed on the stock exchange.

5. Finance

43. Country evaluation studies indicate that credit lines for SMEs and infrastructure issued by development finance institutes have been a common feature of ADB's private sector enabling environment efforts. OED has collected data on the performance of development finance institutions[36] and found that excluding loans to Republic of Korea and Singapore, the success rate of ADB supported development finance institutions projects was 38%. Poor performance was due to a range of factors including: (i) weak ownership incentives; (ii) poor assessment of demand for credit; (iii) governance issues including directed lending, weak credit assessment, corruption, and inadequate monitoring. The OED analysis concluded that generally ADB should not lend to government owned development finance institutions, and any exceptions would need to be strongly justified.

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[34] ADB. 2006. *Sector Assistance Program Evaluation of the Transport Sector in Pakistan*. Manila.
[35] ADB. 2007. *Sector Assistance Program Evaluation of Asian Development Bank Assistance for Roads and Railways in the People's Republic of China. Manila*.
[36] ADB, 2005 *Annual Evaluation Review*, Operations Evaluation Department

6. Private Sector Operations Performance Evaluations

44. While weaknesses remain in the enabling environment for the private sector throughout the region, especially in transport, water, and the financial sectors generally, results from the limited number of OED assessments of individual private sector projects usually have been positive. OED has only prepared 13 independent Project Performance Evaluation Reports for private sector projects between 1992 and 2006. The summarized evaluation results are presented in Appendix 2. The evaluations covered power, cement, fertilizer, steel and textile plants, funds, and various financial institutions across seven countries. The transactions evaluated were not selected using random sampling techniques. As a result, the evaluations are not necessarily representative of the full set of private sector projects. The structure of the evaluation reports has varied over time further limiting their usefulness as a reliable indicator of performance. Despite these concerns, the results of the independent OED evaluations indicated most projects were successful and profitable. Of the 13 private sector projects that have been evaluated, 12 were rated "successful" and one (a power plant in the Philippines) was rated "partly successful".

45. This success rate (92%) far exceeds the average success rate for public sector projects, which was 64%.[37] The success rate for private sector projects exceeds the 80% benchmark that ADB has established for successful operations. The evaluation findings reflect a common set of issues, including lack of coordination between public and private sectors; lack of competition; tariff problems; need for foreign currency; difficulties with exit; and, more recently, problems with resettlement. Most of these issues related to problems with the enabling environment and could only be resolved by policy dialogue undertaken by ADB's regional departments and the host country governments. Despite these problems, the overwhelming majority of PSOD's projects have been successful.

46. In 2002, OED undertook a special evaluation study to assess the impact of investment fund operations. The report concluded that 18 of the 29 investment fund operations covered by the study had high or medium impacts at the fund level. For every dollar of ADB investment, the investment fund investments had mobilized $9.00–$41.40 from other sources. While resource mobilization had been high, financial performance had been modest due to the negative impact of the Asian financial crisis. OED intends to begin updating this study in 2007 for completion in 2008.

47. From 1995 through to 2006, PSOD prepared 35 Project Completion Reports that provided self assessments of private sector transactions (see Appendix 2). Of the 35 self evaluation studies, 20 covered financial institutions and the transactions occurred in 10 countries. Project self evaluation studies are slightly different to the OED project evaluation reports as the focus tends to be on lessons learned rather than rating absolute levels of performance. The project self evaluation studies identified problems similar to those set out in the OED project evaluations, although there was greater variability in financial and economic performance. Issues included (i) PSOD's lack of influence over regulatory reform, (ii) lack of independent regulation, (iii) need for reforms to support sector restructuring, (iv) lack of exit mechanisms, (v) foreign exchange risks, (vi) weaknesses in corporate governance arrangements for fund managers, (vii) weaknesses in judicial systems, and (viii) inadequate minority shareholder rights. Similar to the findings of the OED analyses, most of these issues were derived from the enabling environment and could only be resolved by working with the regional departments and the public sector.

[37] ADB, 2006, *Annual Evaluation Review*, Manila

48. The available evaluation reports account for only a small number of ADB's total private sector transactions. This coverage is expected to increase in the future. The following PSOD targets have been set for preparing project self evaluation studies: (i) an increase from 25% coverage in 2005 to 40% in 2006; (ii) 60% in 2007; and (iii) 100% in 2008. In 2007 OED issued *Guidelines for Preparing Performance Evaluation Reports for Nonsovereign Operations* that will guide the preparation of both PSOD project self evaluation studies and independent OED evaluations.[38] The Guidelines will help to improve consistency over time, and across both OED evaluations and PSOD self assessments. Supporting draft Project Administration instructions have been prepared for project self evaluation studies that are based on the Guidelines.

7. Private Sector Development Strategy Review

49. An ADB-wide review of the *Private Sector Development Strategy* in 2006[39] concluded that its objectives were valid and continued to be important. However, a range of internal problems had prevented ADB from fully implementing the strategy. Contributing factors included (i) weak leadership, (ii) lack of readiness within ADB due to insufficient understanding of issues and "buy in" on reforms, (iii) lack of performance indicators and targets, (iv) incomplete operational framework that did not emphasize clearly the role of public goods to create enabling conditions for private sector investment, and (v) confused operational priorities within programs that did not focus clearly on sectors. A wide range of problems are associated with implementation, including: (i) a lack of screening and monitoring mechanisms to check the private sector development content of programs and monitor results, (ii) a lack of focus in country strategies on private sector development, (iii) policies and procedures designed to support the public sector that did not provide entry points for nonsovereign transactions, (iv) weak skills and a lack of incentives to pursue private sector development as public sector staff are rewarded based on the level of public sector loans, (v) inadequate attention to performance management, (vi) a lack of clear accountabilities, and (vii) a lack of collaboration and teamwork across public and private sector operations.

50. These are a formidable list of problems and, together with findings reported earlier about the lack of impact of Private Sector Assessments in ADB's country strategies, they indicate ADB has failed to fully exploit the synergies of having both public and private sector operations in one organization. The logical conclusion from this review is that in the area of private sector development, ADB is not providing the types of services that DMCs, particularly middle income countries, are demanding. To help resolve these issues, the Task Force recommended that: (i) private sector development be established as a core business theme in ADB's *Second Medium Term Strategy*[40]; (ii) country strategy formats and processes be revised to include sector road maps that explicitly recognize private sector; (iii) policies and procedures be revised so private sector development impacts are identified much earlier in the project review process; (iv) review, and where appropriate remove, operating restrictions on nonsovereign lending; (v) clarify internal and external reporting arrangements for sovereign, nonsovereign, and cofinancing operations, and clearly define accountabilities; (vi) develop more market-oriented products and services in areas such as cofinancing; (vii) rebalance skills mix and realign incentives to increase the capacity and willingness to identify and process nonsovereign transactions; (viii) increase independent risk management capacity; and (ix) strengthen client and relationship management responsibilities. These points are generally consistent with many

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[38] ADB. 2007. *Guidelines for Preparing Performance Evaluation Reports on Non Sovereign Operations*. Manila. Available: http://www.adb.org
[39] ADB. 2006. *Private Sector Development: A Revised Strategic Framework.* Manila.
[40] ADB. 2006. *Medium-Term Strategy II, 2006–2008*. Manila.

of the findings of this evaluation. The Board reviewed the Task Force's recommendations, and the President requested senior management in May 2006[41] to implement the proposed actions on an interim basis.

8. Country Partnership Strategies

51. Following the Task Force's recommendations, the President approved new guidelines in February 2007[42] for enhancing country partnership strategy processes. The new guidelines presented the following proposals for strengthening the link between private sector development and non-sovereign transactions: (i) clearly defining ADB's assistance for private sector development in country strategies, (ii) ensuring synergies between public and private operations by incorporating private sector development in sector road maps, (iii) pursuing private sector transactions within agreed sector road maps on a broad sector basis, and (iv) covering sovereign and nonsovereign operations in business plans. The new country strategies will be results-oriented to support design, monitoring, and evaluation of country strategies using an outcome and output results chain linked to individual interventions. The country strategies will be based on sector assessments that identify constraints and opportunities, including those in thematic areas; and estimate medium-term investment and TA requirements.

52. Whether these recommendations will be implemented successfully and the consequential changes result in the delivery of improved private sector development services that clients are demanding remains to be seen. The main areas of concern are the lack of detail regarding what sector road maps will encompass and achieve. The guidelines do not mention development concepts such as transition, liberalization, competition, independent regulation, property rights, supply chains, private sector participation, or use of quantifiable screening measures such as value for money. Concerns remain that the public sector investment objectives of the regional departments responsible for preparing the country strategies will continue to drive the program. No obvious incentives or reasons exist for a regional department to pursue private sector initiatives, given that staff is rewarded for making regional department transactions.

53. PSOD does not have sufficient staff to fulfill the proposal that its staff participate extensively in country strategy processes. The interface between PSOD and regional departments to develop private sector development strategies lacks clarity. The governance and finance divisions in regional departments have traditionally been responsible for private sector development. However, they have limited interaction with infrastructure sectors, where enabling environment reforms such as privatization and public-private partnership designs are meant to be put into effect. The *Second Medium Term Strategy* approved in 2006 has further complicated the situation as it has sought to prioritize sectors, but these priorities appear to be more relevant to the public sector in low income countries rather than private sector operations in medium income countries. For example ADB is expected to exit from telecommunications, airports and sea ports. There would be opportunities for private sector transactions in these areas even if public sector lending was not deemed appropriate. Reforms in key areas for private sector such as law and judiciary, public finance and economic management, and communications, are now categorized as second or third tier priorities.

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[41] ADB. 2006. *Implementing the Revised Strategic Framework for Private Sector Development—Interim Measures.* Manila.

[42] ADB. 2006. *Further Enhancing Country Strategy and Program and Business Processes.* Manila.

54. Given that the *Private Sector Development Strategy* was approved seven years ago, as well as the concerns about the likely success of these reforms to strengthen country programming, more concrete actions need to be taken to ensure the realization of synergies between public and private sectors. At a minimum, a mechanism to monitor progress is needed. Organizational reforms may be needed if the rapid realization of these synergistic benefits does not materialize.

C. Private Sector Operations

1. Strategic Objectives

55. The *2001 Private Sector Operations: Strategic Directions and Review Paper* [43] is the defining strategic document for private sector transactions under ADB's *Private Sector Development Strategy*. The review paper recommended: (i) focusing on infrastructure and capital markets; (ii) developing new areas, such as information communication technology and social infrastructure on a pilot basis; (iii) continuing to focus on middle-tier and larger DMCs, while seeking to extend ADB's reach, where feasible, to transition and smaller economies; (iv) making wider use of innovative financial instruments, such as guarantees; (v) developing strategic alliances and partnerships with other international financial institutions; and (vi) revising ADB's internal controls to increase the maximum amount of capital allocated to PSOD, raise project limits, and streamline procedures for approving restructuring proposals. PSOD staff numbers were to be increased to support more activity, strengthen risk management procedures, and upgrade financial reporting systems. The Private Sector Operations Group was upgraded to a department (PSOD), headed by a Director General who reports to Vice-President (Operations Group 1).

2. Portfolio Evolution

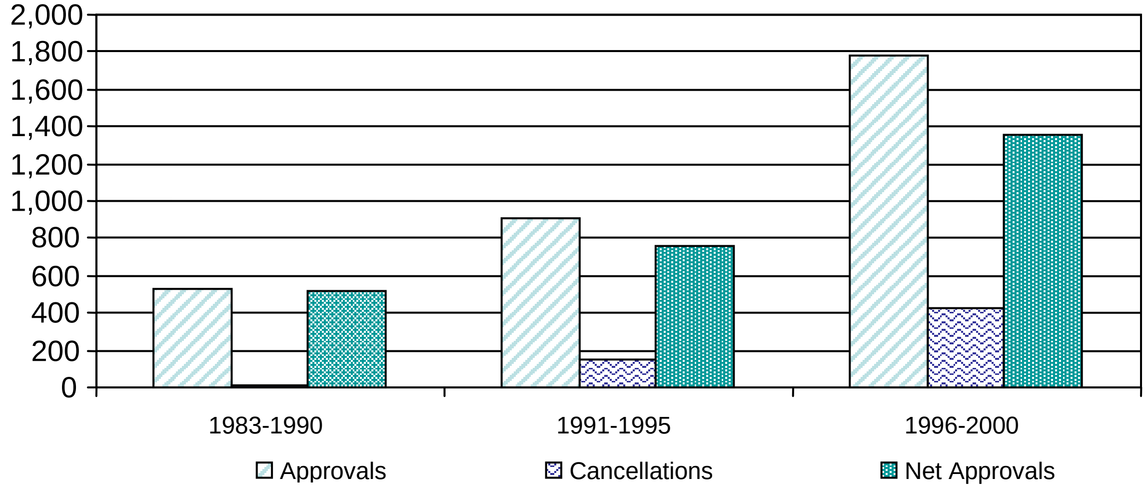
a. Historical Trends

56. ADB's private sector operations began in 1983. The level of activity increased during the latter part of the 1980s following the establishment of a private sector division in 1986 within the Industry and Development Banks Department. The Development Finance Division within the department handled financial sector business, while the Private Sector Division focused on direct investments in manufacturing, agribusiness, infrastructure, and services. In 1989, the two divisions were transferred to a new Private Sector Department, which had three divisions with a geographic focus. Traditional credit lines to government-owned development finance institutions were the dominant business product for this department. In 1994, the Private Sector Division was renamed the Private Sector Group and placed under the Director General leading the public sector-focused Infrastructure, Energy and Financial Department (West).

[43] ADB. 2001. *Private Sector Operations: Strategic Directions and Review*. Manila.

57. During 1983–1990, the Board approved private sector transactions totaling $519.2 million. In the following 5-year period (1991–1995), approvals increased by 48%, reaching $758 million for 61 projects. During 1996–2000, 34 projects with a total value of $1.352 billion were approved—a 78% increase in volume, although the number of projects decreased by 44%. Until the end of 1995, 11% of approvals on average were canceled. The cancellation rate rose to 24% during 1996–2000 (Figure 3). The high level of cancellations during 1996–2000 reflected the impact of the Asian financial crisis and the waning business drive of Private Sector Group following the departmental downgrading. Changes in the organizational arrangements contributed to a lack of focus and an unclear functional identity.

Figure 3: Approved Private Sector Transactions (1983–2000)
$ million

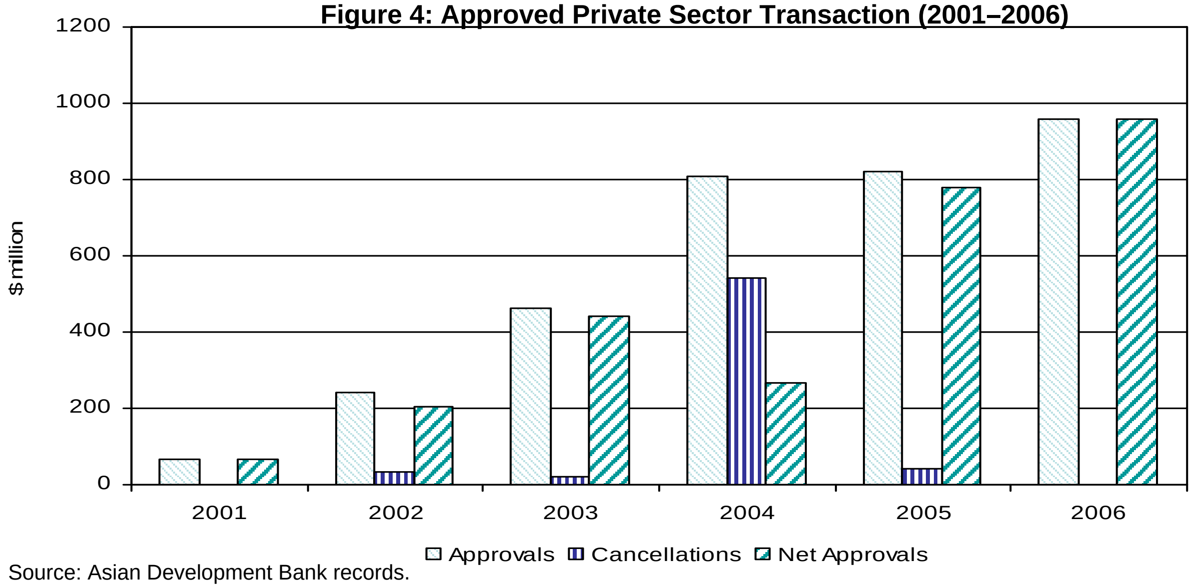


Source: Asian Development Bank Records.

58. Following the approval of the *Private Sector Development Strategy*[44] and establishment of PSOD in 2001 as a department reporting directly to a Vice-President, a new PSOD management team was appointed. The department was restructured and new staff recruited, primarily people from the private sector with commercial banking experience. Not unexpectedly, some time was required before there was a visible impact on business volume. Renewed momentum in transaction volumes was evident by 2003 with the approval of nine projects totaling $462.6. In 2004, 16 projects were approved with a total value of $605.2 million. While a large proportion of approvals from these two years were canceled later, the improved performance indicated a new vigor in PSOD's business activities. The sustainability of the trend was confirmed by the 17 project approvals, totaling $821.5 million[45], in 2005 (Figure 4).

[44] ADB. 2000. *Private Sector Development Strategy*. Manila.
[45] ADB's own account (excluding CFS loans).

Figure 4: Approved Private Sector Transaction (2001–2006)



Source: Asian Development Bank records.

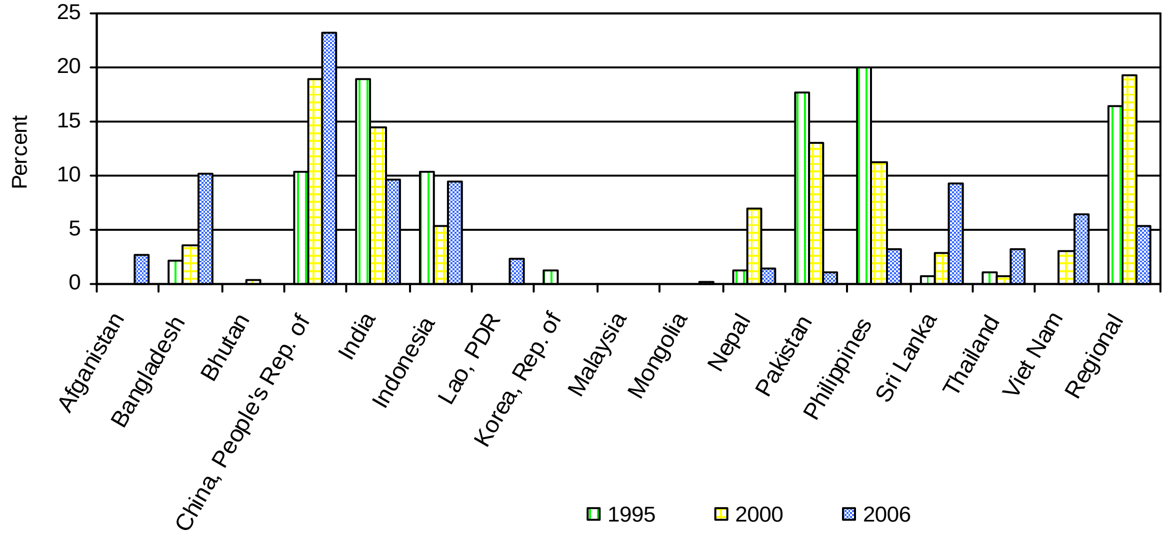
59. Approvals in 2006 increased to 22 projects with a total value of $1.42 billion, including a $455 million complementary financing scheme (CFS) facility. Private sector lending is now an important feature of ADB's total operations. In 2006, PSOD accounted for 17% of total ADB approvals. The corresponding figures, based on net approvals, was 5% in 1996 and 6% in 2000. Cancellations are not a feature of approvals in 2005 and 2006. This result does not mean that projects are no longer being canceled. PSOD is responsible for informing Controllers Department when projects are canceled and recorded as such in PSOD's financial reports. This process can take many years. For this reason, IFC and EBRD focus on committed funds when reporting on performance, although cancellations are an important indicator in its own right.

b. Geographic Trends

60. Details on the distribution of the private sector portfolio across countries are presented in Figure 5[46]. Growth has been greatest in recent years in Bangladesh, India, Indonesia, the PRC, and Sri Lanka.

[46] Disbursed and outstanding at the end of year at market value on ADB's own account.

Figure 5: Distribution of the Private Sector Portfolio Among Countries, 1995, 2000, and 2006



Source: Asian Development Bank records.

61. In 1995, the Philippines had the largest share of the nonsovereign portfolio (20%), followed by India (19%), and Pakistan (18%). By the end of 2006, the PRC had the largest share (23%), followed by Bangladesh (10%), India (10%), Indonesia (9%), and Sri Lanka (9%). The portfolio shares of Philippines and Pakistan (and, until 2006, Indonesia) fell significantly as these countries experienced political or economic difficulties during part of the period under review. In addition to country-specific operations, ADB also supports regional funds. The size of the regional fund portfolio has fallen proportionately and in absolute terms.[47] Under ADB's credit risk exposure limits the maximum country exposure is 25%, indicating that this exposure at any one time tends to be quite high, although over time it has shifted from middle income countries such as Philippines and Thailand to the PRC.

62. PSOD has not made investments in middle-income countries such as Malaysia and Republic of Korea for many years. In 2006, the private sector portfolio was concentrated in a few countries—six accounted for 67% of the portfolio. Many of the smaller DMCs had no transactions. This raises the issue of whether this level of achievement was an adequate response to the *Private Sector Development Strategy* objectives, which called for the expansion of private sector operations to smaller frontier countries with the aim of eventually reaching out to most, if not all, DMCs. The geographic distribution suggests that PSOD concentrated on a few countries with a higher demand to achieve volume priorities, rather than maximize development impacts across DMCs. This conclusion is reinforced by a comparison of the scale of investments and range of countries has approved nonsovereign transactions relative to IFC (Table 4).

[47] From $131.7 million in 2000 (14.1% of the portfolio) to $101.2 million at the end of 2006 (5.3%).

Table 4: IFC and ADB Commitments
($ million)

Country	IFC Commitments[a] as of June 2005	ADB Exposure[b] as of December 2006	ADB Portfolio Exposure (% of Total)	Country	IFC Commitments as of June 2005	ADB Exposure as of December 2006
Azerbaijan	240.5	4.0	0.2	Cambodia	24.2	0.0
India	3,833.7	326.2	12.6	Fiji Islands	27.6	0.0
Indonesia	2,789.8	364.8	14.1	Kyrgyz Republic	52.6	0.0
Kazakhstan	540.2	226.3	8.8	Maldives	72.3	0.0
Lao PDR	7.2	91.9	3.6	Nepal	109.7	0.0
Malaysia	60.3	0.1	0.0	Papua New Guinea	14.5	0.0
Mongolia	10.2	4.5	0.2	Tajikistan	28.0	0.0
Nepal	109.7	28.0	1.1	Uzbekistan	77.9	0.0
Pakistan	1,869.8	21.2	0.8			
Philippines	2,054.4	64.0	2.5			
PRC	2,217.7	546.5	21.1			
Samoa	1.5	0.4	0.0			
Sri Lanka	227.9	177.8	6.9			
Thailand	2,979.3	72.6	2.8			
Viet Nam	444.5	128.0	5.0			
Regional	4,668.3	249.3	9.6			
Total	**22,055.0**	**2,305.6**			**406.8**	**–**

[a] Cumulative commitments composed of disbursed and undisbursed balances.
[b] Exposure is outstanding Private Sector Operations Department portfolio and undisbursed commitments.
ADB = Asian Development Bank, IFC = International Finance Corporation, Lao PDR = Lao People's Democratic Republic, PRC = the People's Republic of China.
Source: ADB. 2005. *IFC Annual Report 2005. Quarterly Report on Private Sector Operations.* Manila.

63. Table 4 indicates that, in theory, more could have been done to diversify the portfolio. While PSOD has some operations in "frontier" countries such as Afghanistan, Bhutan, Lao PDR, and Mongolia, there have been virtually no private sector transactions in the South Pacific.[48] The Central Asian Republics were absent from the portfolio until 2006. Given the opportunities to collaborate with EBRD, which has more than 10 years experience operating in Central Asia, and with IFC, which has also been active in the region, there might have been opportunities for private sector operations in countries such as Azerbaijan and Kazakhstan earlier than 2006.

64. PSOD's sizeable portfolio of regional funds and financial institutions does not mitigate the narrow DMC coverage as the fund managers tend to avoid risky frontier markets unless it has been agreed as a specific fund objective. The limited geographic coverage of the portfolio is linked to staffing constraints. In terms of efficiency of use of staff and volume of transactions, which is the primary incentive for staff on both the public and private sides of ADB, it is more efficient for PSOD to respond to requests for financing from clients operating in traditional countries. Frontier countries can require considerable staff resources to develop transactions that are inherently more costly and risky for PSOD to pursue and subject to much higher failure

[48] There is an ongoing Kula Fund investment for $3.0 million approved in 1997 and a Kula Fund II investment for $4.0 million approved in 2006.

rates. Given the constraints on staffing, it is understandable that PSOD concentrated on building up the size of the portfolio rather than aggressively expanding into frontier countries, although it will inevitably have offset potential development impacts.

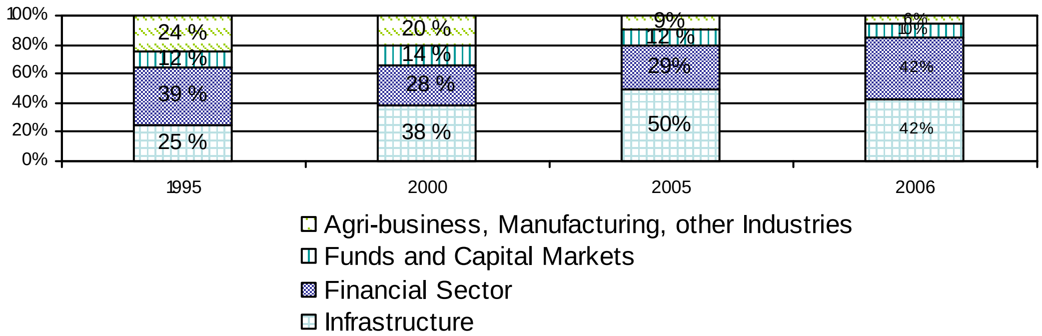
c. Sector Reorientation

65. Until the mid-1990s, private sector transactions primarily targeted the financial and manufacturing sectors. Apart from the power sector, infrastructure received relatively little emphasis. The financial and capital markets in many countries in the Asia and Pacific region were undeveloped, offering few opportunities to mobilize local currency financing. Consequently, apart from investments in equity funds and financial institutions that needed convertible international currencies for their operations, business development focused on manufacturing industries and services with export potential. These direct investments were inherently risky, as they followed ongoing economic liberalization programs where the manufacturing firms became subject to increasing levels of international competition and they lost the benefits of protectionist policies. Further difficulties arose as foreign currency export earning targets could not always be assured. The depreciation of local currency could adversely affect firms, leading to difficulties with currency mismatches and servicing of foreign currency obligations. Several project failures and financial losses were seen in the early stages of ADB's private sector operations, especially following the Asian financial crisis.

66. As opportunities for private sector participation in infrastructure emerged, the portfolio was gradually restructured, a process that accelerated following the approval of the *Private Sector Development Strategy* in 2000. Figure 6 shows the sectoral distribution of ADB's private sector transactions at the end of 1995, 2000 and 2006[49]. The proportion of agri-business, manufacturing and other industries fell from 26% at the end of 1995 to 6% by the end of 2006. While Funds and Capital Market instruments grew in absolute terms, its share of the PSOD portfolio declined slightly. In line with the new strategic emphasis, the share of infrastructure increased from 25% at the end of 1995 to 42% at the end of 2006, with most of these transactions being directed to power generation projects. This exposure to the power sector of 42% is high from a risk perspective, although the figures reported by PSOD are slightly distorted due to recent changes in ADB's non sovereign risk management practices. In April 2007, the Board approved a recommendation[50] that the sector credit limit be raised upwards from 15% to 30% and a new sector classification system be introduced for risk rating purposes. Under the new risk rating system, PSOD is no longer in breach of sector credit limits although it is at the upper limit for power.

[49] Disbursed and outstanding at end of year on ADB's own account.
[50] ADB. 2007. *Review of Prudential Exposure Limits for Nonsovereign Operations.* Manila.

Figure 6: Distribution of PSOD Portfolio Across Sectors



PSOD = Private Sector Operations Department.
Source: Asian Development Bank records.

67. An important positive development that has emerged in ADB's private sector portfolio is the substantial shift away from manufacturing and agribusiness towards infrastructure. This change in sector mix seems appropriate because: (i) financing for manufacturing and industrial facilities can best be left to commercial sources as much of Asia's considerable foreign direct investment occurs in this area; (ii) the long maturities of ADB loans are well suited to infrastructure; (iii) since infrastructure dominates much of ADB's public sector lending, it should be easier to develop synergies between the operations of the public and private sides of ADB; (iv) ADB's ongoing policy dialogue in some infrastructure sectors addresses issues such as the legal and regulatory framework, tariffs and cost recovery and commercialization, all of which help to improve the enabling environment for the private sector; and (v) the access of the public sector side of ADB to senior government decision makers in most infrastructure sectors can be used to help reduce risks and resolve disputes that are commonly associated with infrastructure projects.

68. While good progress has been made in the power sector, there have been limited developments in other sectors such as telecoms, ports, roads, water, and social sectors. The *Second Medium Term Strategy*[51] states that ADB should exit from activities such government administration, telecommunications, and ports. Strengthening of public sector administration would seem to be a core private sector enabling environment initiative to reduce transaction costs and corruption in areas such as taxation, the award of concessions and issuance of licenses through e-government programs. PSOD has made several investments in telecommunications projects in countries such as Bangladesh and Afghanistan. There are few ports in the PSOD portfolio but they would seem to be natural business. These types of facilities are subject to regulatory risks, have large sunk costs, long term funding requirements, and can generate some revenue in foreign currency, partly offsetting foreign exchange risks. Since project evaluation ratings in these sectors are generally satisfactory, presumably the *Second Medium Term Strategy* concluded that ADB should exit from these activities because there has been limited demand in low income countries for public financing in these sectors for the past decade. This approach does not provide a justification for PSOD to withdraw, particularly if it develops capacity to create value by developing entry points for private sector transactions through provision of advisory services in areas such as privatization.

[51] ADB. 2006. *Medium-Term Strategy II, 2006–2008*. Manila.

69. The share of the financial sector in the private sector portfolio grew from 28% in 2000 to 42% in 2006. This change is due to the $75 million Bank of China transaction approved in 2005, and two further bank related transactions in Kazakhstan approved in 2006. Other related activities such as housing and trade finance continue to remain at low levels. The finance sector can potentially play a central role in development. Equity investments in banks have been important components of the development strategies of EBRD, where it is coupled with extensive assistance in the area of legal reform. In ADB this potential does not yet appear to be realized. A critical weakness in the private sector operation for the financial sector is PSOD's dependency upon regional departments to create coherent reform programs, especially in regard to developing credible mortgage, bankruptcy and credit rating systems. Such activities are often not included in the country strategies.

70. There has been a quite rapid growth in the size of the funds and capital markets portfolio over the last three years although ADB's outstanding balance to these types of investments as a proportion of the portfolio in total has fallen from 12% in 1995 to 10% in 2006. Most of this investment has occurred in venture capital funds targeting SMEs. While growth in capital markets was an objective of the *Private Sector Operations Review* (2001), investments in this area continue to be controversial within ADB, including some Board members, due to problems identifying and measuring development impacts and lack of ADB control. OED intends to conduct an evaluation of equity funds in 2007 to help shed some light on this issue. The evaluation of PSOD funds will draw upon the findings of an ongoing OED evaluation of capital markets and an evaluation of ADB's financial sector program loans.

d. Financial Instruments

71. ADB has used eight types of instruments to finance its private sector transactions (Table 5). Senior debt and equity account for two thirds of the portfolio.

Table 5: Cumulative Investment Approvals by Instruments (end of 2006)

Instrument	Amount ($ million)	% of Total
Senior Debt	3,268	47.1
Direct Equity	1,407	20.3
Complementary Financing Scheme	1,433	20.7
Partial Risk Guarantee	714	10.3
Currency Swap	0	0.0
Underwriting	46	0.7
Line of Equity	35	0.5
Subordinate Debt	31	0.4
Total	**6,934**	**100.0**

Source: Asian Development Bank records.

72. The complimentary finance scheme (CFS) instrument accounted for 20.7% of the total portfolio at the end of 2006. This modality, based on IFC's "B Loan," was developed in the 1980s to strengthen the catalytic impact of private sector operations by mobilizing commercial funds to complement ADB's project funding. ADB acts as the lender of record for the commercial loan, passing on its preferred creditor status benefits without taking responsibility for any repayment shortfalls the cofinancier might experience. The envisaged benefits, apart from catalyzing additional investment, were improvements in the terms of the loan by sharing ADB benefits with commercial lenders. The complimentary finance scheme provided tax benefits for lenders in some countries. Offsetting these factors, this instrument is not equally favored by all

co-financiers as they loose their ability to foreclose on a client if ADB does not want to pursue this option and it can create inter-creditor problems. While these issues are important, the main reason for the limited use of this instrument was the reduction in demand for project finance following the Asian financial crisis and the need for greater certainty on risk coverage that could be obtained from other forms of guarantees.

73. Partial guarantees for mitigating political and credit risks have been provided by PSOD since 2000.[52] These credit enhancement instruments have been only moderately successful. By the end of 2006, $714 million, or 10% of cumulative approvals, had been issued in the form of guarantees. In 2004, an innovative $200 million currency swap was pursued with the Central Bank of the Philippines in an effort to access local currency funding. Although ADB approved the facility, the government subsequently decided not to proceed and the swap was canceled. Underwriting is another potential way to leverage fundraising from commercial sources, but it has only been used on a small number of occasions, all of them prior to 1990. The limited level of underwriting services provided by PSOD reflects a lack of incentives and capacity for ADB to sell down new and existing loans and, for that matter, equity investments.

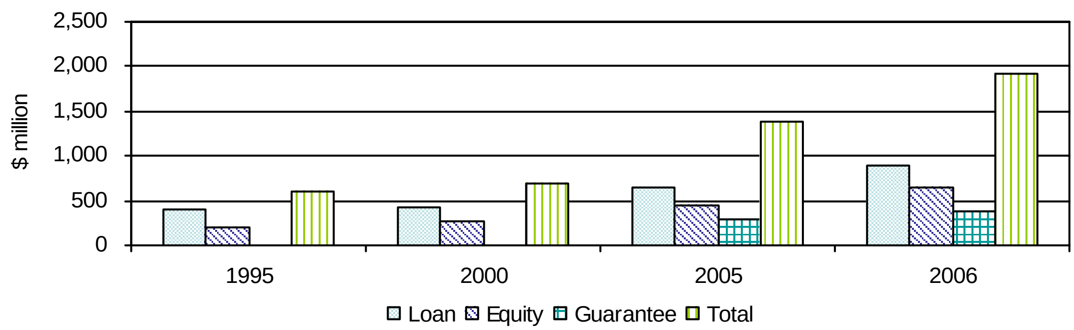
74. Experiments with lines of equity were discontinued in 1991, as ADB had become a direct shareholder with high-risk exposures in many enterprises. ADB had to deal with each of these enterprises individually, especially when problems arose, as occurred frequently. ADB has used almost no quasi-equity products, such as subordinate debt, convertible loans, or other mezzanine instruments. ADB has extended subordinate debt in only three cases for a total of $31 million. This approach might have been taken in part because most infrastructure projects typically rely upon debt, whereas financial sector transactions use equity. Nevertheless, numerous examples are available, especially in infrastructure, of PSOD providing both debt and equity. If ADB provides debt and equity to a single project, it risks a conflict of interest in cases where the views of equity shareholders and lenders differ. If the project experiences difficulties, this divergence of views might be significant. Investors in some of the ADB financed power projects expressed concerns about ADB taking both a debt and equity position. Hybrid instruments can help strengthen the capital base of projects, while allowing ADB to avoid conflicts of interest, and providing it with protection against foreign currency movements and an exit mechanism. This funding modality allows for a more certain pricing structure that is commensurate with the higher risk profile.

75. Figure 7 presents the outstanding portfolio by loan, equity, and guarantee exposures[53]. At the end of 2006, the portfolio was $1.91 billion. Of this amount, $881.9 million (46%) was in the form of loans, $655.8 million (34%) was equity, and $374.2 (20%) guarantees.

[52] Following the *Credit Enhancement Policy Paper* in 2006, ADB no longer refers to “partial guarantees”. It uses the term “guarantees”, which can cover limited risks or be comprehensive.

[53] Disbursed and outstanding at end of year at market value on ADB’s own account.

Figure 7: Evolution of the PSOD Portfolio by Financial Instrument

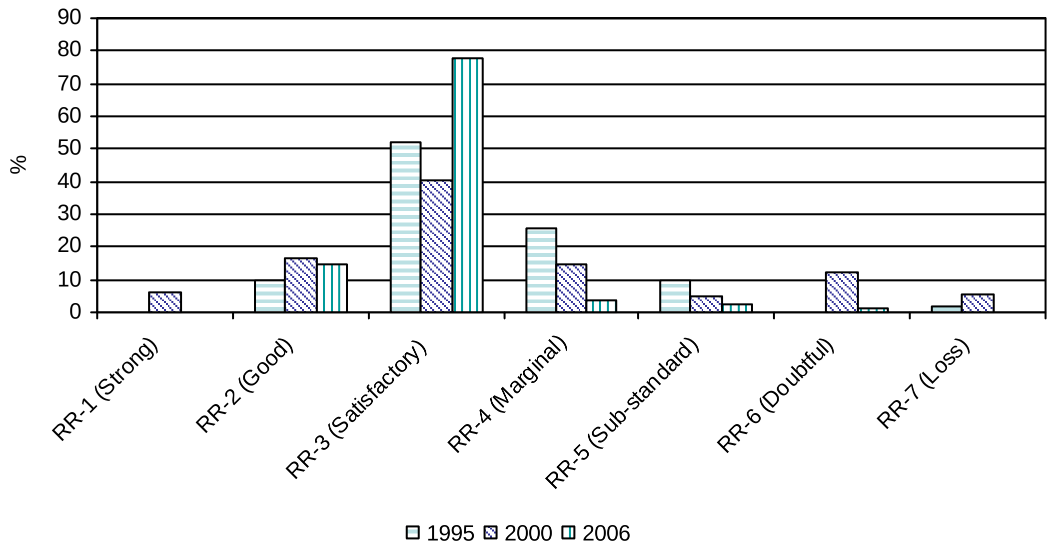


PSOD = Private Sector Operations Department.
Source: Asian Development Bank records.

3. Portfolio Quality

76. Seven risk rating (RR) categories, ranging from RR-1 (strong) to RR-5 (substandard) and RR-7 (outright loss), are used to classify sector transactions. Figure 8 presents the portfolio quality by risk category at the end of 1995, 2000, and 2006.

Figure 8: Distribution of the Portfolio by Risk Categories (1995, 2000, and 2006)



RR = risk rating.
Source: Asian Development Bank records.

77. The quality of the portfolio deteriorated from 1995 through to 2000, reflecting the impact of the Asian financial crisis and the nature of the transactions in the portfolio. In 2000, 23% of investments were rated as good or strong, 37% were marginal or worse, and 41% satisfactory. Following the recommendation of the *Private Sector Operations Review*, in 2001 PSOD established the Risk Management Unit, which began cleaning up the portfolio. These efforts were successful, and the portfolio quality had improved significantly by the end of 2006. The proportion of projects that were satisfactory or better increased to 93%, with only 7% of the portfolio rated as marginal or worse. While this improvement in portfolio quality is encouraging,

concerns about the rigor of this categorization process remain, as PSOD prepared the credit risk ratings for the projects in the portfolio. In line with normal banking practice, where risk management and provisioning is separated from the asset booking unit, the Risk Management Unit was shifted out of PSOD in 2005. However, due to lack of staff the Risk Management Unit does not yet have the responsibility or the capacity to (i) review negotiated projects before signing, (ii) perform post-disbursement project analyses, or (iii) conduct portfolio reviews until loan repayment or equity divestment.

78. As shown in a recent external review of ADB's risk profile,[54] these arrangements vary substantially with those at peer institutions, such as IFC, EBRD, and the African Development Bank. This lack of authority and capacity of an independent risk assessment function, combined with the rapid increase in the size of the non sovereign guaranteed portfolio, represents an important risk exposure for ADB.[55] The external review concluded operational factors constituted the most important risks to ADB. Operational risks relate to issues within a country such as political instability and corruption in procurement agencies, and within ADB to inadequate resources and lack of information to allow decision making in a way that it can manage risks. ADB's risk management functions were lacking in multiple dimensions including weaknesses in risk oversight from the Board by the Audit Committee, misaligned credit risk assessment procedures, and lack of data and portfolio reports. Risk Management Unit was understaffed and lacked certain skill sets.

4. Organization Structure

79. PSOD's organization structure is headed by a Director General. There are two operational divisions consisting of Private Infrastructure Finance and Capital Markets and Financial Sectors. In 2006, the structure of PSOD was revised by: (i) dividing the infrastructure financing division into two subdivisions to mirror the geographic coverage of operations regions 1 and 2 for better alignment with regional departments; (ii) formalizing the operations coordination unit to facilitate increased coordination and collaboration internally (and externally); and (iii) creating a deputy director general position. These changes were designed to support the growth of ADB's private sector transactions, allow PSOD to carry out new initiatives, and support the increasing geographic diversification in frontier and under served countries. Subsequent to this realignment, a safeguard specialist was transferred to PSOD to improve compliance with safeguard environmental and social standards as part of project preparation.

80. Despite reforms to PSOD's organization structure, issues associated with the current arrangements continue to limit the efficiency and effectiveness of its operational performance. The Vice-President (Operations 1), who is responsible for PSOD, also heads the operations of two of five public sector regional departments.[56] This arrangement confuses the setting of priorities and areas of responsibility when considering private sector operations, and introduces geographic constraints. It is not clear that private sector initiatives are pursued with the same vigor in Operations Groups 1 and 2. At the end of 2006 countries in Operations Group 1 accounted for 41% of PSOD's total exposure compared to 59% for DMCs in Operations Group 2. These results are distorted in the Operations 2 region by a small set of large transactions in 2005-2006 in Indonesia, Kazakhstan, and the PRC. In Indonesia, there were no transactions

[54] Ernst and Young. 2006. *Development of An Enterprise-Wide Risks Management Capability, Risk Profiling Benchmarking-Implementation Planning*. United Kingdom.

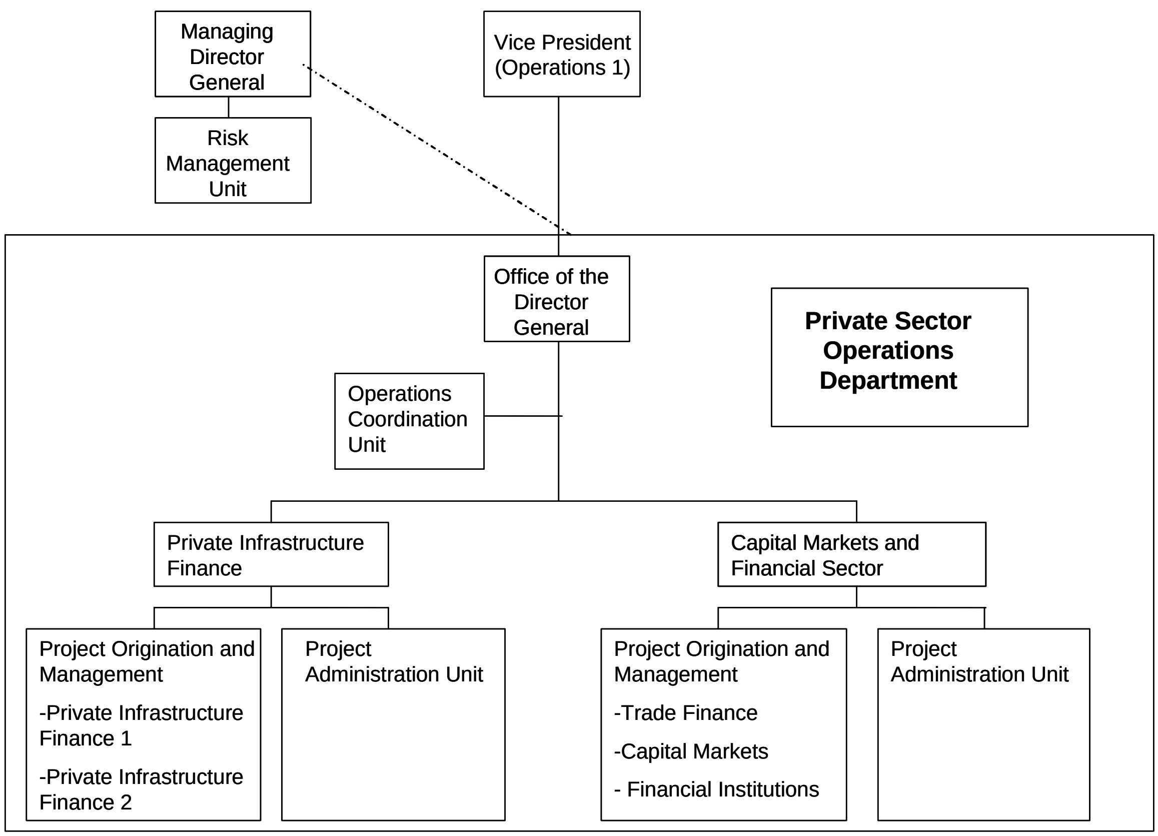
[55] The requirement for risk monitoring capacity is lower for ADB's public sector operations as governments bear the financial risks on transactions. Consequently, regional departments focus on operational aspects and generally do not monitor projects after the project completion report is finalized.

[56] This includes India, PRC, and Thailand resident missions as of end 2006.

from 1998 through to 2005. In Kazakhstan (and more generally Central Asia) there were no transactions approved until 2006 when a former PSOD staff member was made Head of Resident Mission. While the PRC accounted for 21% of the portfolio at the end of 2006, 40% of this amount was related to two investments that occurred in 2005-2006.

81. Lack of in-country representation across all regions compounds these difficulties, with only three PSOD staff being located within resident missions. There are issues associated with the internal organization structure of PSOD and the way in which it manages risk. The rapid growth in transaction volumes since 2003 has placed increasing pressure on PSOD staff and their ability to manage the portfolio. Few PSOD professional staff works exclusively on portfolio administration and restructuring problem accounts in the portfolio. Instead, staff is typically responsible for both project preparation and management, and there is no independent back office function. PSOD is responsible for categorizing and managing distressed assets and financial restructurings. This structure creates a potential conflict of interest. Because PSOD is an integrated part of ADB it does not produce standalone reports covering all aspects of its non-sovereign guaranteed operations, making it difficult to determine the quality and performance of the portfolio.

Figure 9: PSOD Organization Structure



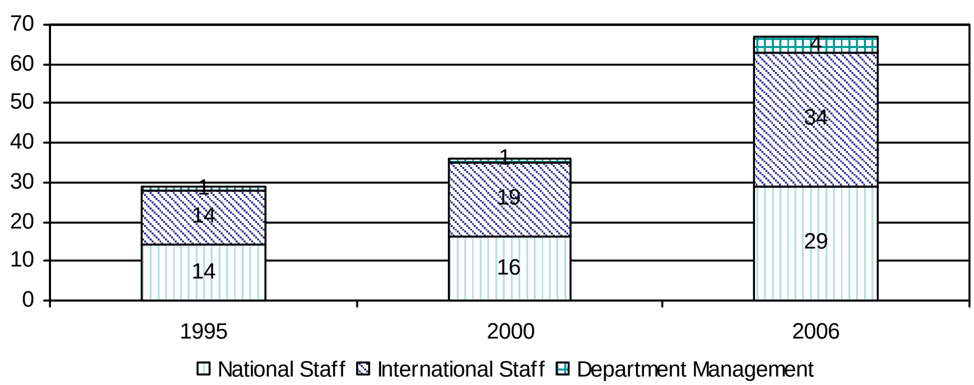
PSOD = Private Sector Operations Department.
Source: Asian Development Bank records.

5. Resources

82. The total number of staff in ADB rose from 1,920 in 1995 to 2,405 in 2006, an increase of 25%. Over the same period the number of PSOD staff positions more than doubled from 29 in 1995 to 67 in 2006 (see Figure 10), an increase of 131%. While the change in PSOD staff numbers was positive, PSOD's volume of approved transactions quadrupled over the same period (and if guarantee instruments were included in this figure it would rise to 717%). The implication that PSOD is understaffed relative to the volume of business and demands from clients was confirmed by a peer comparison with EBRD and IFC undertaken by OED in 2006.[57] The benchmarking study found that PSOD remains understaffed in terms of both processing new transactions and performing portfolio management and administration functions. This result was robust after allowing for differences across institutions in product mix, average project size, overall volumes, and organization structure. PSOD lacks administrative support functions in areas such as planning, legal counsel, treasury, financial control, information and communications technology and human resources. In addition to not maintaining parity with changes in transaction volumes, insufficient staff has been allocated to meet the additional demands of DMCs.

83. As noted in ADB's *Middle Income Countries Initiative*[58] several DMCs have complained that PSOD is under resourced. ADB's traditional approach of tightly controlled, annual incremental budgeting based on historical precedent is not appropriate in a context where there is strong demand. If a strategic choice is made to grow PSOD more rapidly than other parts of ADB, a longer term strategic plan is needed to better align ADB's staff resources with significant changes in corporate priorities. There is a need to address constraints on the likely growth in ADB staff numbers in PSOD and its ability to redeploy positions within the organization between public and private sector operations.

Figure 10: Evolution of PSOD Staffing Numbers



PSOD = Private Sector Operations Department.
Source: Asian Development Bank records.

[57] ADB. 2006. *Annual Report on Loan and Technical assistance Portfolio Performance for the Year Ending 31 December 2005*. Manila. Although, new positions were added in PSOD after that analysis was undertaken, these new positions do not alter the overall conclusions.
[58] ADB. 2006. *Enhancing Asian Development Bank Support to Middle Income Countries and Borrowers from Ordinary Capital Resources.* Manila.

84. The skill mix in PSOD raises concerns. Most PSOD staff does not have experience in sectors such as transport and water, application of guarantee instruments, and economic policy and institutional reforms required to support programs such as privatization. PSOD has few staff with experience analyzing development impacts or the socioeconomic benefits of private sector operations. PSOD has had difficulties accessing safeguard specialists although one person with skills in this area joined PSOD in 2006. Limited attention to these issues, and difficulties preparing coherent Design and Monitoring Frameworks for projects has created tensions between some Board members and PSOD. The departmental annual budget figures reflect a similar trend of under-resourcing (Table 6). The budget for 2006 increased 148% over 1995. ADB's total actual budget increased over the same period by 171% indicating the PSOD budget was adjusted at a slower rate than funding elsewhere in ADB. This result occurred despite the fact that changes in new transaction volumes and transactions under PSOD management were increasing at a much faster rate than the rest of ADB. In 2006, PSOD's staff consulting budget was less than $1.0 million although it did gain access to a $5.0 million TA allocation, an increase from the $3.0 million allocated for the first time in 2005.

Table 6: PSOD Budget Figures (1995, 2000, and 2006)
($000)

Resources	**1995**	**2000**	**2006**
Total PSOD Budget	3,479	4,285	8,637
Of which, Staff Consulting	250	na	950
Technical Assistance Allocation	-	-	5,000

na = not available; PSOD = Private Sector Operations Department.
Source: Asian Development Bank budget, 1995, 2000, 2005.

6. Reporting and Risk Management[59]

85. In 2006, PSOD initiated a system for preparing annual reports on infrastructure projects. This arrangement will be extended to financial sector investments in 2007. There is a consolidated set of annual financial statements prepared for PSOD by Controllers Department but the quality of the information is diminished as the system does not accurately allocate items such as overhead operating costs to PSOD or identify the risk adjusted cost of capital of its projects. The main source of data on PSOD performance is the Private Sector Investment Management (PSIM) Notes that are consolidated in a quarterly report that is appended to a two page covering commentary by PSOD Management. These notes and the annual report do not compare budgets against actual. The project data in the PSIM notes is incomplete, and substantial additional data processing is required to support management decision making. PSOD does not report on development impacts at the country level or in departmental reports. Apart from the PSOD project self assessment reports, formal feedback mechanisms to the Board, Management, and regional departments are not in place. PSOD does not formally report on private sector development constraints that are undermining the performance of projects and identify areas of future reform to strengthen the enabling environment.

86. Reporting arrangements for safeguards appear to be ad hoc, and primarily relate to project processing and approvals. As is the case on the public side of ADB, post-project monitoring to ensure no adverse impacts on environment, livelihoods, resettlement, and indigenous peoples is limited. Credit risk management and reporting arrangements are being revised within ADB; and new risk ratings, exposure limits, and provisioning arrangements are

[59] Further details on these issues are in ADB. 2006. *Annual Report on Loan and Technical Assistance Portfolio Performance for the Year Ending 31 December 2005*. Manila.

being prepared. However, these reforms are only in the early stages.[60] While changes are positive, the Risk Management Unit is experiencing difficulties due to: (i) problems attracting staff; (ii) time required to develop new nonsovereign guaranteed risk management systems from scratch; and (iii) working within procedures that were designed for public sector operations. Progress has been lacking in consolidating and upgrading information systems and preparing reports that help support management decision making regarding performance, risks, and issues requiring corrective action. The Office of Information Systems and Technology plans to consolidate and strengthen ADB's computerized management information systems. However, the program is not clear at this stage, and a detailed assessment of management information needs for PSOD does not appear to have been undertaken.

IV. EVALUATION FINDINGS

A. Overview

87. ADB's private sector development and operations was evaluated following the Guidelines for Nonsovereign Operations and conceptual framework presented in Chapter 1. The overall rating is "**satisfactory**" (see Table 7).

Table 7: Evaluation of ADB's Private Sector Development and Operations

Item	Unsatisfactory	Partly Satisfactory	Satisfactory	Excellent
1.0 Development Impact			**X**	
1.1 Private Sector Development			X	
- Beyond company impacts (improving enabling environment)		X		
- Direct company impacts (catalyzing investment)			X	
1.2 Business Success			X	
1.3 Economic Sustainability			X	
1.4 Contribution to Living Standards			X	
1.5 Environmental Performance			X	
2.0 ADB's Investment Profitability			**X**	
3.0 ADB's Effectiveness		**X**		
3.1 Screening, Appraisal, and Structuring		X		
3.2 Monitoring and Supervision		X		
3.3 Role and Contribution			X	
4.0 ADB's Additionality			**X**	
5.0 Overall Rating			**X**	

ADB = Asian Development Bank.
Source: Asian Development Bank Operations Evaluation Mission.

[60] ADB. 2007. *Review of Prudential Exposure Limits for Nonsovereign Operations*. Manila.

88. Investment profitability and ADB's additionality were rated "satisfactory", while development impacts of private sector operations were rated as being on the margin of "satisfactory". ADB's effectiveness was rated "partly satisfactory". The lower ratings reflect the fact that ADB has not realized its full potential to create synergies between its public and private sector operations, rather than systemic problems with the PSOD portfolio.

B. Development Impact

89. Development impact was evaluated using the following criteria: (i) private sector development including beyond company impacts (i.e., impacts on enabling environment) and direct company impacts (i.e., impacts of private investment); (ii) business performance; (iii) economic development; (iv) contribution to living standards; and (v) environmental sustainability. Overall the development impact of private sector operations was rated as ***satisfactory***.

1. Private Sector Development

a. Beyond Company Impacts

90. This criterion refers to factors such as expansion of the private sector, increasing competition, strengthening industry linkages, improving laws and regulations and creating sound contractual frameworks. There is a lack of data on the linkage between outputs and their impact on the private sector operations. ADB reports, including OED evaluations, PSOD reports and country case studies, were the main sources for information for the evaluation. The rating for this criterion is **partly satisfactory** as the evaluation found that ADB has not realized its full potential to create synergies between its public and private sector operations to improve enabling environment and to mobilize private sector resources to support socio economic development in DMCs. Table 8 presents some examples of where there was good cooperation between regional departments and PSOD. Cooperation is most apparent in the power and energy sectors and in these circumstances the results were often very successful. However, in general, regional departments and PSOD have not worked together sufficiently to develop the synergies necessary to achieve a better development rating.

Table 8: Examples of PSOD Projects Originated by Regional Departments

Country	Project
Bangladesh	AES Meghnaghat Power Project
India	LNG Petronet Dahej Liquified Natural Gas Terminal Tala Delhi Transmission Project
Mongolia	Trade and Development Bank
Pakistan	SME Guarantee Facility
PRC	Chengdu Water Supply Project

LNG = Liquefied Natural Gas; PRC = People's Republic of China; PSOD = Private Sector Operations Department; SME = small and medium-sized enterprise.
Source: Operations Evaluation compilation.

91. As discussed in Chapter III, OED's review of country strategies indicates that private sector was not generally a material feature. Private Sector Assessments and country strategies were meant to be the main instruments guiding the implementation of the *Private Sector Development Strategy* and identifying ways to improve enabling conditions. These reports were found to be ineffective instruments to achieve this objective. The lack of focus on road maps and private sector alternatives meant country strategies and private sector assessments often had little relevance for private sector operations. The 2006 *Task Force Review* of the *Private Sector Development Strategy* found the strategy had not been successfully implemented and this evaluation confirms those findings, especially in regard to creation of an enabling environment for the private sector.

92. A review of private sector project evaluation reports found that PSOD had limited influence on the enabling environment. This result is not surprising as the *Private Sector Development Strategy* formally assigned responsibility for strengthening the enabling environment to regional departments and PSOD did not have the mandate or the resources to perform this task. There are a number of examples where problems arose with tariffs in ADB-supported transactions, and PSOD and regional departments were able to work together to gain access to policy makers to mitigate some of the negative financial consequences for private sector clients. Mechanisms were not put in place to systematically feedback PSOD's experience at the transaction level to broader policy dialogue undertaken by the regional departments to improve the business environment.

93. The country case studies (see Table 9 and Appendixes 4, 5 and 6) indicated there was insufficient activity strengthening the enabling environment for the infrastructure and finance sectors. There was a lack of activity in areas such as establishing public private partnership procurement capacity in sectors such as roads and water. In many cases the realization of ADB's private sector development and poverty reduction objectives seemed to be equated with trying to improve SME access to finance by providing credit lines to government owned financial institutions rather than strengthening the enabling environment and supporting PSOD participation in a wider range of transactions. Alternatively, the focus was on capital market development, even when banks continued to suffer serious problems securing debt and bond markets were years away from being likely sources of private finance. While there were exceptions, this is a narrow focus, especially when non performing loans continue to be a fundamental constraint for banks across Asia.

94. Despite bankruptcies following the Asian financial crisis, limited work was done by the public sector side of ADB in areas such as property rights, secured transaction registries, and mortgage and bankruptcy laws. These areas are fundamental to building an enabling environment for the private sector and providing the basis to moving to capital market development. An important exception was Viet Nam, but it is not clear what level of success has been achieved and there was a lack of follow through in the form of financial sector investments. In the India and Philippines, PSOD has sought to catalyze programs to address the non performing loan problem, although these efforts were not supported by any prior enabling reforms put in place by the regional departments.

Table 9: Private Sector Development Operations in Case Study Countries, 1995-2005

Activity	Philippines		India		Viet Nam	
	Public	**Private**	**Public**	**Private**	**Public**	**Private**
Public Administration[a]	-	-	Some reform to judiciary and executive at state level. No assistance on privatization, or strengthening property rights.	-	Strengthened executive. BOT Law. No direct involvement in privatization or strengthening the Public Private Partnerships. Unit or property rights.	-
Power and energy	Extensively involved in unbundling and regulatory reform.	Funded Independent Power Producers Several Private Sector Operations transactions pending.	Extensively involved in unbundling and regulatory reform in some states.	Transactions in generation, and a liquefied natural gas project.	Involved in sector restructuring and transmission.	Two pioneering power projects contracts.
Transport	Limited activity	Manila road tollway. Tried to support Private Manila air terminal.	Substantial involvement in road programs and some rail.	-	Substantial involvement in road programs.	-
Water and Urban Development	Unbundling Manila Water to create two concessions.	Tried to participate unsuccess-fully in Maynilad Water.	Substantial housing assistance programs.	Small number housing projects unrelated to public sector operations.	Developed water resource management system.	Tried to participate unsuccess-fully in water concession
Finance	Capital markets reform and SME credit lines.	Small number of Non Performing Loan transactions unrelated to Regional Department operations.	Capital markets reform, and infrastructure and SME credit lines.	Banks and Equity Funds main activities. Transactions unrelated to Regional Department operations.	Financial sector reform focusing on restructuring Banks and Non Bank Financial Institutions and providing rural credit lines.	-

SME = small and medium-sized enterprise.
[a] Refers to activities such as fiscal and judicial reform, competition, privatization, property rights, foreign direct investment and public private partnership capacity building.
Source: Operations Evaluation Department staff compilation.

b. Direct Company Impacts

95. Direct company impacts are concerned with assessing the influence of ADB's private sector investments and loans on private sector development by stimulating investment due to factors such as demonstration impacts and transfer of technology. The rating for this criterion is ***satisfactory***.

96. The independent country, sector and project evaluations conducted by OED and self assessments by PSOD are the primary source of data on individual project impacts. The results of these studies indicate the projects have generally been successful once they have been implemented. An overall project success rate of 92% is high compared to public sector success rates. A review of the project evaluations in Appendix 2 indicates that demonstration effects were an important feature of many projects. Projects such as Petronet LNG Limited, Nghi Son Cement Limited, Fujian Pacific Electric Limited were all able to demonstrate the introduction of new technologies and approaches in areas such as governance, marketing, production, complying with social and environmental standards and good community relations. Foreign sponsors were able to bring in new skills and help train up local workforces.

97. PSOD's self evaluations report similar findings. Projects such as Grameen Phone and its role in bringing telecommunication services to the poor have had an international impact in terms of demonstrating what can be achieved by bringing these services to the poor. The Colombo Port is helping revive critical infrastructure that will potentially have spill over effects for the whole economy, and could not easily be financed by the government due to fiscal constraints. The National Development Bank Housing Bank project provided important demonstration effects in the area of improving access of the public to housing, although the project has suffered from weaknesses in the enabling environment due to problems enforcing mortgage laws. The Bhutan Bank project brought international financial services to a remote and under-developed economy.

98. While these impacts were positive, there were some issues, especially among the financial sector projects. These problems appear to have been associated with the Asian financial crisis and arose in areas such as legal property rights that undermined development potential. Similarly, the early industrial sector investments often ran into financial difficulties and did not have a sustained positive influence on development. PSOD has, appropriately, exited from the latter line of business.

99. As part of this evaluation, rapid project assessments over the period 1995-2005 were conducted in the three case study countries. Table 10 provides a summary of performance. Overall the results were positive. Further details on the projects are presented in Appendices 4, 5, and 6.

Table 10: Project Performance in Country Case Studies (1995–2005)

Country	Number Projects Canceled	Number Projects Unsatisfactory	Number Projects Satisfactory	Number Projects Excellent	Total Number of Projects
Philippines	3	2	3	3	**11**
India	9	1	9	3	**22**
Viet Nam	2	0	2	3	**7**

Source: Operations Evaluation Department staff compilation.

100. The Manila North Tollway Corporation project was the only infrastructure project in the Philippines approved and implemented over the period of analysis. The complimentary financing scheme was successfully used to catalyze additional funding for the project, which contributed to overall development impact. The success of the project helped demonstrate the feasibility of public private partnership structures in the road sector. The transaction is replicable and further private road projects are being processed by the government. Given the limited amount of successful public private partnerships in the road sector worldwide, this outcome is positive. The majority of private sector transactions pursued in the Philippines was in the finance sector, encompassing a peso swap that was cancelled, three investments that together were designed to help resolve the non performing loan problems of PCI Equitable Bank and National Housing and Mortgage Company, and establish a credit bureau. While these transactions were small and have only recently been put in place, it appears likely they will have important positive developmental impacts and will help to demonstrate the non performing loan problem in the Philippines can be resolved.

101. In India, the emphasis on infrastructure in ADB's country strategy was not fully reflected in the level of private sector operations. The country strategies repeatedly called for innovative infrastructure financing solutions to help catalyze additional investment using mechanisms such as credit enhancement facilities and financing public private partnership infrastructure projects. In practice, ADB was not directly involved in these types of transactions over the period of analysis as few projects were developed that were financially viable. PSOD focused on financial institutions in India, and in some cases the purpose of this funding was to develop infrastructure. The performance of individual projects in India was generally satisfactory, with three projects being ranked excellent, nine satisfactory and only one small investment ranked as unsatisfactory (see Table 10). ADB made an equity investment in Petronet LNG Limited, the first private sector LNG terminal in India. Other investors have replicated this type of project, indicating the project model is robust and it had an important demonstration effect. A local currency loan made to Tala Delhi Transmission Limited supported a project transmitting electric power from Assam to Delhi. The transmission project was pioneering as it was the first private power transmission project in the Asian region. Private sector transactions in the capital market were developmental and investments appeared to have a positive impact on the enabling environment.

102. In Viet Nam, there was some consistency between the priorities identified in the country strategy and private sector transactions. However, two projects with potentially high developmental impacts were cancelled (i.e., Viet Nam Leasing Company and Lyonnaise Viet Nam Water Company). Of the remaining five projects, three were ranked excellent for private sector development impacts and two satisfactory. In volume terms, two power projects and a cement factory dominated the Viet Nam portfolio. The two power plants are performing an important role servicing the growing electricity demand in Viet Nam and have had strong demonstration impacts. Nghi Son Cement Company has been a pioneer satisfying the demand for cement. RMIT International University of Viet Nam is performing well. There has been a

good effort in Viet Nam catalyzing additional funding from third party commercial sources using the complimentary financing scheme and partial risk guarantee instruments.

2. Business Success and Economic Sustainability

103. Business success and economic sustainability are specific to investee companies and are concerned with sustainability. The rating for both criteria was ***satisfactory***. The quality of the portfolio from a risk rating perspective indicates the financial performance of the underlying projects has improved, following problems that arose in the aftermath of the Asian financial crisis.

104. OED's *Evaluation of the Energy Sector Policy* (2007) found that ADB-supported private sector projects in this sector were generally profitable and performing well. In a number of countries there had been problems with tariff adjustments, but ADB participation had played an important role resolving these types of issues. There are relatively few examples of PSOD projects in the road sector, although the Manila North Tollway is performing well. In the water sector, ADB financed the Chengdu Generale Des Eaux-Marubeni Waterworks Company, which was the first water concession awarded under competitive bidding in the PRC, and it is operating satisfactorily.

105. In the project evaluation reports, the financial internal rates of return ranged from 6.1% to 39.5%, and the economic internal rates of return ranged from 12.1% to 38.8%, with no obvious trends across countries or sectors. While these are satisfactory business and economic outcomes, the performance indicators can only be regarded as indicative due to the small number of projects that have been evaluated. In project reviews in the country case studies the focus of analysis was primarily on project profitability, with a qualitative assessment of whether there were market distortions or externalities that might impact on economic returns. In the Philippines financial and economic performance was mainly satisfactory, with only one investment in an industrial enterprise experiencing financial difficulties. This result was due to the nature of the sector, coupled with the negative effects of the Asian financial crisis. In India, portfolio quality moved from 77% of projects being rated satisfactory or better in 1995, to 45% in 2000, to 75% in March 2006 indicating financial performance was now satisfactory. In the limited number of infrastructure projects, the results were positive and exceeded financial returns. There was only one project in the banking sector that experienced serious financial difficulties, although ADB was able to play a major role in restructuring the enterprise and achieving a profitable exit. In Viet Nam the financial and economic returns over the period of analysis were excellent or satisfactory.

3. Contribution to Living Standards and Environmental Performance

106. Living standards and environmental performance refers to project externalities and the level of compliance with the social and environmental safeguard policies of ADB and governments. The rating for both these criteria was ***satisfactory***. Because of the limited information on the social and environmental impacts of PSOD transactions, the evaluation relied heavily on the country case studies.

107. Employment and tax data are not typically collated and published by PSOD, and formal reports on social and environmental impacts are typically limited to compliance with agreed resettlement programs. Project evaluation reports only consider these issues for infrastructure projects, and then primarily in terms of compliance. Social and environmental impacts of sub-investee companies of financial intermediaries are difficult to identify. PSOD was

only assigned a safeguard specialist in late 2006. While progress is being made, safeguard reporting arrangements are not yet well developed. This lack of information on social and environmental impacts represents a gap in PSOD's management reporting system. In the limited number of projects where detailed social and environmental data has been collected, there has typically been a positive social outcome. However, project evaluation reports indicated there may be some issues arising in regard to resettlement.

108. In the Philippine case study, there was only one infrastructure project closed, and the overall impact was highly favourable. The Manila North Tollway carried increased volumes of traffic and reduced traveling times, leading to a reduction in vehicle operating costs and emissions per kilometer over that stretch of road. The non performing loan and credit rating agency transactions should help contribute to better social living standards by improving SME access to finance, which will help create employment and improve profitability.

109. In India, the Petronet LNG project plays an important role servicing India's large and growing demand for clean energy and supplies 20% of the LNG gas that is used to fuel taxis and buses in major urban centers in India and to industrial commercial users (Box 5). The use of gas rather than oil by vehicles has caused a dramatic reduction in the level of pollution in major cities in India. Petronet LNG contributed to positive social impacts by investing in local road, water, and power infrastructure. During the 3 years of construction, an average of 700 new jobs was created, and when operations commenced 390 jobs were created. The Tala-Delhi transmission project transports clean hydro generated power to Delhi, removing the need to construct more polluting forms of thermal power. ADB's support for housing finance in India has had important positive social benefits.

Box 5: Equity Investment in Petronet LNG Limited

In December 2003, the Asian Development Bank (ADB) approved (i) an equity investment in Petronet LNG Limited (PLL); and (ii) a partial credit guarantee, without government guarantee. The funds would be used to construct and operate a liquefied natural gas (LNG) import and re-gasification terminal with a capacity of 5 million metric tons per year at Dahej, Gujarat. The project would serve gas users along the 2,500-kilometer Hazira-Bijaypur-Jadgishpur pipeline covering Gujarat, Western Madhya Pradesh, Rajasthan, Delhi, Haryana, Western Uttar Pradesh, and Maharashtra. ADB had provided technical assistance in 1996 and 1997 to prepare a plan to develop LNG facilities in India using public-private partnership. Subsequently, four state companies formed PLL to develop the LNG facilities at Dahej, Gujarat and Kochi, Kerala. In 2002, the sponsors approached ADB seeking financial assistance to implement the project in Dahej. The project was to be the first ADB private sector transaction to utilize a long-term partial credit guarantee that would support local currency debt.

The project has realized significant positive development impacts and generated substantial environmental benefits by substituting cleaner LNG for polluting coal. Demand for energy in India continues to grow rapidly, and the increased availability of energy at internationally competitive prices is vital for the development of the country. The project created a facility that provided 20% of the country's LNG needs and 1% of total energy consumption. The project demonstrated that importing LNG at competitive prices is possible, thereby supporting the liberalization of the gas sector and enhancing the level of private sector participation in the energy sector. PLL demonstrated the high standards of performance that a modern, well-run, private company can achieve. The project is being replicated at several other facilities across India. Financial performance has been strong due to lower-than-expected operating expenses and interest costs. ADB's investment returns have been excellent.

Source: Operations Evaluation Department staff compilation.

110. An OED evaluation of a cement plant in Viet Nam constructed in a remote and relatively poor area found that it was having important positive social impacts. The plant had helped attract other private investment to the region and is becoming a nucleus of an export processing zone. Road, rail, port, power, water and industrial infrastructure was being created. The company was the largest tax payer in the province and it had made substantial contributions to the state education system. During construction the project employed 3,500 people, and when operations commenced there were 1,300 jobs. In terms of the environment, the company was rated as being one of the best firms in the country at implementing its environmental plan. ADB had financed two private gas fired power plants in Viet Nam that provide access to clean energy. ADB was active in a series of pilot social projects in the education and health sectors in Viet Nam. Both projects were able to attract international specialists to Viet Nam and the quality of services provided by these operations appears to be excellent.

C. ADB's Investment Profitability

111. This criterion is concerned with investment outcome and sustainability and the evaluation was premised on financial data. The rating for this criterion was ***satisfactory*****,** based on portfolio profitability indicators. The Controllers Department prepares a standalone set of financial statements for PSOD on a quarterly basis. These accounts are indicative in the sense results are derived by attributing notional interest and overhead costs to PSOD. There is no cost of capital deducted for guarantee operations. Loan loss provisions are indicative and are currently being reviewed by the Risk Management Unit.[61] PSOD's balance sheet does not have a notional structure of equity and liabilities, making it impossible to calculate a return on equity. The financial statements indicate that on a consolidated basis PSOD is profitable. Margins on debt and rates of return on equity are positive, although equity is not generating commercial rates of return (i.e. it is lower than its cost of capital), and it is not possible to determine if ADB profitability is commensurate with project risks.

112. While the portfolio is profitable, there is need to ensure that quality is protected over the medium term. These results need to be placed in context, as the Asia Pacific Region has been enjoying an extended period of growth of almost 10 years. In 2000, following the Asian financial crisis, 37% of the PSOD portfolio was rated as marginal or worse, indicating that circumstances can change rapidly for reasons beyond the control of either ADB or the client. The OED evaluation of investment funds in 2002 found only two out of seven exited funds achieved a satisfactory or excellent result. Project evaluation reports repeatedly cite issues such as unenforceable minority shareholder rights, difficulties exiting from projects, and problems with adverse exchange rate movements undermining returns on equity. Offsetting these issues, historical results are distorted by the Asian financial crisis. It is understood performance has improved significantly for funds established post 1997. PSOD has substantial unrealized capital gains from a recent financial sector transaction, although it is a statistical outlier and is not representative of the portfolio as a whole.

113. While the current level of portfolio profitability is satisfactory, there are some issues associated with the risks embodied in the PSOD portfolio. Risk Management Unit prepared its first nonsovereign guaranteed portfolio assessment for the year ended 2006, and it prepared a new set of credit exposure limits for nonsovereign operations that was approved in April 2007. Under these new arrangements, project limits will be based on proportions of a notional portfolio of $5 billion, which has been taken as the operational portfolio target for non sovereign operations for the next three years. This target equates with annual approvals for loans and

[61] ADB. 2007. *Review of Prudential Exposure Limits for Non-sovereign Operations.* Manila.

guarantees of $1.1 billion in 2007 and $1.2 billion in 2008 and 2009 respectively. The country exposure limit will remain at 25% of the portfolio and single industry exposure limit was increased from 15% to 30% of committed exposure. A single obligor will be subject to the following limits: (i) guarantees will be capped at $400 million (8% of capital) or 40% of project cost, whichever is lower; (ii) debt single exposure limit will be raised from $75 million to $250 million (5% of capital) or 25% of project cost, whichever is lower; and (iii) equity would remain at $75 million (1.5% of capital), or 25% of aggregate issued share capital, whichever is lower.

114. Table 11 provides an analysis of the risk exposure of PSOD's outstanding portfolio[62] against several criteria that reflect varying degrees of risk. This analysis is based on country, sector, client and financial instrument classification system maintained by PSOD. The sector classification methodology used by PSOD is slightly different to the one used by Risk Management Unit, which disaggregates figures down to the sub sector level. While the PSOD classification system is slightly dated, it is sufficiently detailed to provide an analysis of the portfolio. A review of this data indicates there are a number of features that may potentially be of concern.

Table 11: Portfolio Risk Exposure, 31 December 2006

Risk Category Exposure	Country	Non Financial Sector	Financial Sector	Obligor/Project	Financial Instrument		
					Loans	Equity	Guarantees and Underwriting
Largest Single Exposure ($ million)	350.0[a]	350.0[a]	75.0	350.0[a]	185.6[a]	75.0[b]	185.6[a]
Percentage of Portfolio (%)	13.5	13.5	2.9	13.5	7.1	2.9	7.1
Portfolio/Sector Exposure (%)	21.3[c]	41.0[d]	27.3[e]	5.8	49.12	35.4	15.5

a = Tangguh LNG project in Indonesia; b = Bank of China; c = People's Republic of China; d = power sector; e = financial sector.
Source: Asian Development Bank Operations Evaluation Mission.

115. A single country exposure of 21% is reaching the upper limits of the credit portfolio restriction of 25%. The country limit of 25% appears to be high as it reduces opportunities to lower portfolio risks through geographic diversification. An exposure to the power sector of more than 40% of the portfolio appears disproportionate, and exceeds ADB's 30% sector portfolio limits. Disaggregating this exposure into energy and power sectors does not reduce this risk materially as returns from these sub-sectors will be correlated. While the total portfolio consists of exposures to 122 companies, a single obligor in a single project represents 13.5% of the total portfolio which is high. A portfolio with 35.4% equity at the end of 2006 is an aggressive structure for a bank that may involve risks. While PSOD has informally applied a ceiling of 30% of the portfolio for equity in 2007, consideration should be given to determining whether explicit

[62] Disbursed and outstanding on ADB's own account

exposure limits should be adopted for types of funding modalities such as equity that are based on formal risk management principles.

116. The current credit limits do not recognise problems of borrowing fixed interest rate funds to finance equity investments with highly variable cash flows. Neither do the new credit limits discuss the portfolio structure and limits on the amount of equity as a proportion of total non sovereign guaranteed transactions. This issue is important as it potentially has implications for ADB's "AAA" credit rating and cost of borrowing funds. Apart from setting a limit of $5.0 billion the Board has not yet considered the issue of the scale of non sovereign risk. The Risk Management Unit has been requested by the Board to prepare a strategic paper analysing this issue. Given the current small size of non sovereign operations, and ADB's high capital ratio, there is a reasonably high degree of flexibility structuring the portfolio. However, this flexibility will diminish as the size of the portfolio increases.

D. ADB's Effectiveness

117. ADB's effectiveness is concerned with ADB's (i) project screening, appraising, and structuring; (ii) monitoring and supervising capacity; and (iii) role and contribution. While there have been exceptions, especially more recently, the rating for the entire evaluation period is ***partly satisfactory***.

1. Screening, Appraising and Structuring Projects

118. The rating for these criteria was ***partly satisfactory***. ***Screening*** is concerned with the way in which projects are prioritized at a strategic level within a country strategy framework. The results of the evaluation indicate the private sector investments could have been targeted more precisely to fit within more clearly defined sector reform programs. As discussed in the Task Force's review in 2006 of the *Private Sector Development Strategy*, there have been problems with the interface between the public and private sector departments in ADB. This was confirmed by this evaluation, both in the analysis of country strategies in general and in the three country studies. This lack of coordination constrains the quality and level of growth of private sector transactions. This result arose due to weaknesses in the planning process led by the regional departments (see Chapter III). There was a lack of PSOD involvement in the formulation of country strategies. There are also issues related to the quality of the private sector related aspects of country strategies and the availability and use of private sector assessments.

119. There was no formal requirement to include private sector development road maps or provide measurable and monitorable performance indicators.[63] While the Private Sector Assessments that were produced appeared to be of a reasonable standard, they were not used in the preparation of country strategies and programs. As a result, country strategies were not effective instruments for ADB to help create a sound enabling environment for private sector development to occur in a structured systematic fashion. In infrastructure sectors, there were few examples of regional departments creating enabling conditions such as public private partnership procurement agencies, sector roadmaps identifying project needs, concession designs, or mechanisms such as funds to help resolve consumer income, and supplier risks. The lack of PSOD engagement in the country strategy process meant that public sector led reviews of sectors were often not subject to any significant internal pressure to consider

[63] This issue was applicable to both private and public sector operations. ADB did not make results based country strategies mandatory until 2006.

alternative private sector modalities when appraising projects. No steps were taken within ADB to introduce techniques to assess value for money arising from public versus private sector provision using project appraisal techniques to explicitly address issues of maximizing productive efficiency.[64]

120. In addition to problems with planning prioritization, there were also issues that arose due to the characteristics of private sector projects that meant they were often not included in country strategies. Two factors contributed to these circumstances: (i) commercial confidentiality concerns for private sector projects under consideration; and (ii) the nature of business as it responds to requests for financing from private sector clients. Public sector lending is programmed two to three years in advance, and ADB typically finances some of the project preparatory work. Private sector sponsors are expected to finance their own feasibility studies to demonstrate their proposed transactions are bankable. When the sponsors approach ADB for financing the transaction has reached a mature stage and they are seeking financing within a year. Private sector clients do not approach ADB for financing in, say, three years before it is needed.

121. Given these factors, it is understandable why country strategies did not include a forward list of private sector projects. What is not understandable is the lack of a private sector strategy within the country strategies that: (i) identifies specific priorities in terms of sectors and types of interventions where PSOD would pro-actively seek to provide assistance; (ii) helps to position ADB's private sector operations; (iii) provides a framework to build synergies between the public and private sides of ADB; and (iv) identifies clear public sector interventions, both for loans and TA, that help to improve the business environment in areas where private sector transactions are anticipated. ADB appears to have recognized the need to strengthen the private sector aspects of country strategies and issued new guidelines governing the preparation of country partnership strategies in 2007 which mandate greater PSOD participation in their formulation. It remains to be seen if these new guidelines will be effective in solving this problem.

122. A Private Sector Development Committee was established in 2000 to help coordinate ADB's private sector development efforts. The committee did not have any representatives from Management, and primarily acted as a network focal point. Various ADB-wide presentations were organized and several studies were produced analyzing issues such as the preparation of development indicators and implementation of private sector reform strategies. Five Private Sector Development Specialists were employed in the regional departments to help prepare Private Sector Assessments and implement enabling environment projects and TAs that would provide a platform for private sector transactions. The independent review of the 2002 ADB reorganization noted that the presence of the specialists did "not seem to have much impact on the private sector development activities. The subject area for the specialists is vast. It is doubtful that even three or four specialists in each regional department could cover the expertise needed for ADB to plan and promote private sector development in individual DMCs."[65] Subsequent analysis by OED indicates that while a lack of breadth of expertise may have been an issue, it was not the critical constraint. There were not enough specialists, and even when present, it appears they were often co-opted to work on other priorities of the regional department.

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[64] An example of this methodology is presented in Minister of Public Works and Government Services Canada. 2003. *The Public Sector Comparator, A Canadian Best Practices Guide*. Industry Canada. Ottawa, Canada: Canadian Government Publishing.

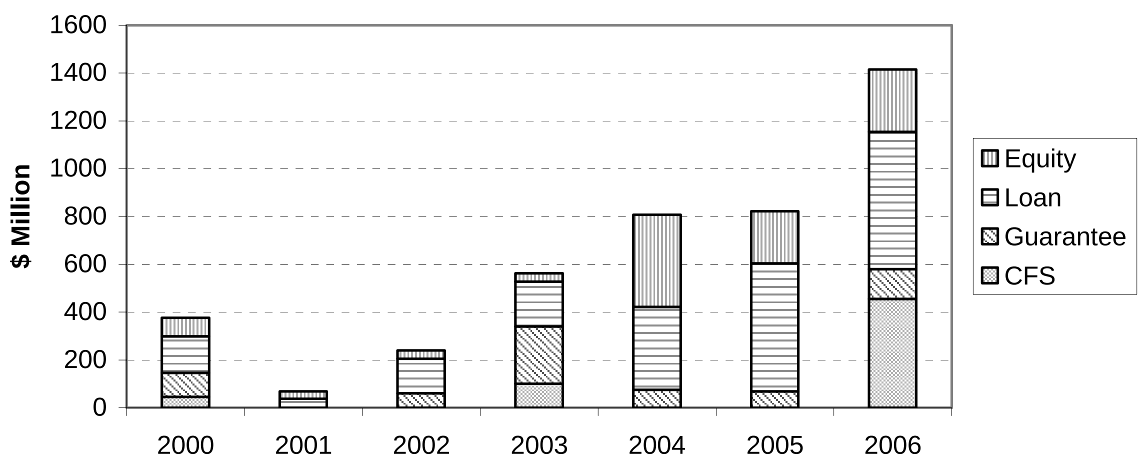
[65] ADB. 2004. *Independent Assessment of the Effectiveness of the Reorganization of the Asian Development Bank Diagnostic Report.* Manila.

123. **Appraisal** quality is concerned with due diligence procedures and compliance with social safeguard requirements. The high level (24%) of cancellations in the PSOD portfolio from 1996 to 2000 suggests there have been weaknesses in ADB's due diligence procedures in a number of cases. Cancellations at this level undermine the effectiveness and efficiency of PSOD operations. Interviews with project managers in the three country studies indicated that cancellations were primarily due to problems with economic instability arising from the Asian financial crisis, lack of political stability in some DMCs, regulatory issues, and lack of demand due to the high cost of ADB funds compared to other sources of financing in the market. The country case studies indicated that in some cases more effective due diligence procedures might have avoided this outcome. In the power sector OED found that standards of due diligence had improved over time.[66] Overall, the level of due diligence appears adequate as PSOD's procedures do not appear to be resulting in projects with a high level of credit risks.

124. A review of PSOD project completion reports indicates the processing time for ADB's financing from due diligence to documentation and signing tends to be lengthy when viewed from a private sector client's perspective. While such delays are frequently due to reasons other than inefficiency, they raise concerns. Some sponsors interviewed by OED voiced concerns about the lengthy turn around time ADB needed to complete all required internal procedures, document transactions, and reach financial close and disbursement. These problems reflect, in part, the nature of ADB's business processes that are derived with a public sector mentality and a lack of harmonization with other international financial institutions in areas such as safeguard policies.

125. **Structuring** is concerned with influencing the characteristics of the assets being financed and the financial structure itself, including type of funding instruments, currency, pricing and tenor. For much of the evaluation period, PSOD relied heavily on conventional debt and equity (Figure 11).

Figure 11: Private Sector Operations Approvals (2000–2006)



CFS = complementary finance scheme.
Source: Asian Development Bank records.

[66] ADB. 2007. *Evaluation of ADB Energy Policy 2000 Review*. Manila.

126. During the evaluation period, more use could have been made of hybrid forms of finance such as subordinated debt. These instruments would help address the risk capital needs of clients without compromising exit options and ADB's need to earn an acceptable return in foreign currency terms. Greater use could have been made of credit enhancement instruments such as complementary finance scheme and guarantees which provide an efficient means of using ADB's capital relative to debt and equity. At the end of 2006, complimentary financing schemes and guarantees accounted for 31% of the portfolio (19% complimentary financing schemes and 11% guarantees[67]). The complementary financing scheme instrument was only used three times from 2000-2005. This result was mainly due to negative market perceptions about the value of the instrument following problems that primarily occurred with IFC's similar instrument in South America. In 2006 demand for complementary financing schemes increased due to improvements in the regional political environment. Four facilities were approved with a total value of $455 million. It remains to be seen whether the increased use of complementary financing scheme instruments will continue.

127. Guarantees are more complex and expensive than complementary financing scheme instruments and have not been used extensively. The demand for Political Risk Guarantees for infrastructure projects has been declining with the improving economic environment in the Asian region. This instrument was used in five countries (i.e., Afghanistan, Bangladesh, Lao PDR, Sri Lanka, and Viet Nam) over 2000–2006. With more innovation and effort, it might have been possible to make greater use of the instrument in countries such as India, the PRC and the Philippines. Partial Credit Guarantees were mainly used to support SME credit lines, and their use was sporadic. After a hiatus of two years, two Partial Credit Guarantees were used in 2006 in capital market securitization transactions in Indonesia and Kazakhstan to support commercial cofinancing facilities, although the Indonesian transaction only had a value of $10 million. Partial Credit Guarantees are more difficult to design than Political Risk Guarantees due to problems of moral hazard, and adverse selection. Despite these factors, there should have been opportunities for ADB to use these instruments to help support local capital raisings.

128. There is potential for making greater use of blends of financing and credit enhancement instruments such as by providing finance for construction followed by a partial credit guarantee to support a sponsor bond issue. The range of risks covered by ADB could be extended to include economic, financial, social and environmental risks. Lack of demand for credit enhancement instruments appears to stem from problems with product characteristics of the credit enhancement instruments and institutional problems within ADB. The product amendments presented in the *Credit Enhancement Policy Paper* (2006)[68] should help stimulate demand for credit enhancement products, although there are concerns about lack of incentives for PSOD to use cofinancing scheme and guarantee instruments.

129. The *Credit Enhancement Operations Policy Paper* reviewed options for facilitating the use of guarantees and syndications through mechanisms such as lender of record, reinsurance and sell down mechanisms. Reforms were proposed to help increase flexibility in the use of Credit Enhancement Operations instruments through measures such as eliminating lender of record provisions, and allowing ADB to provide standalone guarantee products. Provisions were introduced making the risks covered by complementary financing scheme instrument facilities more transparent. While all of these measures were important, it is not clear these issues will be resolved without more fundamental changes to the organization structure and staff incentives

[67] This figure cannot be benchmarked against IFC as it does not directly provide political risk guarantees. This is done by Multilateral Investment Guarantee Agency within the World Bank Group. In regard to CFS, syndications (which encompass CFS type instruments) accounted for 32% of IFC's global portfolio at 30 June 2005.
[68] ADB. 2006. *Review of ADB's Credit Enhancement Operations*. Policy Paper, August 2006.

to utilize economic capital more efficiently through greater use of guarantee instruments. The limited use of guarantee instruments reflects a combination of organizational factors including a lack of: (i) skills and incentives for operational staff to process these types of transactions; and (ii) lack administrative procedures and performance measures that could prioritize the use of these types of instruments in a way that makes better use of ADB capital relative to total investment catalysed by transactions. There are institutional barriers as PSOD and Office of Cofinancing Operations (OCO) report to separate Vice Presidents.

130. ADB has good progress in identifying ways of using local currency finance. ADB has been actively engaged in finding ways of mobilizing local currency since 2004, initially for private sector. This initiative should help to mitigate or avoid some of the risks associated with currency mismatches that arose in the past. However, there are issues related to pricing and tenors of loan instruments. At present PSOD is subject to pricing procedures where financial instruments are priced exclusively by reference to the market. It is difficult to derive efficient funding structures using this approach due to yield curve effects that make tradeoffs between the cost of funds and the tenor of the grace and repayment periods difficult to determine due to a lack of market comparators. There is also a lack of detail on the reasonableness of the size of the risk premium and whether it is commensurate with the probability of loss. ADB's administration costs are allocated to PSOD projects on the basis of headcount rather than actual usage of resources. Without detailed cost information, PSOD will be at risk of either being too expensive and non competitive, subsidizing operations, crowding out the private sector, and not covering the costs of its operations. Pricing needs to: (i) cover ADB's actual costs of operations, cost of funds, and risk return margin adjusted for probability of loss; and (ii) be set at a rate that is competitive in the market.

131. A review of the terms of loan facilities indicates there is a lack of innovation in the area of using performance payments, and limited use of structures such as corporate finance for the construction period, coupled with bond finance for the operations period. The term of grace periods and tenors of loans is invariably determined on a whole of project basis, rather than partitioning risks and finance modalities by stage of project development. Similar to loans, there are concerns about how equity investments and guarantees are priced as there is a lack of formal procedures to determine a reasonable return on investment relative to ADB's cost of capital.

2. Monitoring and Supervisory Capacity

132. The rating for these criteria was ***partly satisfactory***. Many PSOD staff combine project origination and administration responsibilities. While PSOD staff numbers have increased from 29 in 1995 to 36 in 2000 to 67 in 2006, the increases have not kept pace with changes in transaction volumes or reflected rising demand from clients. An OED benchmarking study presented in its *Annual Report on Loan and TA Portfolio Performance*[69] indicated that PSOD had substantially fewer staff resources than peer international finance institutions after normalizing for transaction volumes (see Table 12). In some cases borrower firms were not visited annually to ensure problems were not arising. PSOD would benefit from additional staff with skills in areas needed to define and monitor developmental and socioeconomic impacts of transactions, portfolio management, and management reporting capacity.

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[69] ADB. *Annual Report and Loan and Technical Assistance Portfolio Performance for the Year Ending 31 December 2005*. 2006. Manila. Pages 100–111.

Table 12: Comparison of Volume and Number of Portfolio Transactions Relative to Staff

Outstanding Portfolio 2005 (net of cofinancing)	EBRD	IFC	PSOD
Investments per staff ($ million)	6.4	7.1	17.3
Number of portfolio transactions per staff	0.6	0.9	1.2

EBRD = European Bank for Reconstruction and Development; IFC = International Finance Corporation; PSOD = Private Sector Operations Department.
Source: ADB. 2006. *Annual Report on Loan and Technical Assistance Portfolio Performance for the Year Ending 31 December 2005*. Manila (p. 105).

133. Experience from the public sector side indicates that project supervision and monitoring improves if staff in resident missions is involved. Several sponsors were critical of PSOD's lack of presence in the market relative to institutions such as IFC. Currently, PSOD staff is stationed in only three out of the nineteen resident missions (India, the PRC and Thailand). In most cases these staff report to the Director General of PSOD, and operate independently from other ADB staff at the resident missions. PSOD representation in so few DMCs is inadequate to achieve the objectives identified in ADB's *Private Sector Development Strategy*. This lack of market presence undermines PSOD's ability to pursue business development initiatives and manage the existing portfolio, leading to a competitive disadvantage relative to commercial banks and IFC. In a recent annual review, IFC noted it has almost doubled staff numbers in the field from 669 staff (35% of total staff) in 2000 to 1,249 staff (46% of total staff) in 2005[70]. Going forward IFC intends to accelerate the presence of core operations staff in the field and decentralize management decision making authority for the first time to the East and South Asian region. This vastly greater presence in the field provides IFC with a more credible in-country presence than ADB.

134. It is difficult to monitor and supervise the quality of investee companies of venture capital funds in which ADB has invested, creating a potential reputation risk for ADB. Similarly, there are potential concerns about co-investors in some equity funds. Equity investment implies a high level of endorsement by ADB of sponsors and co-investors. This type of relationship entails risks as ADB becomes more engaged with local firms in the Asia Pacific Region where it can be difficult to obtain reliable information on the integrity of some parties.

135. Reporting systems do not provide a clear indication of development and financial performance or critical risks. Project objectives and report formats lack clarity, and Concept Clearance Papers, Reports and Recommendations of the President, and OED and PSOD evaluation reports, have different performance criteria and stated objectives. In the past there have been few clearly defined performance targets in funding proposals presented to the Board. A Development Impact Framework has recently been introduced as an Appendix in Reports and Recommendations of the President. However, there are no details on the expected level of performance targets, which are not always related to objectives specified in the main text. PSOD is working with the Central Operations Service Office to develop a training module in 2007 to strengthen staff skills in the preparation of design and monitoring frameworks.

136. There are gaps in the data collected for monitoring project development impacts, credit risks, social and environmental effects, and reputation risks. Even assuming data was collected on the proposed development measures, there is no document prepared by PSOD which reports on whether targets are achieved over the life of the project, and reasons for variations. The only time achievement of performance targets occurs is the OED and PSOD evaluation

[70] IFC. 2006. *Strategic Directions Paper.* Washington.

documents which are only prepared once in the life of a project at the point when they reach "early operating maturity". In the absence of specific quantitative and qualitative development targets, planned resource utilization patterns, and reports against targets, it is not possible to determine if the private sector development and operational objectives are being achieved. A PSOD annual report for monitoring projects was introduced in 2005 but reports are incomplete due to factors such as difficulties measuring project risks and allocating indirect administration costs. Contrary to the recommendation in the *Private Sector Development Strategy*, no balanced scorecard has been produced to help guide private sector development reforms. These problems are compounded by the fact that information systems are incomplete. In many cases the information systems are manual, based on distributed systems, and are not secure, creating risks of errors and omissions.

3. Role and Contribution

137. Role and contribution was ***satisfactory***. Evidence indicates PSOD played a positive role in transactions. In some cases, when projects encountered difficulties related to government actions, sponsors particularly appreciated ADB's ability to access senior decision makers, in the role of an honest broker, to help resolve the problem. During the country studies PSOD was complimented by sponsors on a number of occasions on its efforts to establish standards of high corporate governance in both infrastructure and financial sector projects. Various sponsors valued the endorsement of project quality in the area of safeguards that rose through ADB participation.

138. ADB's safeguard policies are typically valued by clients, and project evaluation reports indicate that implementation has been of an acceptable standard in most cases. However, there are issues with ADB's safeguard policies and standards that need to be addressed related to IFC's recently announced intention to apply equator principles to its projects when considering environmental impacts. There is a need to harmonize the ADB and IFC approach to safeguards, particularly when they are both cofinancing a project. The situation is further complicated by local governments that have different standards to ADB and the World Bank in areas such as resettlement and compensation, raising an issue of which standards should apply.

E. ADB's Additionality

139. Additionality is concerned with answering the question: "Is ADB adding value?" Additionality was evaluated along two dimensions: (i) ADB's contribution to improving design and functioning of the private sector projects; and (ii) the extent ADB helped support the realization of the projects and mobilized private finance, either directly or indirectly. Additionality appears to have been present to a material degree in the majority of the private sector transactions that were reviewed. Although the PSOD portfolio has been growing rapidly in recent years, the lack of involvement in project design and small scale and narrowness of investments by country and sector has meant a rating of ***satisfactory*** rather than excellent has been assigned to this criterion.

140. Feedback from most sponsors about the positive benefits of their involvement with ADB was encouraging. Some sponsors considered that ADB's involvement was critical as a means of enhancing creditworthiness and catalyzing commercial funding. In infrastructure projects, ADB participation provided an important means of ameliorating political risk, especially for tariffs and adherence to contracts in the power and energy sectors. While there have been exceptions (e.g., Manila water sector; the Manila North Tollway), ADB has not been able to play a significant role in strengthening design of concession agreements in sectors such as roads and

water. Following the Asian financial crisis it became apparent that infrastructure concession agreements did not properly allocate risks in areas such as tariff, traffic and currency movements. ADB could potentially add value to transactions by introducing concession designs such as annuities for roads and affermage agreements for water. Improving the structure of concession agreements would, however, require ADB to be involved very early in the project cycle.

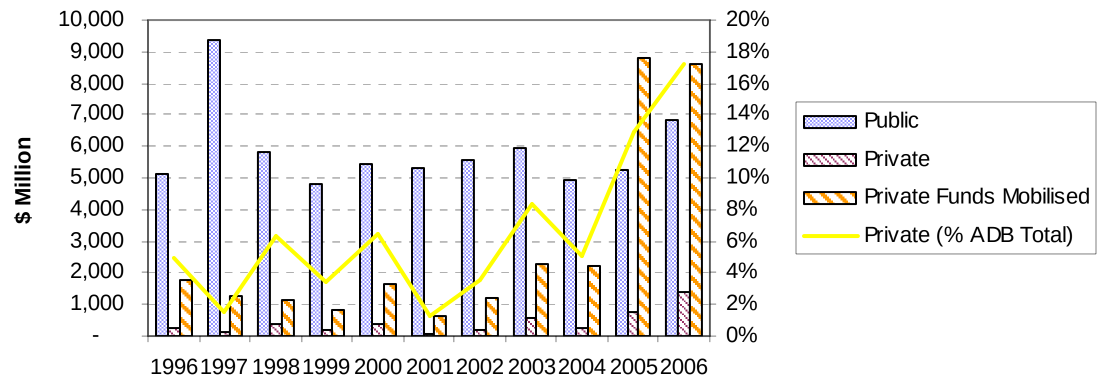
141. In the financial sector, ADB has played an important role enhancing credibility of financial institutions by providing a quality seal on sponsors, improving governance systems, and, in some cases, taking positions on the boards of directors to oversee operations. Offsetting these positive factors, financial sector projects lacked focus in some cases and did not clearly target development solutions to alleviate constraints on financial mobilization. It is difficult to measure performance of private equity funds. Funding is often provided in the form of equity or credit lines without clearly demonstrating whether property and financial rights are capable of being enforced.

142. These design problems have arisen in part, because PSOD is dependent upon regional departments and third parties to strengthen the enabling environment and develop its project pipeline. The regional departments have lacked incentives to pursue private sector enabling reforms. PSOD's lack of a mandate and resources mean it operates in a reactive rather than proactive fashion and had limited involvement in undertaking advisory work to create entry points in areas such as privatization, and design of public private partnerships. PSOD's lack of market presence and inability to access significant TA resources to initiate enabling environment reforms on its own account has exacerbated these weaknesses.

143. PSOD has made progress in helping to mobilise funds for private sector projects. ADB funding represents on average 15% of total project costs, or a leverage ratio of 6.7. Under risk management procedures, ADB is not permitted to finance more than 25% of project costs (or 50% of guarantee projects). ADB's public sector has traditionally been able to finance up to 40%, 60% or 80% of project costs, depending upon the country classification, and now under the Innovation and Efficiency Initiative it can finance up to 100%.[71] As a result of these rules, the potential leverage in terms of the amount of dollars invested by third parties for every dollar invested or loaned by ADB in regard to private sector funds mobilization is substantial and far exceeds that of typical public sector operations. PSOD has made greater use of ADB's capital in recent years, as demonstrated by the level of direct funding as a percentage of total ADB lending. Trends in both of these sources of leverage are illustrated in Figure 12. The results indicate the level of investment mobilized by PSOD (as defined by project costs) exceeded public sector lending in 2005 by 67% and in 2006 by 26%.

[71] ADB. 2006. *Innovation and Efficiency Initiative, Cost Sharing and Eligibility of Expenditures for Asian Development Bank Financing: A New Approach.*

Figure 12: Annual Approvals for Public and Private Sector Operations Compared to Private Sector Funds Mobilized



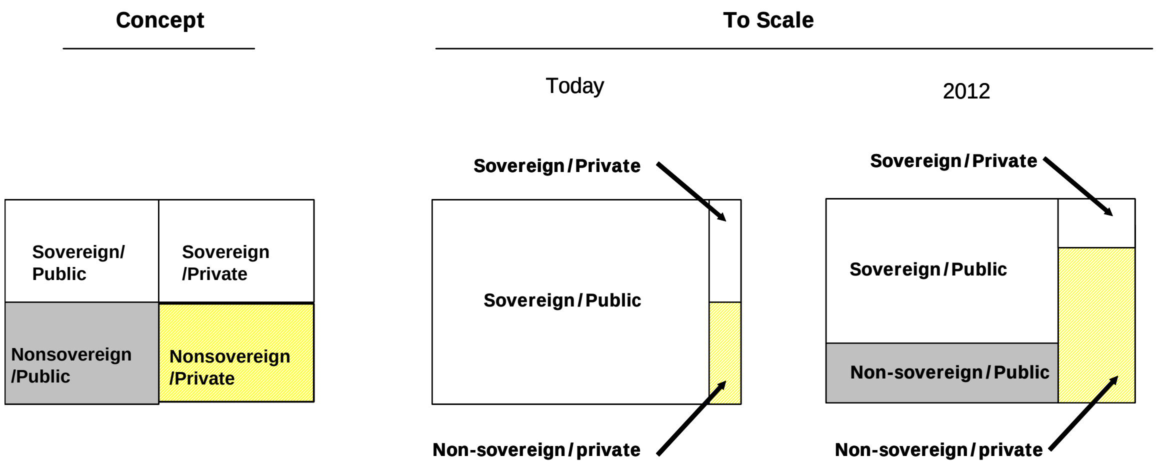
ADB = Asian Development Bank.
Source: ADB Lotus Notes database on Loan, TA, Grant, and Equity Approval.

V. ISSUES AND RECOMMENDATIONS

A. Overview

144. The purpose of this section is to identify the implications of the evaluation findings and consider possible options for leveraging strengths and addressing weaknesses in the future. The market context for both public sector products and private sector operations in which ADB is operating is changing, particularly in middle income countries. There is a growing demand for ADB to finance more non-sovereign transactions, and despite strong growth in the size of the PSOD portfolio, many DMCs are complaining that ADB is not responding adequately to this demand. In most countries in the Asia Pacific Region, the private sector is playing a much greater role in financing, managing and delivering services than was the case 40 years ago when ADB was founded. This is particularly the case in sectors such as energy, transport, and water utilities. The financial sectors in many DMCs, particularly in middle income countries have deepened. Governments are shifting their operational focus to policy and regulatory functions (see Figure 13). These trends require changes in the nature and scope of both public and private sector operations and demand greater synergy between ADB's departments.

Figure 13: Asian Development Bank's Current and Forecast Client Mix



Source: ADB. 2006. *Asian Development Bank's Role in Private Sector Development, Task Force Discussion Paper.* Manila.

145. As discussed in the *Second Medium Term Strategy*[72] and the presentation of the Private Sector Development Task Force to the Board in 2006, the role of private sector operations within the context of ADB's operations is expected to grow substantially over the next five years. To achieve this adjustment in customer mix and scale of operations, there will need to be changes to the roles, products, responsibilities and organization structures of ADB in general and PSOD in particular. These changes will involve the level and type of resources, and PSOD's reporting arrangements to Management. An operational review of PSOD was conducted as part of the evaluation (see Appendix 7) and the findings have helped inform the discussion in this section on areas where potential reforms could be introduced to increase the effectiveness and efficiency of ADB's private sector development activities. These types of reforms are complex, and require changes in the organization culture and the way in which things are done. It will take time, strong leadership and changes in incentives and possibly organization structure to achieve these reforms. Nevertheless, the potential benefits are likely to be very large and the challenges are not unique to ADB. To varying degrees these issues are being tackled by all of the large international financial institutions.

B. Issues

1. Organization Structure

a. Overview

146. Over the years, ADB has struggled to find the best organization structure for PSOD. The vision given in Figure 13 that nonsovereign lending will grow significantly faster than sovereign lending will create tensions within ADB's organization structure. Future changes in ADB's organization structure may be required to achieve this vision. It is beyond the scope of this evaluation to make specific organization recommendations. However, some observations can be offered that may be useful for future deliberation when this issue is considered.

[72] ADB. 2006. *Medium-Term Strategy II, 2006–2008*. Manila.

147. ADB's organization model has failed to achieve the *Private Sector Development Strategy* (2000) objective of realizing synergies through cooperation of public and private sector operations. This has constrained ADB's ability to increase the scale of its private sector transactions. To ensure that ADB is well positioned to respond to the changing demands of its major clients, an organizational review could be undertaken to determine the most suitable structure to provide private sector development and operations in these evolving market conditions. Currently, tension is evident between geographic, sector, and thematic objectives, which is undermining the strategic performance of ADB. Other international finance institutions have addressed conflicting requirements by developing an organization structure that places sector orientation and country and regional orientation in a matrix. This framework requires a movement away from binary concepts of public and private sector towards a continuum between sovereign and nonsovereign guaranteed operations.

b. Role of Management

148. The Vice-President (Operations 1) is responsible for PSOD and all public sector operations in Central and West Asia and South Asia. The Vice-President (Operations 2) is responsible for East Asia, South East Asia, the Pacific, and Central Operations Services Office. The Vice-President (Knowledge Management and Sustainable Development) is responsible for the Office of Cofinancing Operations, Regional Sustainable Development Department, and Economics and Research Department. Risk Management Unit reports, through the Managing Director General, to the President. This organization structure is inconsistent with PSOD's mandate to process and administer private sector investments in all DMCs. Further, it makes it difficult for Management to provide strong leadership to drive an integrated delivery of services. With rising demand for private sector transactions, ADB should consider whether it would be desirable to review this structure.

149. There are a number of possible options that could be considered including: creating a fifth Vice President to provide strategic leadership for all of ADB's private sector business; separating sovereign and non-sovereign responsibilities between two Vice Presidents; having PSOD report to the Managing Director General; or having PSOD report directly to the President. Decisions related to revising the reporting structure for PSOD are complex and involve factors that extend far beyond matters that are covered in this report. However, if the ADB's private sector operations grow at the rate that was expected in the 2006 private sector review, ADB will need to consider at some point whether the current allocation of responsibilities among Vice-Presidents is optimal for ADB's changing business mix. This issue could be considered in the context of the midterm review of the *Long-Term Strategic Framework* currently being undertaken by the Strategy and Policy Department (SPD) and OED.

c. Role of Resident Missions

150. In line with the vision in the resident mission policy, more resident missions need to have PSOD staff with private sector skills and capabilities. The resident missions must take on greater responsibility, accountability, and leadership to promote this type of business. The current situation, where PSOD cannot make full use of resident missions in countries with significant private sector operations potential, is unsatisfactory. It calls for a review of the roles and responsibilities of resident missions, their staffing and skills mix, and overall business orientation. This issue extends beyond the scope of this evaluation as it involves fundamental questions related to ADB's role of resident missions, the balance of staff in ADB's headquarters and resident missions, and ADB's business processes. These broader issues are being addressed in an ongoing evaluation of resident mission effectiveness. The results of that

evaluation will feed into the work that is being undertaken by SPD, and the Budget, Personnel and Management Systems Department (BPMSD) to review the effectiveness of the resident mission policy and to propose changes. Following the example of IFC and EBRD, consideration could be given to placing PSOD staff in major commercial centers, and focusing initially on resident missions located in countries where the development of the private sector is a major element of ADB's country strategy.

d. Organization Structure of PSOD and OCO

151. There are some conflicts of interest inherent in the current organization structure of PSOD, where project origination and administration are combined to an unusually high degree. These activities should be in separate divisions within PSOD. There is a need to strengthen guarantee origination capacity within PSOD. The *Credit Enhancement Operations Policy Paper*[73] clarified responsibilities of PSOD, Regional Departments and the Office of Cofinancing Operations in the guarantee syndication process. The paper noted that operating departments would be responsible for the design and due diligence of financial structures (including both direct and indirect financial instruments) and the Office of Cofinancing Operations would act in an advisory capacity and have responsibility for arranging and financing all reinsurance and syndications. Various other reforms were proposed to simplify use of Credit Enhancement Products.

152. While the structure and actions in the guarantee policy paper are important, other issues associated with lack of staff incentives and institutional barriers limiting the potential application of credit enhancement products are still outstanding. To help resolve these concerns, ADB can consider transferring staff with guarantee expertise to PSOD, and setting up an independent syndication and reinsurance function. Office of Cofinancing Operations would be responsible for syndication of existing and new loans such as complimentary financing scheme, reinsurance of guarantees, possibly the divestment of PSOD's equity shareholdings, and the PSOD workout function. The establishment of this type of structure might warrant a review of where Office of Cofinancing Operations should be located in ADB. Because PSOD is the main user of guarantee products, a case could be made for Office of Cofinancing Operations to report to the same Vice-President as PSOD.

e. Risk Management

153. An independent review of ADB's risk management procedures found many material weaknesses relative to other international finance institutions[74]. ADB does not have a senior management credit committee that discusses credit issues on a non-transaction basis from an overall risk management perspective. Risk Management Unit did not start preparing consolidated quarterly reports for the Board and Senior Management until December 2006. Reporting lines to Board and the Audit Committee through the President need to be strengthened. It was found there was a lack of understanding in ADB about the role of Risk Management Unit and this issue should be addressed through a bank wide communications program. Risk Management Unit staff do not always have sufficient seniority at meetings, undermining their ability to balance risk management and business objectives and provide for independent monitoring.

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[73] 2006. *Review of ADB's Credit Enhancement Operations*. Policy Paper, August 2006.
[74] Ernst and Young, 2006. *Development of an Enterprize-wide Risk Management Capability*, Manila.

154. ADB's credit strategy and policies need to be documented, including details on approved authorities, scope of work, committee terms of reference, relations between business units and Risk Management Unit, a standardized due diligence process, and guidance on transaction structures. Risk Management Unit resources with appropriate skills needed to be increased as a matter of priority to allow for appropriate risk assessments and portfolio monitoring. Risk Management Unit should have sufficient staff to maintain involvement in transactions post credit committee approval. A management committee should be established to review credit risks on an ongoing basis. The risk ratings methodology needs to be revised and standardized across the whole PSOD portfolio, with regular reports prepared throughout the life of projects. A framework needed to be developed to manage operational risks in areas such as reputation risk. It was recommended that information systems in areas such as credit data management be upgraded to support these reforms.

f. Responsibility and Accountability for Private Sector Development

155. Private Sector Development Specialists were recruited and assigned to the regional departments to ensure that private sector development activities were embedded firmly in country strategies. Productive links were meant to be created between PSOD and the public sector side of ADB. This approach has not worked as envisaged. By assigning full accountability for private sector development objectives to regional departments, PSOD was effectively disengaged from initiatives defined in the Private Sector Assessments and country strategies. PSOD was not involved in essential enabling environment reforms that would provide the basis for generating future business. To help avoid this fragmentation of PSOD's business processes, ADB needs to reconsider its strategy on how to develop synergies to promote private sector development. One option would be to assign PSOD the responsibility and accountability for all private sector development activities, along with the associated private sector specialist staff positions. Alternatively, regional departments could continue to address private sector development issues, but PSOD could be given the capacity to pursue initiatives in this area where they provide critical entry points to support private sector transactions.

156. The Private Sector Development Specialists could be placed in a new division within PSOD. Transferring these staff to PSOD would strengthen its staff skill mix in the areas needed to define, monitor, and assess the development and socioeconomic impacts of transactions. This structure would (i) provide capacity within PSOD to improve its strategic planning, (ii) ensure private sector transactions had stronger development features, and (iii) allow PSOD to be more directly involved in formulating country strategies and preparing country business plans to private sector operations and departmental management reports. These staff could provide inputs to help prepare and implement the public sector program, as well as policy-based lending and non-lending activities that have positive impacts on the enabling environment for the private sector. PSOD's role could be broadened and deepened to encompass the development of entry points within a country, such as public-private partnerships procurement units, property rights systems, and e-government.

2. Policy, Strategy and Project Selection

157. More effective PSOD participation in the country strategy process would help to ensure that niches are identified for ADB involvement in supporting private sector development. ADB needs to be better positioned to provide the expected support by ensuring the resources required for delivery are consistent with PSOD's staffing and the country strategies do not raise unrealistic expectations. The sector roads maps that will be included in country strategies will

help address this issue, and PSOD can use them as a basis for preparing more focused country business plans. Projects can be formulated following project appraisal methods that assess value for money (estimated by comparing the unit cost of private versus public sector provision), using a range of financial instruments encompassing guarantees, equity, and debt. While public financing would be appropriate for many projects, the *Private Sector Development Strategy*[75] indicates that it should not be considered the automatic default option. There is little evaluative evidence to suggest that ADB has seriously considered private sector as an alternative to public sector financing, once a project enters the country programs. Indeed the informal incentives that govern behavior of ADB staff probably work against this approach as loan approvals is an indicator of staff performance on both the public and private sector sides of ADB. The use of value for money appraisal techniques would help counter this bias.

3. Scope of Investments

158. The *Middle-Income Country Initiative* and the *Second Medium Term Strategy*[76] program call for a concerted effort toward more private sector operations. There are many opportunities for PSOD to diversify its markets. Opportunities include: (i) middle-income countries such as Thailand and Malaysia; and (ii) non-traditional sectors such as ports, airports, roads, and water; and (iii) engaging in areas such as recapitalization and financial restructuring of state owned enterprises to strengthen operational competitiveness; (iv) privatization to help governments move forward with their stated policies by providing technical advice and investment funds to support restructuring efforts; (v) securitization of assets as a means of mobilizing resources, and (vi) trade facilitation to expand regional cooperation; (vii) adopting more innovative concession designs such as annuities and affermage contracts to make private investments in non-traditional sectors, such as roads and water, more attractive; (viii) mergers and acquisitions; (ix) acting as a “matchmaker” for joint ventures; and (x) serving as a “project developer” by creating the basic components of a project in a market where the private sector finds it difficult, if not impossible, to develop the facility, and then invite private firms to bid and take over the operations.

159. In line with these opportunities, the broadening of PSOD’s range of business activities is something the middle income countries have been demanding and ADB has committed to achieve in recent strategy documents. However, PSOD should not pursue all opportunities in all countries. Selectivity is required. The strategic choices should be made in the context of country partnership strategies. For example, where the public sector is active developing road and rail transport corridors and ADB participation in private airports and seaports that act as gateways to these facilities would seem to offer substantial potential for synergies. Similarly, if ADB’s public sector operations decided to scale up public sector administrative reform projects based on e-government initiatives, then telecommunications support through PSOD would potentially form a central platform for realizing the full benefits of this type of assistance. In other cases there may not necessarily be a direct linkage between public and private sector operations. Nonsovereign funding in a country might or might not be supported by policy work undertaken by the public sector side of ADB. The demonstration of development impacts that create additionality should be a major criteria used for selecting those areas where PSOD will operate in a particular country.

160. The *Private Sector Development Strategy* advocated the creation of strategic alliances with other institutions. These alliances should not be limited to partners such as IFC and EBRD.

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[75] ADB. 2000. *Private Sector Development Strategy*, Manila.
[76] ADB. 2006. *Medium-Term Strategy II, 2006–2008*. Manila.

Strategic alliances could be formed with local institutions by making investments with a dual purpose. ADB could collaborate with local banks and provide foreign currency debt, which the borrower can swap into local currency finance. ADB can increase efforts to provide equity to funds operating in frontier countries. Further, it can provide funding coupled with an agreement requiring the entity receiving the investment to help support PSOD in those markets. These forms of strategic investments would provide a form of local presence that would be helpful for business promotion, market intelligence, and project monitoring, especially in countries without resident missions, or at the state or provincial levels of large countries such as India and the PRC.

4. Financial Instruments and their Application

161. ADB has relied upon a narrow set of financial instruments. PSOD can rebalance its financial products to manage portfolio risks better, improve flexibility, and respond to different market conditions. PSOD should carefully manage the use of equity due to conflicts of interest, substantial resource requirements, inadequate systems, lack of incentives to divest ownership interests once development objectives are achieved, and high levels of reputation and financial risks in some cases. PSOD could increase the use of quasi-equity instruments that carry some of the characteristics of straight equity, but carry lower risk. These instruments can be employed as means of strengthening the capital base of projects without needing to resort to equity. The use of these mezzanine instruments provides flexibility and room to maneuver when designing the financial structure and ADB's role in projects. It also allows for an exit strategy and a more certain pricing structure that is commensurate with the project risk and return profile.

162. More sophistication and flexibility can be introduced in deal pricing and structuring by using mechanisms such as progress- and performance-linked fee structures and interest margins that act as performance incentives. More flexible amortization schedules can be linked with cash flows, and might include features such as cash consolidation and cash repayment mechanisms. Instruments such as B loans and guarantees could be used more often. The use of guarantees with local banks can serve multiple developmental purposes by (i) improving project sponsors' access to local currency funding at more affordable terms, (ii) exposing local banks to project financing techniques, (iii) facilitating capacity building of local financial institutions, and (iv) helping develop financial markets by creating a benchmark curve in the bond and swap markets. The use of these guarantee instruments can increase the development impact of ADB by leveraging the use of its capital base.[77] The scope of guarantees could be broadened to cover social and environmental risks, as well as traditional political and credit risks. Guarantees can be used to support output-based aid payment mechanisms for public sector procurement funds, as well as secure funding risks for project sponsors.[78]

5. Operational Safeguards and Quality Controls

163. Two important issues that emerged from the country case studies were the potential risks that ADB's safeguard processes create for PSOD projects and the high level of project cancellations that occurred after Board approval. Both factors can undermine development impacts, reduce effective demand for private sector services, and increase ADB's transaction costs.

[77] See the World Economic Forum. 2006. *Building on the Monterrey Consensus: The Untapped Potential of Development Finance Institutions to Catalyze Private Investment.* New York. This report argues for multilateral development banks to make better use of guarantee and risk mitigation instruments and capabilities to increase commercial investment in development projects.

[78] von Klaudy, S. and U Goswami. 2005. *Credit Enhancing Output Based Aid*. Washington, DC: World Bank.

a. Safeguard Policies and Standards

164. As a matter of prudence, consistency, and operational strategy, international financial institutions promulgate policies for various aspects of corporate activities, including lending and investment operations. Some of these activities need to be documented in legal agreements. In general, safeguards for social and environmental policies tend to be reasonably well harmonized among international financial institutions. However, differences exist that tend to complicate matters for clients and international financial institutions alike, when cofinancing is involved. This may be the case for large infrastructure projects. This issue has become more pronounced since IFC began to apply the Equator Principles to evaluate environmental impacts. ADB is preparing a safeguards policy update. For PSOD to remain competitive ADB's safeguard policies and standards should be harmonized with those of IFC to the greatest extent possible.

b. Integrity Risks

165. Increasingly, PSOD is forming partnerships with local sponsors. While this strategy has the potential to strengthen development impacts, it also creates counterparty risks. Procedures need to be codified to ensure PSOD staff processing transactions comply with integrity due diligence guidelines that form part of *ADB's Anticorruption Policy Framework*. This framework should encompass various aspects of corruption, including fraud, money laundering, and terrorist finance. Mechanisms need to be put in place to address critical areas of risk, such as public sector procurement and corruption. Provisions can be adopted to facilitate detection and allow for investigations and audits, if required. In the first instance, operational staff should be required to provide their judgment and decide whether a specific due diligence report is necessary. Risk Management Unit or the private sector credit committee should also have the ability to request integrity due diligence investigation if reasonable grounds for concern are found. Similarly, a mechanism needs to be established, such as a signed due diligence checklist, where PSOD can confirm that adequate procedures are in place. This will allow PSOD to monitor project implementation, and ensure that procurement procedures meet ADB's Corruption Policy standards.

c. Credit Committee Structure and Operations

166. The Vice-President (Operations 1) chairs the Private Sector Credit Committee, which reviews nonsovereign guaranteed proposals to assess development, financial, social, and environmental impacts. The effectiveness of this committee is compromised, as it cannot make decisions on the value of development returns relative to financial risks, because pricing is the responsibility of the Credit Enhancement Committee led by the Managing Director General. Merging these two subcommittees would allow Management to make decisions based on risk-reward tradeoffs.

167. The Credit Committee only meets to review specific transactions. In line with other international financial institutions, it could be established as a permanent body that meets regularly, independent of transaction volumes. While the chair of the Credit Committee should be a representative of Senior Management, its members need not all be line managers. It is more important to ensure the members include professionals with strong hands-on private sector investment experience. Membership of the Credit Committee should include representatives from Controllers, Office of the General Counsel (OGC), Office of Cofinancing Operations, PSOD, Regional Sustainable Development Department (RSDD) for social and environmental compliance, Risk Management Unit, and Treasury Department. Representative

members of relevant regional department should attend to discuss development impacts and relationships with public sector operations.

168. Current internal credit review procedures tend to rely on written comments solicited from concerned departments independently, creating concerns about the effectiveness of procedures for exchanging information. Another problem is that PSOD is required to consult, rather than demonstrate that comments have been considered and issues addressed. This type of procedure sometimes can result in superfluous reviews and comments for the sake of procedural compliance, rather than emphasizing substance through open, frank discussion. PSOD is responsible for recording the minutes of credit committee discussions. This arrangement has the potential for conflicts of interest. The Credit Committee could have an independent secretariat to record discussions and follow up on actions.

169. The scope of the credit reviews should be extended to encompass Concept Clearance Papers, and Reports and Recommendations of the President. This would help ensure that development impacts, including social, environment, and credit concerns are embodied explicitly in project designs. Formal procedures and guidelines need to be established to determine pricing based on market benchmarks and a clear understanding of ADB's own cost of capital. An additional stage is needed in the credit approval process to allow the review of projects after Board approval, following the completion of negotiations with the sponsor, and before disbursement of ADB funds. The purpose of this review would be to confirm that the underlying terms of the transaction have not changed materially since ADB approval.

6. Plans and Resources

170. PSOD should develop a strategic plan for its private sector development and operational activities and likely volume of transactions over five years that has clear objectives and benchmarks against which to assess performance, and if necessary make mid term corrections. This plan should be supported by indicative forecasts of activity by country and sector, a revised organization structure and functions in headquarters and resident missions, and estimated staff and TA resources to meet forecast needs. Subsequently, the planning process can be institutionalized by consolidating country business plans to prepare rolling 3–5 year PSOD country and department plans. These plans can be used to forecast staff and other resources, including TA, based on staff drivers, such as volume of transactions. PSOD needs to be given sufficient resources to meet demand forecasts and perform functions in a way that reflects best practices in peer comparator international financial institutions. The staff skills mix might need to be modified to include staff with transaction experience in roads and water, and guarantees. Supporting functions, such as Risk Management Unit and Office of Cofinancing Operations, need to be strengthened in areas such as risk management and syndications to allow resource levels to keep pace with the growth in transaction and portfolio volumes.

171. PSOD needs the capacity to support privatization and provide public-private partnership units with advice and assistance in the design of concessions, as well as transparent and competitive procurement procedures, as they create the necessary entry points for PSOD transactions. PSOD's links with the public side of ADB need to be strengthened to develop regulatory agencies for infrastructure and finance. Capacity needs to be created to establish registries for property and financial rights (creditor and shareholder); and to support bank corporatization, privatization, and financial sector liberalization programs. Improving property rights requires a range of skills interpreting local customs and differentiating between formal and informal rights, understanding and modifying legal systems, and developing title-based registries. These registries could be created in the context of e-government projects that

address issues such as compliance with taxes and regulations. These are only some examples of issues that need to be considered when assessing ADB's staff skills mix to provide the level and types of services that ADB's clients are requesting.

172. Given the limitations on the future growth of ADB staffing numbers, decisions on the desirable skills mix should be made after strategic decisions are made related to focus and selectivity. Vacant staff positions could potentially be reallocated from elsewhere in ADB to PSOD-related functions. There may be a need to introduce more flexibility into the number and location of staff positions, job descriptions and recruitment practices to support this process. Similar types of resource issues will need to be considered concerning the allocation of TA to support private sector development activities, and upgrading of ADB's management information systems. Financial incentives can be introduced to help reward staff responsible for project origination and processing. These incentives could be based on the effective use of economic capital relative to the level of project funding that is mobilized, using similar concepts to measure capital as the Risk Management Unit when it performs risk assessments.

7. Reports and Information Systems

173. ADB should develop a more systematic framework for assessing the development impacts of PSO based on a clear and focused set of indicators that link impacts, outcomes, outputs, activities and resources. Report structures used by PSOD are not based on a common framework, which weakens the process for evaluating project impacts in a standardized manner. The Evaluation Cooperation Group's *Good Practice Standards for Evaluation of Private Sector Operations*[79] and OED's *Guidelines for Preparing Project Performance Evaluation Reports for Nonsovereign Operations*[80] could be used in the design and monitoring frameworks in Board documents to define objectives and provide a reference for project approval and post-evaluation. Similar to IFC and EBRD, ADB could develop reports based on balanced scorecard principles that present indicators on: (i) development impact; (ii) operational performance; (iii) financial performance; (iv) organizational performance; and (v) resource needs in terms of staff and expenditure. The scorecard could be used as a framework for setting objectives at both the country and departmental levels and monitoring performance.

174. Like other international finance institutions, ADB can develop a management and reporting system that is based on a central portfolio management concept and individual project risk reviews. The frequency of such reviews (annual, biannual, quarterly, or more frequently for watch list or problem loans) will depend on risk ratings assigned by an independent and adequately resourced Risk Management Unit. The results of these individual project reviews can be incorporated in quarterly and annual reports. These reports would compare forecasts from country and departmental business plans to actual development and financial outcomes, provide details on major risks, and identify any likely corrective actions that might be required. To support this type of system ADB's management information systems would need to be strengthened to provide a single comprehensive online application that ensures data consistency, and provides financial data at the individual transaction level. The review of information technology needs should be supported by a clear specification of report requirements.

[79] Evaluation Cooperation Group, 2006. *Good Practice Standards for Evaluation of Private Sector Operations.* Washington.
[80] ADB. 2007. *Guidelines for Preparing Project Performance Evaluation Reports for Nonsovereign Operations.* Manila.

C. Recommendations

175. The following recommendations are directional and are designed to help address the main issues outlined in this report.

Table 14: Recommendations to Strengthen Private Sector Development and Operations

Recommendation	Responsibility	Timing
1. Corporate Level:		
(i) Assess the need for changes in organizational structure supporting Private Sector Operations and Private Sector Development activities such that the potential synergies of the public and private sectors working together are more effectively captured.	BPMSD with SPD, RDs, OCO, and PSOD after completion of the LTSF review	2009/10
(ii) Establish a permanent unified credit committee that is supported by a permanent independent secretariat. Revise credit committee operations so that it considers risks and returns of transactions. Encourage a more direct and frank exchange of information by meeting on a regular basis, and review projects from concept clearance stage.	VPs and Managing Director General	2008
(iii) Strengthen the Risk Management Unit in anticipation of a significant increase in non-sovereign lending.	VPs and Managing Director General	2008 and onwards
(iv) Develop a corporate management plan covering a five year period that aligns resources with aspirations to expand private sector operations, including details on necessary administrative budget, technical assistance resources, staff skill mix, and strengthening supporting functions of risk management and commercial co-financing. Introduce balanced scorecard framework for assessing achievements in private sector operations, drawing on the experience of other similar multilateral development agencies.	PSOD, RDs, SPD, and BPMSD	2009
2. Department Level:		
(i) Prepare country business plans for delivering private sector operations and private sector development related outputs in the country partnership strategy framework.	PSOD and RDs	Beginning in 2008
(ii) Develop and implement a medium term strategic plan, including new products for supporting private sector and non-sovereign clients, monitorable results indicators, and resource requirements.	PSOD and BPMSD	2008
(iii) Prepare and implement integrity due diligence guidelines for private sector operations that form part of ADB's anticorruption policy framework encompassing various aspects of corruption, including fraud, money laundering, and financing for terrorism.	PSOD and OAGI	2008

ADB = Asian Development Bank; BPMSD = Budget, Personnel and Management Systems Department; LTSF = Long-Term Strategic Framework; OCO = Office of Cofinancing Operations; OAGI = Office of the Integrity Division; RD = Regional Department; RMU = Risk Management Unit; SPD = Strategy Policy Department; VP = Vice President.
Source: Operations Evaluation Department Staff Evaluation.

LITERATURE REVIEW

A. Private Sector Participation[1]

1. Increasing private sector participation has been a key objective of economic reform in developed and developing economies for the past 15 years. A large amount of research has been undertaken to identify ways of reducing constraints in the enabling environment for competitive private investment.[2] It has become increasingly apparent the development of market-based instruments that can be used by the private sector entails a transformation of governments and markets.[3] International financial institutions have been seeking to broaden the relevance and performance of their services; and providing public goods, such as policies, laws, regulations, and institutions, through policy adjustment modalities.[4] Table A1.1 illustrates some of the many different forms of private sector participation.

Table A1.1: Source of Resources and Allocation of Risks under Various Private Sector Participation Options

Option	Labor	Capital Investment/ Financing	Private Contract Duration	Output Risk (Quality, Minimum Unit Costs, and Secure Availability)	Investment Risk (Competitive Return on Capital)
Government ownership and private finance	Public	Private	–	Public	Public
Service contract	Private	Public	1–2 years	Public	Public
Management contract	Private	Public	3–5 years	Public	Public
Operating lease to private sector	Private	Public	8–15 years	Public	Public
Concession	Private	Private	8–15 years	Public or private	Public and private
Divestiture and green field investments	Private	Private	Indefinite (might be limited by license, or alternatively free entry)	Private	Private

— = not applicable.
Source: Operations Evaluation Department compilation.

[1] This section draws upon material presented in Nellis. J. 2006. C*enter for Global Developmen*t. *Privatization in Developing Countries: A Summary Assessment*. Washington DC.
[2] World Economic Forum. 2006. *Building on the Monterrey Consensus: The Untapped Potential of Development Finance Institutions to Catalyze Private Investment*. New York.
[3] Sachs, J., C. Zinnes, Y. Eilat. 2000. Patterns and Determinants of Economic Reform in Transition Economies: 1990–1998. *Consulting Assistance on Economic Reform II Discussion Paper 61* Cambridge, MA: Harvard: Institute for International Development.
[4] World Bank. 2005. A Better Investment Climate for Everyone. *World Development Report*. Washington, DC.

2. These private sector participation techniques have been used to different extents in most countries in the world. The structure that is adopted, which varies by case, is determined by the risks, returns, and overall value for money (VFM) associated with each transaction. This might include lower costs, improved access and availability, and better quality outputs through innovation and improved risk allocation.

B. Private Sector Development Strategies

1. Overview

3. A reasonably high degree of consensus has emerged on the primary constraints impeding Private Sector Development (PSD) in developed and developing countries. These include (i) macroeconomic instability, (ii) widespread informality to avoid excessive taxes and regulations, (iii) absence of the rule of law, (iv) lack of competitive pressure for large companies, (v) limited availability of physical and social infrastructure, and (vi) an inability of small and medium-sized enterprises (SME) to access finance. The magnitude of these constraints has been documented extensively through initiatives such as Asian Development Bank Institute reviews[5], Asian Development Bank's (ADB) private sector assessments (PSA), World Bank's *Doing Business* database and investment climate studies, and the European Bank for Reconstruction and Development's (EBRD) transition reports.

Box A1: Privatization

Privatization has been one of the most widespread techniques used to support private sector development. The rate of privatization in the new millennium has been lower than the rates achieved through the 1990s, even though the "vast majority of studies report post-privatization increases in profitability, efficiency and returns to shareholders."[a] While privatization has been successful in most cases, it was less likely to succeed in low-income countries or in places lacking institutional capacity, as was the case in some post-communist countries. Privatization is less likely to be successful in natural monopoly segments of infrastructure sectors, and banks and insurance services where regulations are required to protect consumers and depositors. Typical problems that arose included (i) false records on tariffs, value of assets, and liabilities; (ii) difficulties adjusting regulated tariffs; (iii) enforcement of contracts and property rights through the courts, particularly for minority shareholders; and (iv) difficulty enforcing private sector obligations. These problems are primarily a function of the quality of the institutions, especially the executive and judiciary, and their ability or willingness to enforce regulations, property rights, and contracts. In the early 1990s, reform programs initially assumed the creation of a system of property rights through privatization would generate demand for institutions that would allow the market to work. However, in low-income and some post-communist countries, it was often more rational for investors to use private "mafia"-based solutions to enforce ownership rights, rather than rely upon the state.

[a] Nellis, J. 2006. *Privatization in Developing Economies: A Summary Assessment*. Washington DC: Center for Global Development.

Source: Operations Evaluation Department staff compilation.

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[5] Quibria. M. 2002. *Growth and Poverty: Lessons from the East Asian Miracle Revisited*. Tokyo: Asian Development Bank Institute.

4. These analyses have led to international financial institution (IFI) programs that are focused on addressing enabling environment issues such as (i) fiscal and monetary reform; (ii) strengthening the rule of law by institutional reforms to eliminate conflicts of interest and increase transparency; (iii) enforcing property rights by strengthening the judiciary, preparing accurate land cadastres, and property and creditor registries; (iv) reforming taxes and regulations to reduce compliance costs and encourage entry to the formal sector; and (v) developing skills, knowledge, and institutional capacity in areas such as foreign languages, information technology, regulation, and public private partnerships (PPPs).[6]

5. While the types of PSD constraints are widely recognized, it is apparent there is no unique combination of policies and institutions that can be used to achieve development objectives. The former Soviet Union (FSU) and Eastern Europe adopted capitalist systems, and rebuilt their economies by rapidly creating markets and privatizing firms. In comparison, India and the People's Republic of China (PRC), which together account for about 40% of the developing world's population, adopted incremental reform programs, slow market liberalization, and limited privatization. The transition process in the FSU proved to be more difficult than anticipated, and only recently have economies such as the Czech Republic started to recover. In comparison, growth in India and PRC has been rapid, although often occurring in geographically restricted areas with an emphasis on new investment rather than restructuring existing businesses.[7]

6. These trends have broadened the recognition of the diverse range of options for creating policies and institutions that support PSD and economic growth. Country-specific diagnostic studies are needed that identify interventions that focus on binding constraints, rather than applying uniform policy prescriptions across countries. While the diversity in potential adjustment programs that can be applied by different developing member countries (DMCs) is considerable, some common themes that have emerged from reforms in the 1990s: (i) macroeconomic stability is critical; (ii) trade openness and competition are key elements of reform; (iii) privatization programs need to reflect institutional strengths and weaknesses in a country; (iv) level of success of financial liberalization will depend upon quality of institutions, property rights, and macroeconomic stability; (v) public sector governance reform should be incremental and pragmatic; and (vi) effective political checks and balances are needed.[8]

2. Private Infrastructure

7. Through the 1990s, many governments sought to include the private sector in the provision and financing of infrastructure by a combination of divestment and—more importantly in volume terms—greenfield investment supported by concessions. Because of privatization, the proportion of assets in private ownership in emerging economies is estimated to be: power, 45%; telecommunications, 42%; water, 40%; and transport, 30%.[9] The decline in privatization and relatively low level of private sector participation in infrastructure ownership reflects a number of factors, including problems that arose, especially concerning macroeconomic instability in the late 1990s, and political constraints on regulated tariff adjustments. Some high-profile renegotiations of projects occurred, particularly after changes in government or major currency devaluations, and some contracts were canceled or renationalized. This reduced the

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6 United Nations Development Programme. 2000. *Unleashing Entrepreneurship, Commission on the Private Sector and Development*. New York.

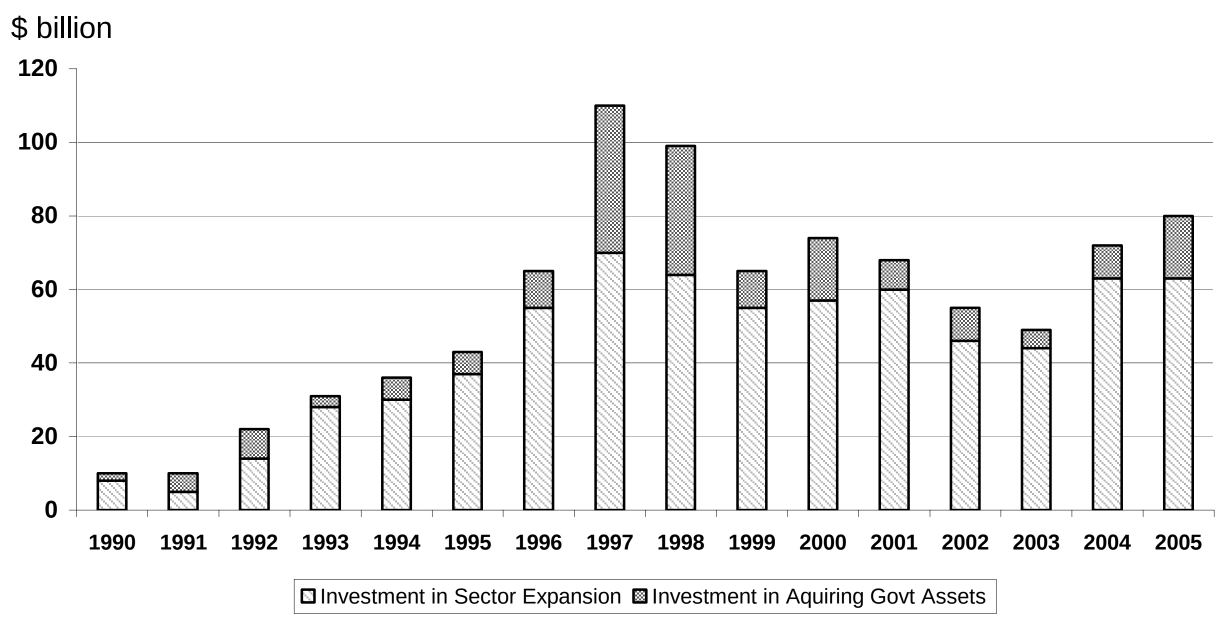
7 ADB. 2004. *Private Sector Development in the People's Republic of China*. Manila. A discussion on reform in PRC can be found in T. Kanamori and Z. Zhijun.

8 World Bank. 2006. *Economic Growth in the 1990s*. Washington, DC.

9 Kikeri, S. 2006. *IFC Presentation: Privatization Trends*. Washington DC.

appetite of many traditional foreign investors and financiers for such projects, and many are no longer pursuing projects in developing economies. Some public discontent related to private sector infrastructure provision also has been evident, especially in the electricity and water sectors. Notwithstanding these developments, local governments are facing significant funding constraints and huge demand to maintain and upgrade infrastructure. Consequently, private sector participation continues to be recognized as an important source of financing, operational expertise, and technological innovation in most DMCs. Emerging market sponsors are becoming increasingly important in telecommunications, power, transport, and water sectors.[10] Many IFI reforms are targeting strengthening local capital markets to support private infrastructure development.

Figure A1.1: Investment in Infrastructure Projects with Private Participation in Developing Countries by Purpose, 1990-2005



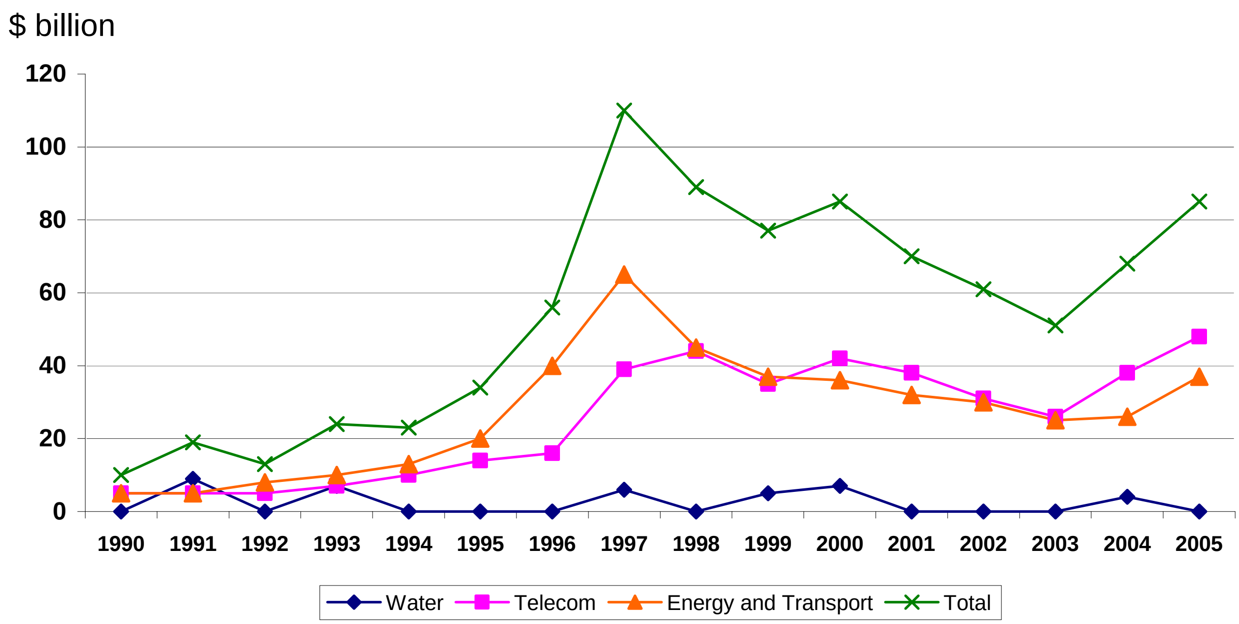
Source: The World Bank and Asian Development Bank Public Private Infrastructure Facility (PPIAF), PPIAF project database.

8. These largely foreign-financed investment flows peaked in 1997, and then subsequently dropped by more than half by 2004, before starting to recover. Most private investment in infrastructure in developing countries during 1990–2003 occurred in telecommunications (50%), power (36%), transport (8%), and water (3%).[11] The greatest efficiency gains from private sector participation in infrastructure have been achieved in sectors such as telecommunications and power, and are concentrated in urban areas. The main problems limiting privately financed infrastructure are a lack of fundamental reform of policies and institutions in areas such as procurement, tariffs, regulations, and contracting arrangements. In some cases, optimism about the ability of governments to implement reform, particularly in a short time frame, has been

[10] Izaguirre, A. 2005. *Private Infrastructure, Emerging Market Sponsors Dominate Private Flows, Public Policy for the Private Sector*. Washington, DC: World Bank.
[11] Kikeri, S., and A. Kolo. 2005. *Privatization: Trends and Recent Developments*. Washington, DC: World Bank.

excessive. In other cases, demand has been overestimated. Establishing competent and legitimate regulators also has been difficult. In the power sector, many Asian countries have preferred to use concessions to purchase power from greenfield projects on a take-or-pay basis, rather than introduce competition by unbundling the sector infrastructure and buying power on a competitive basis. Procurement agencies often have lacked experience, and some transactions have been opaque, with sole source negotiated agreements, rather than concessions, being awarded based on transparent competitive bidding. Public sector decentralization and increasing urbanization have further complicated the development of road and water infrastructure. Local government agencies responsible for administering infrastructure often have lacked the experience and necessary credit profile to access capital markets. Weak domestic capital markets in many cases have led to large currency mismatches in projects with revenues denominated in local currency and debt service obligations in international currencies. As the Asian financial crisis demonstrated, such are projects vulnerable to currency devaluations.

Figure A1.2: Investment in Infrastructure Projects with Private Participation in Developing Countries by Sector, 1990–2005



Source: The World Bank and Asian Development Bank Public Private Infrastructure Facility (PPIAF), PPIAF project database.

9. There is now a much better awareness of critical risks and public-private partnership schemes are an increasingly important mechanism for facilitating private investment in infrastructure. In addition to providing a means of accessing long-term finance, concessions have the potential for generating large cost savings for governments through competition, innovation, and risk transfers to the private sector.[12] The United Kingdom has been a leader in

[12] An overview of the Private Finance Initiative can be found in: Dixon, T., et al. 2005. Lessons From the Private Finance Initiative, Benefits, Problems and Critical Success Factors. *Journal of Property Investment and Finance*. 23(5):412–423.

this area through its Private Finance Initiative. As of April 2003, it had contracted $104 billion worth of infrastructure using this modality. This initiative increasingly has come to be seen as a way of achieving better value for money (cost savings through procurement from the private sector rather than in-house provision by the public sector) compared to government provision. Public sector construction and infrastructure projects have a reputation for being poorly managed, leading to cost and time overruns and long-term technical problems.

10. The central tenet of the Private Finance Initiative is the transfer of risk from the public to the private sector in a competitive environment. By achieving the correct allocation of risk, the government is able to treat public sector expenditure on projects as off-balance sheet. This provides fiscal space for governments to pursue spending in other areas, such as health and education. While the results are less apparent in more complex facilities such as schools and hospitals, the potential gains appear to be substantial. A study[13] estimated that project cost savings had been on the order of 17%, and the National Audit Office confirmed that costs savings can be significant.[14] This success has generated interest among other governments. In India, such modalities are now an important component of its transport development program. Recent research by ADB in the Indian road sector indicates the cost and time savings of privately financed and managed projects are substantial. Traditional public sector construction contracts have incurred costs exceeding the awarded contract price by an estimated 20%, with delays on average of 16 months. Private annuity projects achieved costs 3% in excess of awarded contract price and had average delays of 3.3 months. Build Operate Transfer (BOT) projects achieved costs savings of 44% relative to contract award, and projects were completed 1.1 months ahead of schedule. In addition to being cheaper and available earlier, the average size of projects was $24 million for public sector construction contracts versus $71 million for Build Operate Transfer projects.[15]

3. Financial Markets

11. PSD initiatives have focused on domestic capital formation and the need for efficient financial markets and institutions. Assistance is often split between targeting SMEs, and more generally strengthening banks and creating capital markets that can be used to mobilize savings and allocate funds efficiently. Subsequently instruments such as insurance and derivatives can be developed to hedge risks such as price volatility.

12. The most effective way of providing assistance to SMEs has been the subject of an ongoing discussion. Most government assistance to SMEs is provided in the form of subsidized finance. Research indicates that, while access to finance is a major constraint, this tends to reflect problems with the enabling environment, particularly in areas such as the quality of the legal framework for property rights and availability of accurate financial information (footnote 21). Evidence[16] indicates that providing credit lines for SMEs is not sufficient. These firms have difficulties accessing finance because they represent a material credit risk, not due to a lack of finance or resources available to these firms. Some skeptics[17] have questioned whether SMEs should be singled out for assistance, or whether reforms should be targeted at all firms that form part of private sector value chains.

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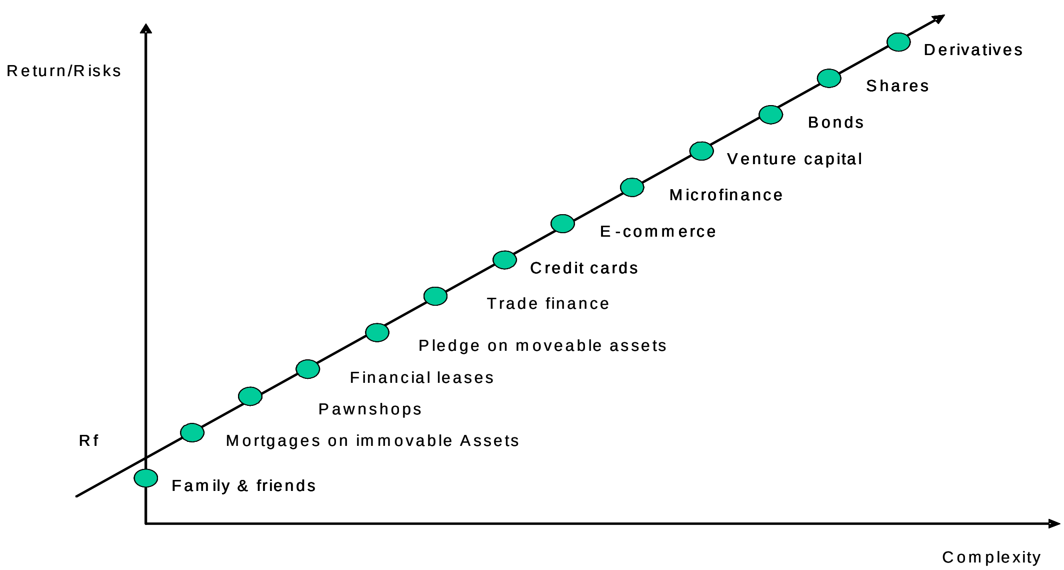
[13] Arthur Andersen/Enterprise LSE. 2000. *Value for Money Drivers in the Private Finance Initiative* London.
[14] National Audit Office. 2003. *PFI: construction performance.* The Stationery Office, London, Report No. HC 371.
[15] Tsukada, S. Mainstreaming the PPP for Infrastructure Development in India–Emerging Modalities in the Transport Sector. ADB presentation, April 2007, ADB Manila.
[16] ADB. 2006. *Best Practice Notes on Small and Medium-Sized Enterprise Support*. Manila.
[17] World Bank. 2007. *SMEs, Growth and Poverty, Do Pro-SME Policies Work?*. Washington, DC.

13. The quality of property rights and the effectiveness of the legal system[18] are key determinants of the level of investment and effectiveness of the financial system. An important study of investment behavior in the Central Europe[19] found that entrepreneurs with weak property rights reinvested almost 40% less of their profits than individuals with secure property rights. The analysis found no evidence that access to bank credit stimulates more investment for these firms. Firms with weak property rights did not wish to borrow, even when they had assets that could be used as collateral. These results suggest that, irrespective of the quality of the banking regulatory framework and bank corporate governance systems, internal investment and bank development will not occur without effective property rights. Once property rights are defined, the key issues that need to be addressed are the identification of ways to reduce the transaction costs and risks associated with providing various forms of debt and equity finance, and insurance to third parties. Evidence suggests the effectiveness of the secured transaction laws and the availability of registered collateral are probably the most important determinants of the level of external finance that can be accessed by the private sector. A debtor that can provide secure collateral can anticipate receiving six to eight times more credit, take two to ten times longer for repayment, and pay interest rates 30–50% lower than borrowers without secure collateral.[20] Once frameworks have been developed for relatively low risk mortgage and lease finance modalities reforms can progress to more complex types of finance such as venture capital and bonds. Figure A1.4 illustrates the indicative risk-return profiles of the various financial instruments available to the private sector that need to be developed.

Figure A1.3: Indicative Risk Return Profiles for Various Financial Instruments



Rf = Risk Free.
Source: Operations Evaluation Department Staff compilation.

[18] La Porta, R., F. Lopez-de-Silanes, A. Shleiffer, R. Vishney. 1998. Law and Finance. *Journal of Political Economy*. volume number 106: 1113-55 .

[19] Johnson, S. J. McMillan, C. Woodruff. 2002. *Property Rights and Finance*. Nashville,TN: American Economic Association. Massachusetts Institute of Technology, Stanford University and the University of California, San Diego.

[20] ADB. 2000. Law and Policy Reform at the Asian Development Bank. Volume II.

4. Future Directions

14. Privatization continues to be a primary mechanism for many governments to support private sector development. Apart from 1997, transaction volumes in 2005 were the highest since the World Bank started collecting data in 1990.[21] The scope for strengthening the definition and transferability of property rights in agricultural and urban properties and financial assets (e.g., shares) is substantial. Property rights for nontraditional assets, such as forests, fisheries, water, and carbon credits, can be developed.[22] The vast amounts of assets in DMCs[23] ensure that programs to facilitate financial intermediation will continue to play a central role in development efforts. A key mismatch exists between the poor, who typically have movable assets, and the banks, which prefer immovable assets as collateral. The European Bank for Reconstruction and Development (EBRD) has used special purpose legal teams and technical specialists to develop legislation and registries for recording pledges on moveable assets such as floating charges over stock or accounts receivable. The International Finance Corporation (IFC) has specialist legal departments independent of transaction teams to develop leasing legislation that can be used by SMEs to finance items such as equipment. Venture capital is an important tool to help develop SMEs, especially in frontier economies. A wide range of development finance institutions invest in SMEs using these types of financial instruments.

15. The successful implementation of public-private partnership schemes requires significant institution building within government. Legislation and institutional capacity need to be strengthened to (i) simplify procurement procedures at country and sub-sovereign levels, (ii) increase transparency, and (iii) reduce costs and the risk of corruption.[24] Sector reform programs need to be complemented with regulators that are well-staffed and genuinely independent, with powers to establish contractually defined cost-based tariffs, subject to adequate measures of accountability. Clear processes for dispute resolution, the ability to enforce contracts, and effective lender remedies under bankruptcy and insolvency laws are needed to support the enabling environment for the private sector. Concession structures need to be designed to enable donors and governments to help mitigate risks that the private sector cannot afford to assume due to a lack of control. Opportunities exist to (i) introduce innovative concession designs, such as leases and affermage[25] contracts; (ii) develop more user-friendly risk mitigation products in the areas of regulatory and contractual risk; (iii) enhance the development of local capital markets; and (iv) increase the use of credit-enhancement products, such as political risk guarantees. Private investments potentially can be coordinated through regional development programs for geographically defined special economic zones or along transport corridors.

16. Creative project designs can be developed that meet the twin goals of addressing the needs of a broader cross section of people, while pursuing commercial returns. The private sector potentially could provide services in sectors that traditionally are serviced by the public sector, such as water, without compromising social objectives. Projects such as the privately financed Manila Water Concession, which was developed with ADB assistance, required bidders to provide services to poorer areas using mechanisms such as public standpipes or low

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[21] World Bank. 2007. Privatization Trends. *Public Policy for the Private Sector, Note Number 314*. Washington, DC.

[22] Tietenberg, T. 2002. *The Tradable Permits Approach to Protecting the Commons: What Have We Learned?* Department Economics, Colby College, Maine.

[23] World Bank. 2006. Unlocking Dead Capital, How Reforming Collateral Laws Improve Access to Finance, *Public Policy for the Private Sector. Note Number 307*. Washington, DC.

[24] Harris, C. 2003. *Private Participation in Infrastructure in Developing Countries: Trends, Impacts and Policy Lessons*. Washington, DC: World Bank.

[25] These types of contracts are similar to leases and are commonly used in the French water utility sector.

lifeline tariffs for water supply, with the Government bearing the associated financial impact in the form of lower concession revenues. There have been experiments with the establishment of state and municipal funds to subsidize consumers or compensate private providers of noncommercial services in sectors such as roads, where charging tariffs using output-based aid concepts is difficult. Using these types of arrangements, the introduction of mechanisms such as voucher schemes and the provision of connection or consumption subsidies are possible. On the supply side, payment to private sector suppliers can be linked to service delivery using direct consumer charges or shadow tolls, or based on availability of facilities. Governments have opportunities to facilitate private sector infrastructure financing through the development of national and municipal procurement funds that pool risks and potentially can issue financial instruments in the local bond markets. These state funds can be given access to tax revenues, as well as the use of credit ratings and guarantee instruments to reduce credit risks and interest costs, and to extend the tenors of debt instruments. ADB can provide assistance managing the funds at the portfolio[26] and project level through provision of finance to address timing issues and guarantees to mitigate credit and political risks.[27]

17. In some DMCs, domestic bonds and cross-currency swaps are becoming feasible sources of local currency finance for IFIs. Like IFC, ADB has issued local currency bonds in countries such as India, Philippines, and the PRC to help develop capital markets and provide access to local currency finance. Following the introduction of the Innovation and Efficiency Initiative (IEI) in 2005, ADB can provide commercial multitranche financing through its public and private sector windows to sovereign and nonsovereign entities. Funds can be provided on a limited or non-recourse basis, in foreign or local currency, and can be used for greenfield developments, or to refinance existing facilities. The efforts of ADB's Office of Regional Economic Integration to strengthen capital markets in Asia are supporting this capacity.[28] The *Financing Partnership Strategy*[29] and the *Credit Enhancement Operations Policy Paper*,[30] prepared by the Office of Cofinancing Operations in 2006, have introduced the additional flexibility offered by credit enhancement instruments such as guarantees and syndications. ADB has provided support in DMCs to securitize collaterized debt assets in bond markets and encourage cross border flows.

18. International financial institutions have been extending the range of services offered to frontier countries and regions, and developing policies and procedures to help mitigate social and environmental risks associated with private sector provision. Best practice in dealing with social and environment risks and meeting global standards is not only ethically desirable, but also a sign of commercial and forward-looking management. Environmental, involuntary resettlement, and other social policy standards supported by ADB have provided a useful benchmark that levels the playing field for all market participants, particularly in infrastructure.

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[26] Boyle, G. et al. 2005. *Techniques for Estimating the Fiscal Costs and Risks of Long-term Output-based Payments*. Washington, DC: Global Partnership on Output Based Aid.

[27] Von Klaudy, S. et al. 2005. *Credit Enhancing Output Based Aid* Washington, DC: Global Partnership on Output Based Aid.

[28] Capital market reforms in Asia have tended to be more successful in equity rather than bond markets. ADB provides TA to support regional integration in areas such as transport, communications, and financial flows. ADB helps strengthen capital markets and regulatory frameworks, and conducts research on issues such as the types of capital controls required at various stages of development.

[29] ADB. 2006. *ADB's Financing Partnership Strategy*. Manila.

[30] ADB. 2006. *Review of ADB's Credit Enhancement Operations*. Policy Paper, August 2006. This paper defines credit enhancement products as (i) guarantees, which could be in the form of partial credit guarantees or political risk guarantees issued by ADB; and (ii) syndications through "reinsurance" and non-funded risk participations or other means that allow ADB to transfer risk associated with loans and guarantees made by ADB, or through the use of a "B loan" (formally known as complementary financing scheme) or "guarantor of record" program under which ADB shares risk (and salvage) with co-financiers, while taking no counter party risks.

ADB is currently undertaking a review of its safeguard policies and expects to issue an updated policy framework in 2008 that will help address issues in areas such as private financial services and the need to harmonize standards with other international financial Institutions and local governments' regulations.[31] ADB has been pursuing strategies to reduce the potential for corruption and fraud in its private (and public) operations through the application of its Anti-Corruption Policy and investigations undertaken by the Integrity Division within ADB's Office of the Auditor General.

[31] ADB. 2005. *Safeguard Policy Update, A Discussion Note*.

PROJECT EVALUATION REPORTS

Table A2.1: Project Performance Evaluation Reports (1992–2006)

Name	Country	Year	Result
Petronet LNG	India	2006	Satisfactory
Nghi Son Cement	Viet Nam	2006	Satisfactory
Fujian Pacific Electric	PRC	2006	Successful
SBI DFHI	India	2005	Satisfactory
CESC Limited	India	2002	Successful
Investment Fund Operations	Regional	2002	Generally Satisfactory
Batangas Power	Philippines	1999	Partly successful
Fauji Fertilizer	Pakistan	1998	Generally successful
National Devt. Leasing	Pakistan	1997	Generally successful
Philippine Long Distance Telephone	Philippines	1996	Successful
BBL Dharmala Finance (Lease)	Indonesia	1994	Generally successful
Planters Development Bank	Philippines	1993	Generally successful
PT Gunung Garuda (steel mill)	Indonesia	1993	Generally successful
Padma Textiles	Bangladesh	1992	Generally successful

LNG = liquefied natural gas, PRC = the People's Republic of China.
Source: Operations Evaluation Department staff compilation.

Table A2.2: Project Completion Reports (1995–2006)

Name	Country	Year	Result
Grameen Telecommunications	Bangladesh	2005	Satisfactory
Colombo Port	Sri Lanka	2005	Excellent
NDB Housing	Sri Lanka	2005	Satisfactory
Bhutan National Bank	Bhutan	2004	Successful
AIG Sectoral Equity Fund	India	2004	Satisfactory
Nghi Son Cement	Viet Nam	2003	Successful
Asia Pacific Ventures	Regional	2002	Partly successful
Fauji Kabirwala Power	Pakistan	2002	Successful
Walden AB Ayala Ventures	Philippines	2002	Partly successful
Himal Power	Nepal	2002	Partly successful
Mutual Fund Company of Philippines	Philippines	2001	Not formally rated, but unsatisfactory financial performance
Global Trust Bank	India	2001	Not formally rated, but appears satisfactory
SBI Gilts	India	2001	Not formally rated, but appears partly satisfactory
China Asset Holdings	PRC	2001	Not formally rated, but unsatisfactory financial performance
Centurion Bank	India	2001	Not formally rated, but appears partly satisfactory
IL&FS Venture Capital	India	2001	Not formally rated, but appears partly satisfactory
H&Q Philippine Ventures	Philippines	2000	Not formally rated, but appears partly satisfactory
Asian Convertibles and Income Fund	Regional	2000	Not formally rated, but unsatisfactory financial performance

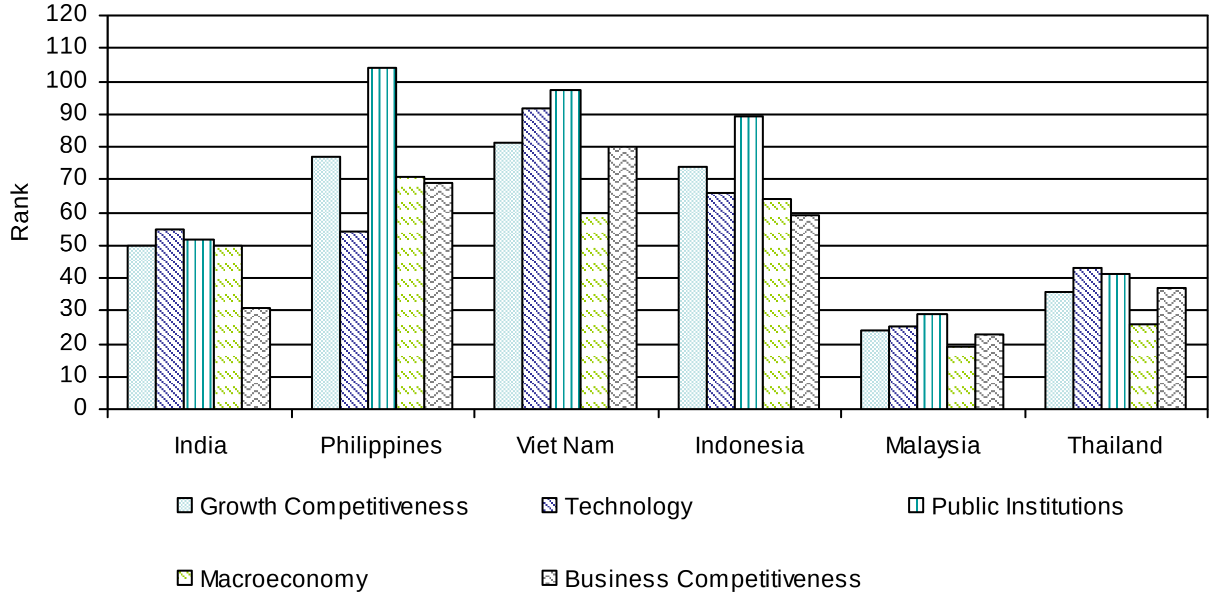
Name	Country	Year	Result
Union Assurance	Sri Lanka	2000	Not formally rated, but appears partly satisfactory
Merchant Bank of Sri Lanka	Sri Lanka	2000	Partly satisfactory
CESC (Power)	India	1999	Not formally rated, but unsatisfactory financial performance
IL&FS and Kotak Mahindra Finance	India	1999	Not formally rated, but appears satisfactory
Korea Technology Finance	Republic of Korea	1999	Not formally rated, but unsatisfactory financial performance
Xiamen International Bank	PRC	1999	Not formally rated, but appears partly satisfactory
Pacven Investments	Regional	1999	Not formally rated, but appears satisfactory
Hopewell Power	Philippines	1997	Not formally rated, but appears satisfactory
Jyoti Spinning Mills	Nepal	1996	Not formally rated, but unsatisfactory financial performance
Batangas Power	Philippines	1996	Generally successful
United Leasing	Bangladesh	1995	Not formally rated, but appears satisfactory
Pakistan Synthetics	Pakistan	1995	Not formally rated, but appears satisfactory
Guangzhou Pearl River Power	PRC	1995	Not formally rated, but appears satisfactory

PRC = the People's Republic of China.
Source: Compiled by ADB Operations Evaluation Department staff compilation.

COUNTRY CASE STUDIES: COMPARISON OF INVESTMENT CLIMATES

1. Figure A3.1 shows the global competitiveness index ranking of India, Philippines, and Viet Nam compared against three other regional countries, Indonesia, Malaysia, and Thailand.

Figure A3.1: Comparative Global Competitiveness Index Ranking of Target Countries



Source: World Economic Forum 2005.

2. Over the past 10 years, the Heritage Foundation and Wall Street Journal jointly have produced an index on economic freedom that is updated annually. The economic freedom index reflects various features of the enabling environment, and provides time series data on areas that are constraining economic growth. The Index of Economic Freedom for 2006 was measured for 161 countries against a list of 50 independent variables divided into 10 broader categories of economic freedom. The results for 2006 are in Table A3.1.

Table A3.1: Business Environment Characteristics

Countries Categories	Philippines	India	Viet Nam
Overall Rank (Among 161 Countries Included)	**98 – Mostly Unfree**	**121 – Mostly Unfree**	**142 – Mostly Unfree**
1. Trade Policy	**Moderate level of protectionism.** Weighted average tariff 2.6% (2003). Widespread corruption and irregularities in customs.	**Very high level of protectionism.** Weighted average tariff 28% (2004). Extensive nontariff barriers, e.g., confusing bureaucracy.	**Very high level of protectionism.** But weighted average tariff down from 17.4% (2001) to 13.7% (2003). Nontariff barriers also falling.
2. Fiscal Burden	Moderate income tax (top 32%) **High corporate tax (35%)** Government expensive at 19.2% (2003) of GDP.	Moderate income tax (top 33%). **High corporate tax (33%).** High cost of Government at 29% (2003) of GDP.	High income tax (top 40%) **High corporate tax (28%)** High cost of Government at 29% (2003) of GDP.
3. Government Intervention in the Economy	**Low level.** Public sector consumption 11.4% of GDP (2003)	**Moderate level.** Public sector consumption 12.8% of GDP (2003).	**High level.** 5,000 state-owned enterprises generate 41% of industrial output.
4. Monetary Policy	**Low inflation.** Weighted average inflation (1995–2004) 5.15%.	**Low inflation.** Weighted average inflation (1995–2004) 3.85%.	**Low inflation.** Weighted average inflation (1995–2003) 5.98%.
5. Capital Flows and FDI	**High barriers.** Negative sector lists restrict FDI, e.g., engineering, medicine, accounting, law, retail, media, security, marine resources.	**Moderate barriers.** Limits on equity and voting rights, mandatory Government approvals and capital controls.	**High barriers.** Time-consuming licensing, ownership restrictions, allocation of investment rights, domestic protectionism, etc.
6. Banking and Finance	**Moderate level of restrictions.** NPLs down from 17.3% (2001) to 11.3% (2003). State banks hold 11.1% of market.	**High level of restrictions.** Increasing tolerance toward foreign banks. State banks have 70% of market.	**High level of restrictions.** Five state banks hold 75% of sector assets. Since 2004, 100% foreign-owned banks permitted.
7. Wages and Prices	**Moderate level of intervention.** Minimum wage maintained. Most prices market-driven. Controls in electricity, water, and public transport.	**Moderate level of intervention.** Price controls on “essential” commodities, e.g., electricity, petroleum products.	**Moderate level of intervention.** Minimum wage maintained. Price controls on electricity, water, petrol, telecommunications, and public transport.
8. Property Rights	**Low level of protection.** Slow judicial system, insufficient skilled judges, corruption, etc. International arbitration preferred by foreigners.	**Moderate level of protection.** Applied unevenly across India. Large backlog creates long delays.	**Very low level of protection.** Complicated legal system, interferences, and corruption. International arbitration preferred by foreigners.
9. Regulation	**High level.** Burdensome and lack of transparency and haphazard enforcement, etc.	**High level.** At federal and state level.	**Very high level.** Lack of transparency, uniformity, and consistency, etc.
10. Informal Market	**High level of activity.**	**High level of activity.**	**High level of activity.**

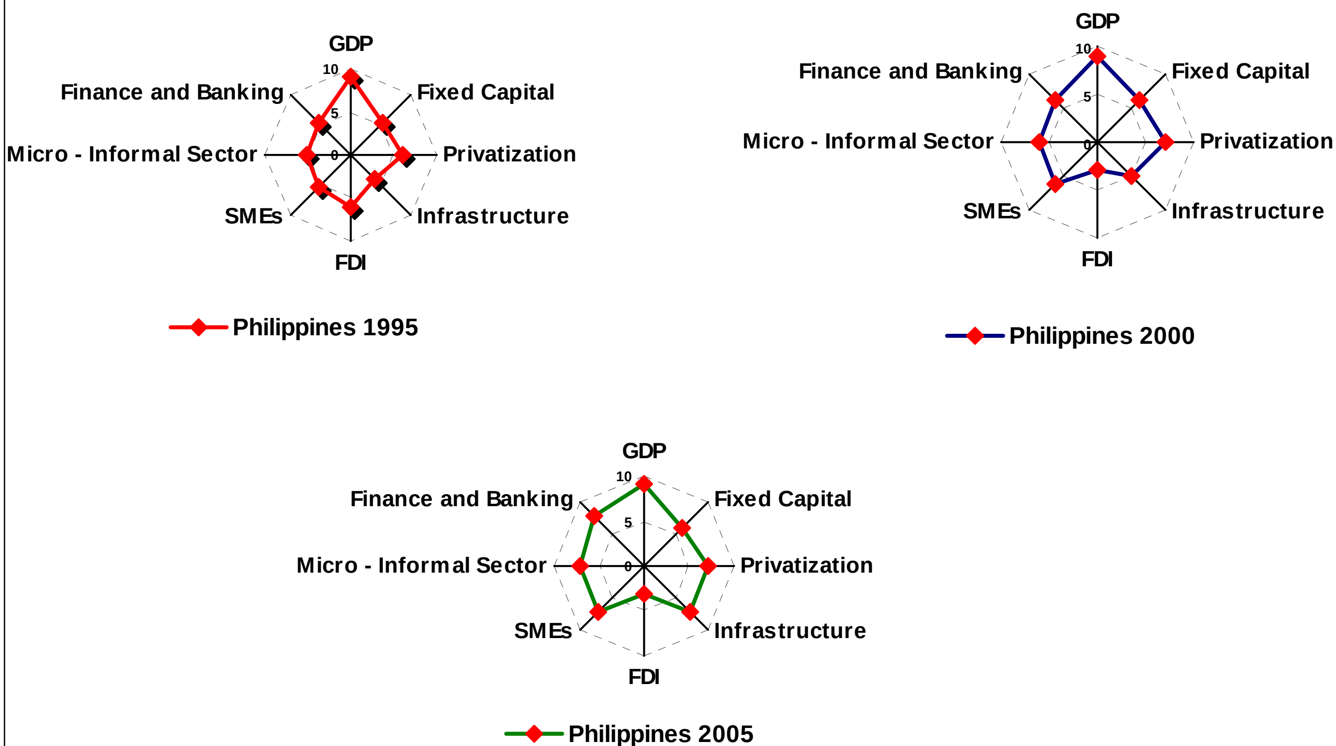
FDI = foreign direct investment; GDP = gross domestic product; NPL = nonperforming loan.
Source: Based on the Heritage Foundation’s and Wall Street Journal’s Index of Economic Freedom, 2006.

3. Despite the difficulties in defining precisely the constraints on private sector development (PSD), all three case study countries clearly are making important progress in this area. The spider charts presented in Figures A3.2 (Philippines), A3.3 (India), and A3.4 (Viet Nam) provide a means of evaluating PSD progress in broad terms by assessing the changing patterns in economic structure and the increasing levels of participation by the private sector in the economy. The spider charts show the change in PSD against each of the following eight criteria that have been given a score on a scale of 0 to 10:

- (i) The proportion of private sector contribution to gross domestic product (GDP);
- (ii) The proportion of private sector investment in fixed capital;
- (iii) Progress in privatization in terms of proportion of existing state-owned assets having been privatized;
- (iv) Private sector participation in infrastructure by relating private sector investment with public sector investment, and the prevalence and progress of public-private partnerships (PPP) and independent power producers (IPP);
- (v) The proportion of foreign direct investment (FDI) of GDP;
- (vi) The expansion and contribution to value added by the small and medium-sized enterprise (SME) sector;
- (vii) Progress made in registration, organization, and arrangement of financing for microfinance and the proportion of the sector's contribution to GDP; and
- (viii) The share of private sector participation in finance and banking, based on assets and loan portfolios.

4. Because of limited statistical data on some of the criteria, the scores contain a degree of subjectivity. However, the purpose of the spider charts is to show PSD progress in the three target countries on a comparative basis and not in absolute terms. The case study countries have made some progress on PSD. In the Philippines, the private sector was substantially in place over the review period, although weak institutions have undermined its effectiveness. In India, after many years of incremental liberalization, private sector growth is emerging. However, limited progress has been made on privatization, use of PPPs in infrastructure, and access to FDI. In Viet Nam, while the level of private sector participation is still quite low, limited privatization and development of PPP facilities have occurred. Access to FDI has helped fuel strong growth in special economic zone (SEZ) enclaves on the coast. All three countries have high levels of nonperforming loans (NPL), one of the factors that restrict SME access to finance. In India, NPLs have been reduced significantly, although some existing NPLs may have been warehoused rather than worked out, and problems with the underlying flow of bad debts continue.

Figure A3.2: Private Sector Participation Progress in the Philippines

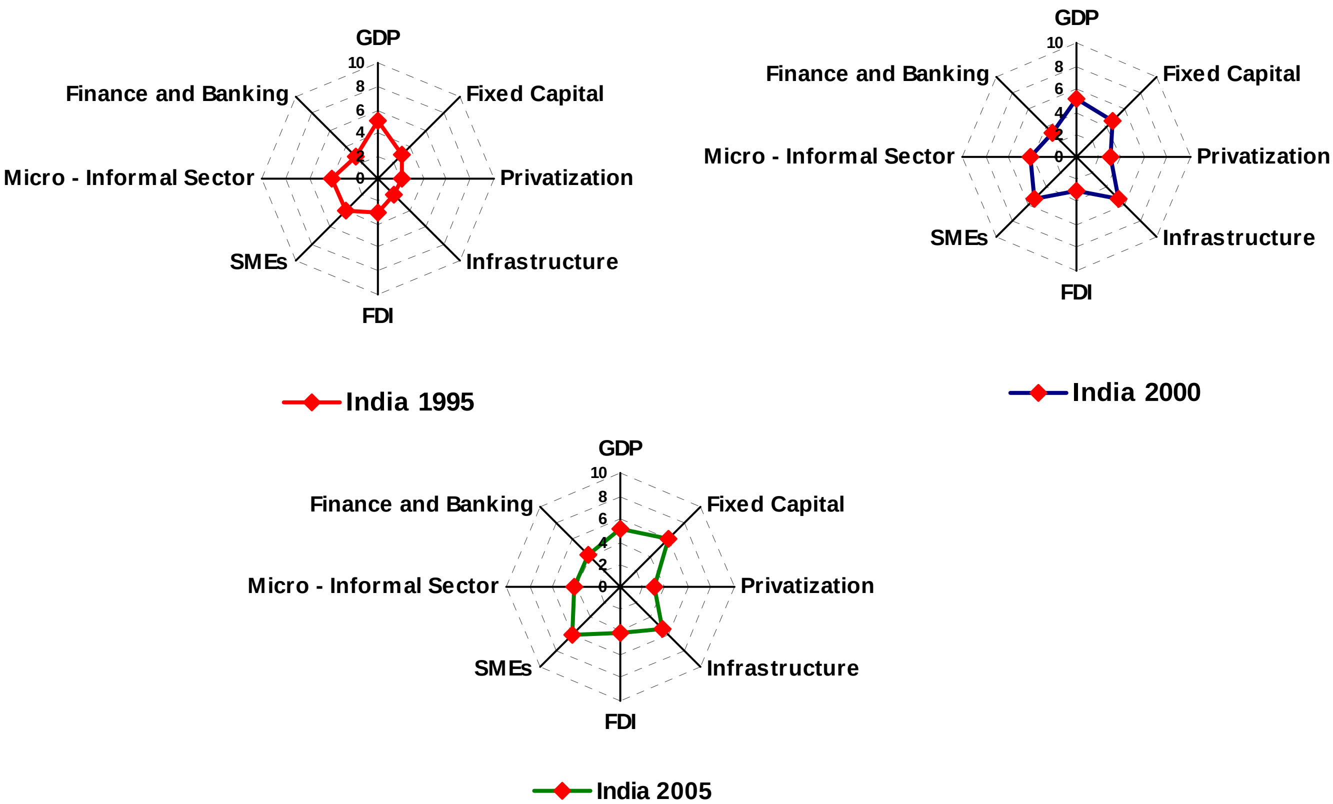


FDI = Foreign Direct Investment; GDP = Gross Domestic Product; SMEs = small and medium enterprise.
Source: Operations Evaluation Department staff compilation.

1. Philippines

5. Private sector participation plays a dominant role in the Philippines, with the private sector contributing 95% of GDP. In 1995, privatization was progressing and FDI accounted for about 2% of GDP, although private sector participation in infrastructure was modest. The private sector accounted for about 75% of total banking assets. By 2000, all criteria showed positive movement except FDI, which had fallen to only 0.5% of GDP due to the Asian financial crisis, concerns about political stability, and a deteriorating business climate. Privatization progressed and private sector participation in infrastructure and finance increased. By 2005, a further expansion of the octagon can be observed with increased private sector participation against most criteria except FDI, which has only marginally recovered. Slight improvements are noticeable for private sector participation in fixed capital formation at 70%. Private sector participation in infrastructure has increased, with private IPPs' share of power generation exceeding the output of the public sector. Similarly, the micro and SME sectors had grown, accounting for 32% of value added. Private sector participation in finance and banking made substantial progress, with private banking assets (including foreign) representing 88% of total assets in 2005.

Figure A3.3: Private Sector Participation Progress in India



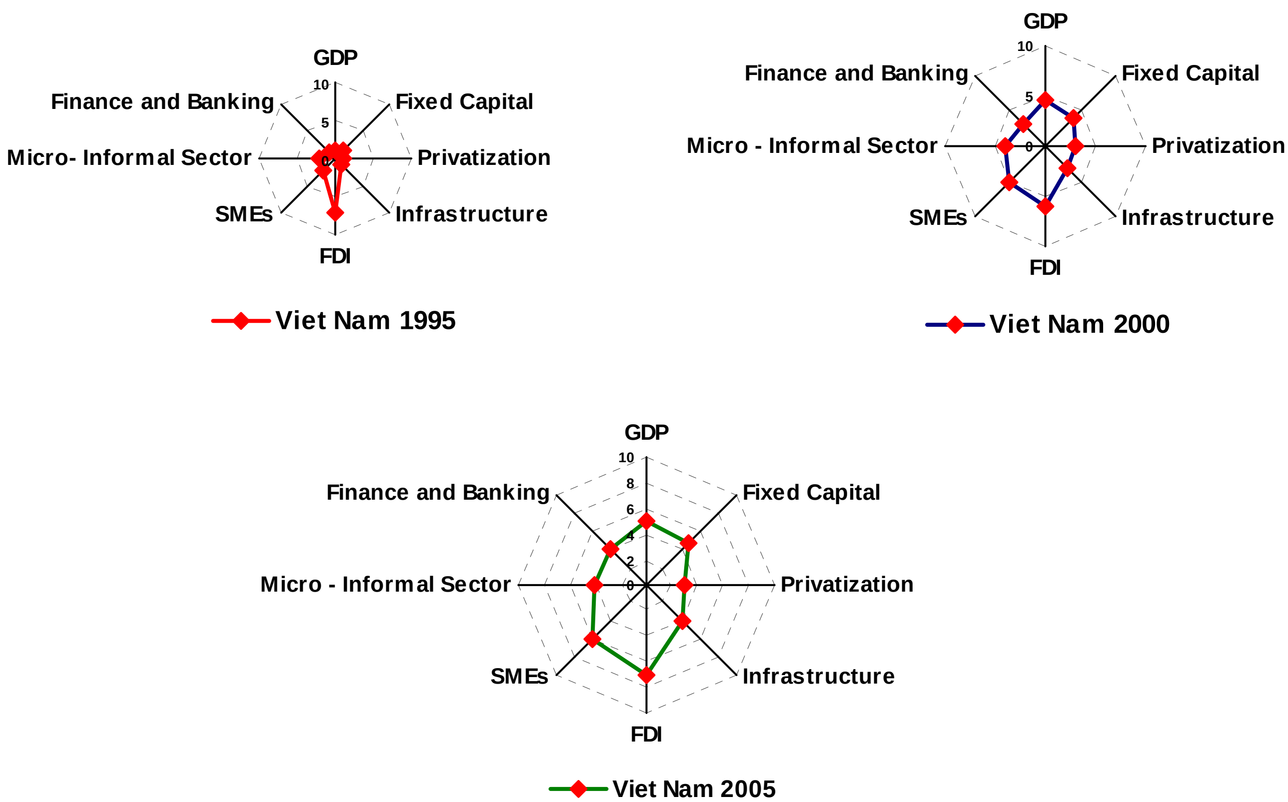
FDI = Foreign Direct Investment; GDP = Gross Domestic Product; SMEs = small and medium enterprise.
Source: Operations Evaluation Department staff compilation.

2. India

6. In 1995, India showed modest progress in private sector participation for all criteria, especially privatization, infrastructure, and finance. The area within the 1995 octagon is small. The private sector accounted for about 70% of GDP and 62% of fixed capital formation. FDI, at around $3 billion in absolute terms, was well below 1% of GDP. By 2000, private sector had improved. Its contribution to fixed capital formation had risen, privatization grew, and private sector participation in infrastructure had increased. The largest improvement involved SMEs, where the number of firms is growing rapidly and their importance in the economy is increasing. Private sector investment and FDI, as proportions of GDP, had not changed between 1995 and 2000, and private sector participation in finance and banking did not increase. By 2005, the impact of the economic liberalization was clear, as illustrated by an expansion of the octagon. While private sector participation as a proportion of GDP (74% in 2005) had remained fairly constant from 1995 through to 2005, the proportion of fixed capital formation owned by the private sector increased from 62% in 1995 to 71% in 2005. Following a Government policy review, progress on privatization was put on hold, and private sector participation in infrastructure increased only slightly. As a proportion of GDP, FDI grew marginally to 0.8% by 2005, but increased substantially in absolute terms. The number of registered SMEs increased to 15 million in 2005, and SMEs were receiving increasing attention and financial support from

Government. Private sector involvement in banking and infrastructure made further progress, although the private sector share of banking assets is still only 25%.

Figure A3.4: Private Sector Participation Progress in Viet Nam



FDI = Foreign Direct Investment; GDP = Gross Domestic Product; SMEs = small and medium enterprise.
Source: Operations Evaluation Department staff compilation.

3. Viet Nam

7. Given its stage of transition from a centrally planned to a market economy, Viet Nam's very limited private sector involvement in 1995 was not surprising. The private sector accounted for 20 to 30% of GDP and 10% of fixed capital formation. Infrastructure and banking had virtually no private sector. Although the SME sector had begun to make progress, it was relatively small in 1995, and the micro-enterprise sector was disorganized and lacked attention. Most points shown in the 1995 octagon in Figure A3.4 cluster around the center. The notable exception relates to FDI, which accounted for 4% of GDP. By 2000, clear progress had been made on private sector participation in Viet Nam. Private sector accounted for 40% of GDP, and the private sector share of fixed capital formation had increased to 23%. However, privatization (equitization) had made little progress, although IPPs had entered into power generation. Because of the Asian financial crisis, FDI dropped to 2% of GDP in 2000, about half of the 1995 level. The number of registered private SMEs increased from a few thousand to 44,000, and the private sector was present in the banking sector. The rapid progress in private sector

development continued. By 2005, private sector participation exceeded 50% of GDP, and the share of private investment in fixed capital had increased to 31%. Although privatization remained the exception, the private sector accounted for 21% of power generation. FDI had recovered to 4% of GDP by 2005, and the number of private SMEs had increased to more than 200,000. In addition, about 2.7 million micro-enterprises were registered at the district level, and their access to microfinance was improving. The share of banking assets owned by the private sector is increasing, reaching 30% in 2005. While private sector participation in Viet Nam is still comparatively modest, the progress during the past 10 years has been remarkable.

COUNTRY CASE STUDY: PHILIPPINES

A. Investment Climate

1. Background

1. In the Philippines, the private sector has always played an important role in the economy. The country has been progressive in East Asia in terms of liberalizing the economy, privatizing state-owned firms, and procuring privately financed and operated infrastructure by using public private partnership (PPP) arrangements. While these programs initially made substantial gains in the early 1990s, the openness of the economy and weakness of institutions created significant problems following the Asian financial crisis. After almost a decade of relative stagnation, private sector-led growth is starting to become apparent again.

2. Macroeconomic Stability

2. Following the Asian financial crisis and political instability in 2001, the exchange rate fell by almost 50%. The economy still has not recovered fully from the instability, and significant structural weaknesses persist. An important macroeconomic policy requirement has been the need to address the fiscal imbalance by raising budget revenues on a sustainable basis. As tax revenue in recent years has persistently remained at 15% of gross domestic product (GDP), and interest costs on public sector debt denominated in foreign currency have risen, the Government has had difficulty investing in adequate levels of physical and social infrastructure. The Government is addressing these concerns through continued restructuring and liberalization of the economy, with an increasing emphasis on improving the enabling environment for the private sector.

3. Competition and Trade

3. The legacy of "crony capitalism" under President Ferdinand Marcos, and the impact of past policies based on import substitution and price controls, led to high levels of industry concentration in many sectors. The resulting vested interests of dominant family business groups, which often are interlinked with banks, have limited the level of competition and discouraged private investment. Despite these constraints, trade policy liberalization and deregulation has been quite successful in the Philippines. Nominal average tariffs fell from 28% in 1985 to 7.2% in 2004, and nontariff barriers have been reduced. The Philippines accession to the World Trade Organization (WTO) in 1994 and participation in Association of South East Asian Nations (ASEAN) Free Trade Area (AFTA) have helped to improve the trade regime. Under AFTA, the intention is to create a free trade area that includes Japan and the People's Republic of China (PRC) by 2010. The Philippines has numerous bilateral trade and investment agreements.

4. Domestic liberalization has been occurring in many sectors. Telecommunications, shipping, air transport, and retail trade have been opened to greater competition since 1987. Despite these reforms, competition laws are not effective at addressing problems of oligopoly. Some parties have expressed concerns about labor productivity, which is seen to be low relative to other countries in the region due to high minimum wage rates and moderately restrictive employment laws. While a consumer protection law is in place, a comprehensive antitrust law does not exist, and unfair trade practices are addressed through ad hoc legislation. Essential items, such as rice, have price ceilings in case of national emergency. Specific regulators

handle electricity, water, telecommunications, public transport, ports, and road tolls. These regulators are not independent, and they do not have the ability to set tariffs based on cost recovery principles.

4. Privatization

5. Privatization of Government agencies started in 1986. Significant progress was made—about 450 of the 562 Government-owned and -controlled corporations (GOCC) had been privatized by the end of the 1990s. Privatization has slowed since 2001, as most of the remaining assets constitute the more difficult cases. The Government continues to own substantial interests in companies such as Philippine National Oil, Light Rail Transit Authority, Philippine National Railways, National Power Corporation, five banks, and a state pension system. The private sector plays a leading role in delivering some infrastructure services, such as telecommunications, bus and trucking services, and power distribution in Manila. However, the public sector is also a major provider of infrastructure services. Most GOCCs have posted sustained deficits, constraining their ability to provide services. The sale of the shares in the Philippine National Bank in September 2005, the biggest privatization since 1995, demonstrated the Government's continuing commitment to reform in this area. Progress in privatizing the infrastructure services include (i) unbundling the power sector to allow independent power producers (IPP) to generate electricity, (ii) privatizing the water supply in Manila, and (iii) privatizing the Manila International Container Terminal in the 1980s.

5. Public Private Partnerships

6. Public sector procurement through PPPs has been an important component of the Government's infrastructure programs. Build-operate-transfer (BOT) laws were enacted in 1990 and 1994 to allow private sector participation (PSP) in the development and operation of infrastructure, especially in the power sector. By 2003, the Philippines had commitments for $25 billion in private finance using concessions.[1] This program has been substantial, encompassing 45 power-related projects with a total value of $10 billion, 20 transport projects with an aggregate value of $6 billion, 17 environment-related projects valued at $8 billion, and 49 other projects in areas such as property development and information technology procurement.

7. While the scale and scope of PPP projects in the Philippines is impressive, some problems have arisen. Ambiguities in the implementing regulations of the BOT laws have led to challenges. The law permits a "Swiss challenge", which allows a challenger to make a counter bid to an unsolicited proposal. This creates the potential for inefficient litigation. Loopholes in the rules for reviewing projects after award, which can extend beyond technical and contractual considerations, create the potential for expropriation of assets. The Supreme Court has ruled on several PPP contracts, sometimes to the detriment of private firms. While the Government has not unilaterally revised any contracts, it has renegotiated 18 of 35 IPP contracts in the power sector that were signed in the early 1990s. Most of these contracts were negotiated contracts and were not awarded based on transparent competitive bidding, creating concerns among the public about crony capitalism. In 2002, the Government introduced the Government Procurement Act, which was designed to promote competitive bidding, transparency, and accountability. Despite these reforms, the recovery of the PPP program has been slow.

[1] N. Kintanar et al. 2003. Locking Private Sector Participation into Infrastructure Development in the Philippines. *Transport and Communications Bulletin for Asia Pacific*. No 72, 2003.

6. Foreign Direct Investment

8. Foreign Direct Investment (FDI) was liberalized in 1991 to allow 100% foreign ownership of Philippine assets, apart from those on two negative lists that included restricted foreign ownership of items such as land. In 1993, legislation was enacted that allowed foreigners to lease land for 50 years, renewable for an additional 25 years. Profits and capital can be repatriated fully, and private firms face relatively few restrictions in borrowing offshore. These reforms led to a significant increase in investment by multinational corporations in manufacturing facilities in the early to mid-1990s. The Philippines established several export processing zones to attract FDI, and made a available a complex system of incentives. Despite these arrangements, the level of FDI in recent years has been about 0.5–0.7% of GDP, which compares unfavorably with other countries in the region.

7. Infrastructure

9. Due to the Philippine's weak infrastructure, coupled with persistent public sector funding constraints, the Government has sought private sector investment since 1994 when it enacted the BOT Law. Initially, this legislation was successful, stimulating (mainly foreign) investment of more than $25 billion to increase capacity in the power and road sectors. This form of investment has largely dried up, partly because of concerns about corruption and political instability. In addition, contractual and regulatory disputes between the public and private sectors in the power, water, and airport sectors have eroded private investment. To stimulate private investment, coherent sector plans need to be developed, supported by capable public sector agencies that include independent regulators, unbundled competitive operations, and clear rules on procurement using PPP instruments, tariffs, and dispute resolution. While sector regulators have been established, Congress typically is responsible for setting tariffs. Politicization of the tariff process has led to tariffs in the power and water sectors being set at levels below cost in some cases, without any compensation provided for private sponsors.

10. Private investment has been most successful in communication infrastructure due to the nature of the technology and ability to rely on greenfield investment in mobile rather than regulation of existing fixed lines to generate competition. The Government deregulated the telecommunications sector in 1993, removing the monopoly of the privately owned Philippine Long Distance Telephone Company and allowing the development of competitive service providers, particularly in the mobile phone and Internet markets. In the power sector, domestic energy capacity increased substantially following large state investments in geothermal and hydropower generating capacity and private IPPs in the 1990s. The rate of electrification in the Philippines is relatively high by East Asian standards. However, this is offset by the many interruptions, and transmission and distribution system losses of about 14% of capacity. Electricity charges are the highest in the region. As noted in the Philippine Power Sector Assistance Program Evaluation (SAPE), and similar to other countries, the restructuring and unbundling of the power sector has been a difficult and time-consuming task in the Philippines.[2]

11. The transport sector was liberalized in the 1990s, although institutional complexity has hindered progress on reforms to support increased private sector participation. Sixteen agencies are involved in the operations and management of the transport network, which makes coordination and inter-modal planning difficult. Cost-based tariffs administered by independent regulators are needed, but these types of institutions are not yet in place in the transport sector.

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[2] ADB. 2005. *Sector Assistance Program Evaluation of ADB Assistance to Philippines Power Sector*. Manila (paras. 30–31).

The Government remains the predominant owner of the physical assets in roads, rail, air, and seaports. A notable exception to Government infrastructure ownership was the successful Manila North Luzon Expressway BOT project, which was financed by Asian Development Bank's (ADB) private sector operations (PSO), and the Manila International Container Terminal. In contrast, the Philippine International Air Terminal Company (PIATCO) airport project is embroiled in legal disputes between the Government and its sponsors.

12. The Government has pursued reforms to increase the level of private sector engagement in the water sector with mixed results. Private sector participation has consisted of two concessions in Manila, a concession in Subic, and many small-scale independent providers that serve about 15% of the urban population and 10% of the rural population using technology ranging from pushcarts to small piped water systems. Problems coordinating the wide range of public sector agencies involved in water provision have constrained planning of water projects. The Metropolitan Water Systems Services (MWSS) regulates two private concessions in Manila, and it continues to have operational responsibilities that create a conflict of interest. The tariff adjustment mechanisms, which became a major issue for one of the Manila concessions (Maynilad), have faced problems. Due to currency mismatches associated with the large amount of MWSS foreign-denominated debt assigned to Maynilad, the concession experienced financial difficulties following the substantial depreciation of the peso and disputes over the timing of tariff adjustment. Because of these problems, the concession was canceled. In contrast, the Manila Water concession has been successful, and provides an excellent example that water infrastructure can be financed privately.[3] Apart from the Manila concessions, private sector participation in the water sector has been limited. Local Government units have been unable to sign any contracts with private operators, despite attempts to do so, due to concerns about quality of the system and regulatory framework.

8. Small and Medium-Sized Enterprises

13. Micro-enterprises and small and medium-sized enterprises (SME) account for 99% of business establishments, 32% of value added, and 68% of employment. SMEs traditionally have been a high priority sector for the Government. In 1991, the SME Magna Carta was enacted, which highlights the importance of lowering the costs of doing business, raising productivity, and improving access to technology and finance. The legislation (i) created an SME Development Council that is responsible for coordinating development of SMEs; (ii) specified mandatory bank credit allocations to SMEs; and (iii) created the state-owned Small Business Guarantee and Finance Corporation, which is part of Department of Trade and Industry. In 1999, the Government required the guarantee agency and the state-owned Philippine Export Import Credit Agency to start direct lending to SMEs. In 2004, President Gloria Arroyo announced a 10-point reform agenda that included provisions to triple available credit for SMEs.

9. Financial and Capital Markets

14. About half of Philippine companies use bank financing for working capital, while the remaining 50% of funding is sourced primarily from retained earnings. Banks dominate the Philippine finance sector, accounting for 64% of financial assets in 2004, followed by the Philippine Stock Exchange with 22% and nonbank financial institutions (NBFI) with14%. The

[3] IFC, 2006, *Making a Difference, how private enterprise is creating opportunities and improving lives in developing economies*, Washington DC, IFC. This report provides an interesting case study on Manila Water Company Limited:

Government is still an important participant in the finance sector, partly owning one universal bank (Philippine National Bank) and three specialized banks: Development Bank of the Philippines, Land Bank of the Philippines, and a small special purpose Islamic bank. The remaining banks are privately owned, typically by a larger conglomerate that uses the banks as a means of accessing finance. Of the 21 foreign financial institutions, four are large commercial banks.

15. Loan portfolios grew rapidly before the Asian financial crisis, but subsequently slowed as economic growth rates fell and credit constraints increased due to the deteriorating quality of loan portfolios. Loan security is weak due to problems related to foreclosing on collateral. At the end of 2003, nonperforming loan (NPL) ratios were estimated to be 15% of bank loans, representing 53% of bank capital. The central bank has initiated reforms to clean up NPLs. This program is making progress, and by 2005 NPLs for commercial banks had declined to 7.5%.

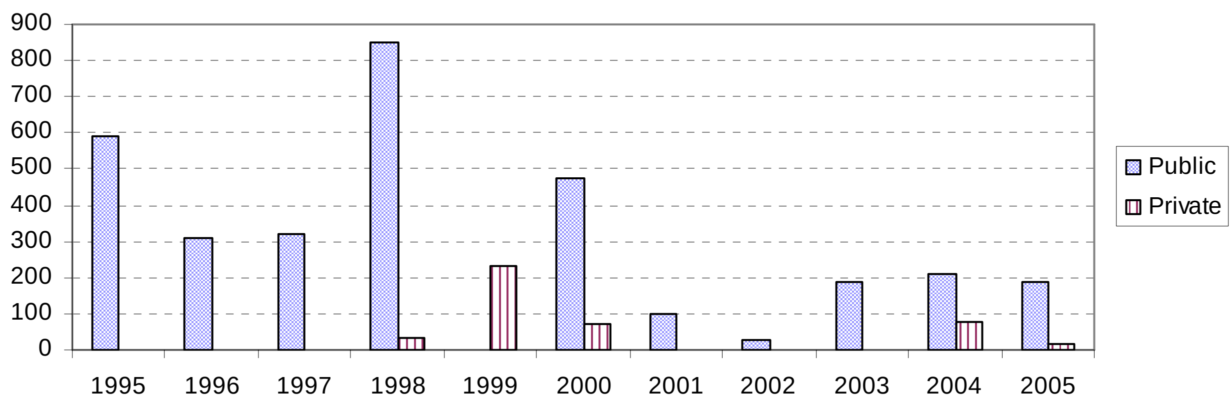
16. The stock exchange is small relative to others in South East Asia, with only 237 listed companies and an average of about four initial public offerings per year. The corporate bond market is virtually nonexistent, and large Philippine companies prefer to list offshore to take advantage of better liquidity and pricing. Weaknesses in minority shareholder rights, restrictions on foreign ownership, and high transaction costs constrain growth in demand for equities. To help resolve these issues, the Securities Exchange Commission, in association with the Capital Markets Development Council, recently prepared a blueprint to strengthen the capital markets on a wide range of fronts.

B. ADB's Country Strategy and Development Program

1. Overview

17. ADB started operations in the Philippines in 1969. Traditionally, ADB has focused on a mixture of public sector-financed infrastructure projects designed to support growth and other operations to meet rural development, and social and environmental objectives. As illustrated in Figure A4.1, public and private sector financing levels have been volatile and trending downwards.

Figure A4.1: Public and Private Sector: Annual Approvals in Philippines
($ million)



Source: Asian Development Bank records.

18. Annual public sector lending, which peaked at $851 million in 1998, has averaged $170 million per year since then. From 2003 through 2005, public sector lending ranged between $175 and $213 million. Volatility has been associated with the Asian financial crisis in 1997, political instability in 2001 and 2002, and the Government's fiscal situation that made debt service increasingly difficult. During 1995–2005, lending has come almost exclusively from non-concessional ordinary capital resources (OCR), with a shift from project to program lending.

19. PSO, which ADB began in 1986, have been much more limited than public sector operations. ADB has approved 29 PSO projects for $579.8 million on ADB's own account, yielding an average project size of $20 million. In addition, loans totaling $233.6 million were approved under the complementary financing scheme (CFS) for two projects in transport, one in water distribution, one in energy, one in manufacturing, and two in the petrochemical industry. Like public sector lending, PSO has been volatile. In the 11 years since PSO began, ADB made private sector loans in 5 of the years. ADB did not have any PSO in the Philippines in the balance of the period. The early investments in the Philippines related to manufacturing. ADB then moved into telecommunications and power. A significant expansion in PSO took place during the early 1990s when ADB played an important role in the Government's "fast track" approach to solve the acute power shortages.[4] ADB invested in three of the 10 IPP projects that were put in place. At the end of 2005, Private Sector Operations Department's (PSOD) country exposure totaled $112 million, which represented 6.6% of the PSO portfolio. These PSO investments were made almost exclusively to financial institutions.

2. Country Strategies

20. In the early 1990s, slow economic growth was the primary concern of the Philippines. Reflecting the Government's priorities, the ADB's 1993 country strategy focused mainly on infrastructure development, supported by social and environmental initiatives, such as employment generation and environmental protection. The Asian financial crisis slowed economic growth and precipitated a substantial depreciation of the peso. The exchange rate adjustment created pressure on inflation and the financial performance of projects that generated local currency receipts but were financed in foreign currency.

21. The 1998 country strategy program[5] (CSP) concluded that ADB's strategy in the Philippines should focus on five areas: (i) upgrading the country's infrastructure by improving efficiency in public provision and laying the groundwork for private provision through policy and institutional reform, particularly by (a) enhancing BOT bidding procedures and creating a project pipeline, (b) strengthening PPP capacity at local Government level, and (c) developing capital markets; (ii) rural development through microfinance; (iii) human resource development in areas such as basic education and primary health for the poor; (iv) more balanced regional development, with a special focus on Mindanao; and (v) environmental management. Infrastructure continued to be a priority as investment during the 1980s had lagged other parts of South East Asia, and electricity shortages were widespread in the 1980s and early 1990s.

22. In 2001, the country strategy was revised. It noted that PSD assistance would focus on (i) SME support; (ii) increased private sector participation in rural infrastructure, railroads, tollways, telecommunications in rural areas, power and renewable energy, water supply, and waste management; (iii) restructuring of Philippine National Railways; and (iv) privatization of National Power Corporation. In 2005, ADB published a private sector assessment (PSA) that identified

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[4] ADB. 2005. *Sector Assistance Program Evaluation of ADB Assistance to Philippines Power Sector*. Manila.
[5] ADB. 1998, Philippines: Country Operational Strategy: Manila.

specific measures to implement the PSD strategy in Philippines. Following early findings of the PSA, resolving NPLs, enhancing local government access to finance, and increasing PPP in areas such as housing were emphasized. Judicial reform was identified as an important enabling environment objective. PSOD focused on supporting privatization, especially in power infrastructure, and developing the finance sector in areas such as NPL resolution. More recently, PSOD has been looking for ways to mobilize local currency finance, particularly through the use of swaps. In October 2005, ADB issued a local currency bond in the Philippines of P2.5 billion.

3. ADB Assistance Program

23. Table A4.1 provides a breakdown of public sector lending in the Philippines that is relevant to PSO. Infrastructure appears to have gradually declined in importance relative to finance sector assistance.

Table A4.1: Sector Allocation of Public Sector Loans
($ million)

Year	Public Administration	Power and Energy	Transport	Water and Urban Development	Finance	Total
1995	30	244			150	424
1996		5	167	50	20	242
1997		191	93			284
1998		300		320		620
1999					3	3
2000				175		175
2001				30	75	105
2002		40				40
2003				34	150	184
2004						0
2005					175	175
Total	**30**	**781**	**260**	**609**	**573**	**2,253**

Source: Asian Development Bank records.

24. Apart from two large public sector loans for urban redevelopment projects in Manila, the major volume of lending during 2000–2005 was directed to capital markets, SMEs and microfinance. The public side of ADB was not involved in the telecommunications sector, and it has gradually disengaged from the transport and water sectors. ADB provided extensive assistance to MWSS, which resulted in one highly successful water concession. The other water facility that ADB intended to finance through PSO was canceled. Public sector lending in the power sector shifted from project to program lending to support ongoing efforts to restructure the industry. Key issues addressed included unbundling the sector, improving the legal framework, developing an independent regulator, promoting privatization, and addressing tariff issues. Restructuring the power sector, which should create more business opportunities for PSO, has been a long and difficult process.

25. PSOD has followed a broadly similar strategy to the public sector, with several large water- and transport-related infrastructure PPP projects being the main priorities in the late 1990s—all of which were negatively impacted by the depreciation of the peso and political uncertainty. PSOD was not active in the Philippines from 2000 through to 2004. In 2005, PSOD

initiated a series of NPL transactions and obtained approval to invest in a credit bureau, although these transactions were small.

4. PSO Transactions in the Philippines

26. Table A4.2 presents a summary of ADB's PSO investment approvals for the Philippines from 1995 through 2005. During this period, 11 projects were approved for a total of $613.1million, including CFS loans for $193.58 million and a partial guarantee for $18.4 million. Investments approved for the finance and capital market sector dominate the country portfolio.

Table A4.2: PSO Investment Approvals in the Philippines (1995–2005)

Name	Sector	ADB Financing ($ million)					Year Approved	Status
		Loan	CFS	Equity	PCG	Total		
Management Company[a]	Finance	–	–	0.05	–	0.05	1995	
Mutual Fund Company	Finance	–	–	3.85		3.85	1996	
Oleochemicals[a]	Industry	19.42	8.58	5.84	-	33.84	1998	Investment liquidated
Water Services	Water	45.00	120.00	–	–	165.00	1999	Canceled
Air Terminals	Transport	40.00	40.00	–	–	80.00	1999	Canceled
Tollways Corporation	Transport	45.00	25.00	–	–	70.00	2000	
Peso Swap and Financing Project	Finance	200.00	–	–	–	200.00	2004	Canceled
Guarantee Corporation	Finance	–	–	2.00	–	2.00	2004	
Disposal of NPLs	Finance	33.00		1.00	–	34.00	2004	
Housing Finance	Finance	29.24	–	–	–	29.24	2004	
Bank Disposal of NPLs	Finance	5.00	–	–	–	5.00	2005	
Facility and Credit Information	Finance		–	1.00	18.40	19.40	2005	

– = not applicable, ADB = Asian Development Bank, CFS = complementary financing scheme, NPL= nonperforming loan, PCG = partial risk guarantee, PSO = private sector operations.
[a] Includes initial investment.
Source: Operations Evaluation Department staff compilation.

27. Several large projects that were canceled after approval distort these figures. The Maynilad Water Services project did not reach financial close due to the financial difficulties experienced by the company. The investment in PIATCO air terminal was canceled as implementation and operational disputes emerged between the sponsors and the Government before the commissioning of the completed terminal. The Government canceled the peso swap facility. While the justification for this move is not clear, it was probably because the Government believed it could access sufficient foreign currency on a more flexible basis through the local foreign exchange market. These cancellations totaled $445 million, or 73% of gross approvals. ADB did not approve any investments in 2000–2003, and 50% of the transactions by number have occurred since 2004.

28. Following the cancellations, the remaining portfolio is $168.1 million, consisting of $102.5 million in loans on ADB's own account, $33.6 million under CFS, and $18.4 million under partial risk guarantee. ADB's equity exposure is $13.7 million, or a reasonable 8% of the country portfolio. Of the projects that were not canceled, one infrastructure and one industrial project account for $103.4 million, or 61% of the gross total; the remaining eight ($60.9 million) were financial and capital market transactions.

29. The Philippines has benefited from some of PSOD's regional funds. Over more than 10 years, 48 SMEs in a wide variety of sectors have received equity investments from these funds totaling $16.64 million. The average size of the investment has been about $350,000, with the smallest being $20,000 and the largest $3.56 million. This source of SME funding, especially for the smaller segment of new ventures, has been highly useful.

30. An OED evaluation of the PSO projects in the Philippines, based on a mixture of desk-based reviews and company visits, derived the indicative project performance results shown in Table A4.3.

Table A4.3: Summary of Evaluated Project Performance in the Philippines (1995–2005)

Project	PSD	Investment Performance	Comments/Issue
Management Company	Satisfactory	Marginal	–
Mutual Fund Company	Unsatisfactory	Unsatisfactory	–
Oleochemicals[a]	Unsatisfactory	Unsatisfactory	Investment liquidated
Water Services	Canceled	–	Project canceled
Air Terminals	Canceled	–	Project canceled
Tollways Corporation	Excellent	Excellent	–
Peso Swap and Financing Project	Canceled	–	Canceled by client
Guarantee Corporation	Satisfactory	Satisfactory	–
Disposal of NPLs	Excellent	Satisfactory	–
Bank Disposal NPLs	Excellent	Satisfactory	–
Facility and Credit Information	Satisfactory	Satisfactory	Project not yet operational

– = not applicable, NPL = non performing loan, PSD = Private Sector Development.
[a] Including initial investment in 1993.
[b] Source: Operations Evaluation Department staff compilation.

C. PSD Issues in the Philippines

31. The Philippine's is a country that has high potential for PSO as it is strategically located in East Asia, has a large relatively well-educated population that speaks English, and has an open economy and a political and legal system based on American standards. The private sector accounts for about 95% of GDP and 70% of fixed capital formation. Despite these advantages, growth has been volatile and low by regional standards; and investment, especially from FDI, has fallen dramatically.

32. Because of the Asian financial crisis and the derived fiscal problems, ADB's public sector lending has been limited since 2002, and PSO has been marginal throughout the period of review. Power sector reform and urban development projects have been the dominant areas of public sector lending. In the country strategy documents, PSD has been a high priority, with infrastructure being the focus in the 1998 CSP. In subsequent updates of the CSP, the focus started to shift to SMEs and NPL resolution, coupled with a continued focus on power sector reform. The Country Assistance Program Evaluation prepared in 2003 concluded that only 29% of public sector projects had been successful during 1986–2001, and some private infrastructure projects had run into serious difficulties. The PSA published in 2005 set out a clear strategic framework for facilitating private investment, focusing on strengthening competition, pursuing corruption eradication efforts, strengthening the judiciary and the legal framework, establishing independent regulators, and strengthening capacity to procure privately financed infrastructure. While the CSPs (and updates) have a strong PSD orientation, the level of cooperation between the public and private sector sides appeared to be poor. PSOD staff had limited involvement in the preparation of the last CSP.

33. Despite a strong private sector orientation in the CSP, and calls for increased levels of cooperation between public and private sector departments, the results on the ground were disappointing. Public sector lending has been declining, and PSO has not taken off. In public administration reform, the public sector provided advice to the LGU Guarantee Corporation in 1996, which might have helped pave the way for a PSOD investment of $2.0 million in 2004. The public sector has been heavily engaged in the power sector, and it appears to be putting in place the policy and institutional framework that will support increased levels of private sector participation in the sector. ADB's public sector operations were heavily involved in the MWSS privatization program, which was followed by a PSOD loan approval. Conversely, in the transport and urban development sectors, the regional department appears to have provided little advice or technical capacity building to support greater PSOD involvement. ADB's public and private sector operations have been heavily involved in the finance sector. However, the public sector appears to have focused primarily on NBFIs and capital markets, while PSOD has concentrated on NPLs.

34. The size of the PSO portfolio in the Philippines is small at $111.9 million, or 6.6% of the ADB's PSO portfolio as of 31 December 2005. The quality of the portfolio appears to be deteriorating, mainly due to legacy funding facilities provided in high-risk manufacturing sectors, such as agricultural process, that was discontinued in the early 1990s. The Asian financial crisis and subsequent macroeconomic instability also have undermined the quality of investments, and the ability to close transactions. Infrastructure investment has almost ceased following problems with Maynilad, PIATCO, Manila Electric Company, and Manila North Tollway. PSO has sought to turn these difficult circumstances to its advantage by putting in place a series of innovative NPL transactions that acts as an important constraint on SME's ability to access funds.

COUNTRY CASE STUDY: INDIA

A. Investment Climate

1. Background

1. India's economic liberalization reform process started approximately 15 years ago. At the time, because of a socialist philosophy, Government regulation and administrative processes at the national, state, and local levels were extensive. Public sector investment dominated the economy. The economy was inward oriented, based predominantly on agriculture with a large public sector and an import substitution policy. High tariffs protected domestic industry. Following a balance of payments crisis in the early 1990s, the Government decided to review the import substitution policy and began to introduce a program of market liberalization. This program has been largely successful, and has laid the foundation for India's impressive economic performance over the past decade.

2. Macroeconomic Stability

2. India avoided the worst effects of the Asian financial crisis due to the rigid foreign exchange controls that were in place. Similar to the Philippines, the fiscal deficit is the primary risk to macroeconomic instability, and political constraints have made it difficult to implement reforms that are needed in taxation, public expenditure reduction, and privatization of commercial state enterprises. Nevertheless, the Government has started to make progress on fiscal reforms, although monetary policy continues to be subject to high levels of political influence.

3. Competition and Trade

3. The Government has started to liberalize the economy under its obligations to the World Trade Organization (WTO), which India joined in 1995. Despite these measures, increased agricultural tariffs and the imposition of anti-dumping duties have offset reductions in the overall rates. The Government also has moved to modernize domestic competition, and introduced the new Competition Act (2002). The Government has removed bureaucratic restrictions on business licensing. Nevertheless, the regulatory environment is still very constrained compared to other countries in the region, and price controls and state monopolies continue to be prevalent. Obsolete labor laws further constrain the development of a competitive manufacturing sector in India.

4. Privatization

4. Privatization has not been a feature of private sector development (PSD) programs in India. A Cabinet Committee on Disinvestment, headed by the Prime Minister, was set up in 2000 to supervise a divestment program. The policy was unsuccessful. By 2005, the Government had divested its controlling shares in only 17 industrial companies and 19 hotels. The Government continued to own 222 public sector units, of which 130 were incurring losses. With the change of Government in 2004, the divestment policy was put on hold.

5. Public Private Partnerships

5. Public-private partnerships (PPP) have played a limited role in India, and almost 50% of the PPP investment has occurred in Gujarat. Given the fiscal constraints, PPPs are being given a larger role to play in financing infrastructure. The Government has established a PPP Appraisal Committee at the national level that will evaluate central Government projects. This committee will help address a key constraint on PPPs, as traditionally no single agency has been responsible for public sector infrastructure procurement. Line agencies at the central and state levels have been responsible for their own projects, creating problems with project formulation and implementation.

6. In 2005, the Government initiated a new framework designed to strengthen the legal and regulatory environment. The Government intends to provide “viability gap” funding in the form of grants to private sponsors to cover up to 40% of project costs. The Government also established the India Infrastructure Finance Company Limited, which has authority to provide loans covering up to 20% of project cost and refinance loans on a tenor of at least 5 years. The Government’s $40 billion road development program is the main area envisaged for PPPs, although it is also inviting private investors and contractors to build airports and ports, water systems, and electricity distribution networks.

6. Foreign Direct Investment

7. The Government has sought to encourage foreign direct investment (FDI) and foreign portfolio investment in non-strategic sectors, including parts of the manufacturing sector, telecommunications, finance, and insurance. Portfolio investment has risen dramatically, attracted by high growth rates coupled with the liberalization of foreign ownership laws and the opening of Indian stock exchanges to foreign capital. FDI has been rising, although the amount represented less than 1% of gross domestic product (GDP) in 2005. To help streamline FDI approval processes, the Government formed the Foreign Investment Implementation Authority in 1999. An export-import policy was introduced in 2000 that launched a series of special economic zones (SEZ) based on the Chinese model, consisting of geographic duty free enclaves. Most FDI has been directed towards information communication technology (ICT) and outsourcing. FDI could play a critical role in financing India’s infrastructure deficit, although reforms in this area have been only moderately successful to date. India’s largest FDI project was a power plant at Dahbol, where the funding facility was withdrawn due to problems with the tariff, leading to a withdrawal of most foreign companies from power generation projects sponsored by the Government.

7. Infrastructure

8. The quality of infrastructure in India is considered particularly poor, and it is one of the main constraints on growth. The Committee on Infrastructure has estimated the investment needed for ports, national highways, and airports are equivalent to 8% of GDP per year over the next 5–7 years. Traditionally, the Government has financed about 80% of infrastructure, although it is seeking to increase the level of private sector participation through PPPs.

9. **Telecommunications.** Although the industry continues to lag other countries, such as the People’s Republic of China (PRC), telecommunications infrastructure has seen the most progress on reform and development. While some disputes over issues such as interconnection

and availability of spectrum rights have arisen, the overall regulatory framework in the communications sector appears to be working reasonably well and the sector is expanding rapidly.

10. **Power Generation.** This is the most resource-intensive infrastructure sector, and private sector participation has been very limited to date. Problems with supply include (i) inefficient production, (ii) theft and technical losses of about 25%, (iii) tariffs set at levels substantially below cost, (iv) cross-subsidization policies that distort demand, (v) substantial underinvestment, and (vi) failure to enforce billing. While central and state governments are involved in the power sector, the 21 state electricity boards and 14 electricity departments traditionally have had monopoly rights for generation, transmission, and distribution. In 2003, the Government enacted the Electricity Act, which led to 13 states initiating reform programs by the end of 2005 to unbundle vertically integrated state boards and establish independent regulators to initiate tariff reforms. The Government is seeking additional capacity of 100,000 megawatts (MW) over the next 10 years, and much of this capacity will need to be financed by the private sector.

11. **Transport.** The Government still dominates almost all aspects of infrastructure provision in this sector, although PPP schemes are being pursued, especially at the national level. The National Highways Authority of India is responsible for developing the national road network. The National Highways Development Project seeks to expand the 14,000-kilometer (km) network by 10,000 km under private sector concession, and increase the width to between four and six lanes. The private sector is financing many of these roads under PPP arrangements, using a combination of toll revenue-based concessions and annuities financed by the Government from the Central Road Fund. The Government recently announced a PPP program in the road sector with a total value of $40 billion, which is probably the largest such program in the world. The Government has decided to liberalize airlines and move forward on privately financing airports in major centers, such as Mumbai, and more that 30 non-metropolitan airports across the country. The development of seaports has progressed in states such as Gujarat. The Government continues to own and operate the rail system, although it recently permitted private sector participation in non-core functions such as container services.

12. **Water.** In this sector, private sector participation is constrained by the absence of a national water regulatory body and cost-based tariff system administered by independent regulators. Private sector participation in the water, sewerage, and sanitation systems is almost nonexistent, as tariffs in most cities are set at levels substantially below cost, and revisions are politically difficult. Overstaffing and poor revenue collection practices accentuate problems with low levels of cost recovery. Unaccounted for technical water losses generally range from 40% to 50%. In the past, the predominant sources of finance were state and central government loans and grants, although they have been declining in importance due to fiscal constraints. Governments in states such as Tamil Nadu are experimenting with commercial sources of water.

8. Small and Medium-Sized Enterprises

13. The main means of supporting small and medium-sized enterprises (SME) has been directed credit through the Small Industries Development Bank of India (SIDBI). SIDBI uses the concept of industry clusters and small enterprise financial centers to service SMEs, often in conjunction with commercial banks. In 2005, the Government announced a comprehensive policy package requiring public sector banks to double the amount of funding directed to SMEs.

The Government also reserves some labor-intensive industries, such as textile manufacturing, for small enterprises. These provisions are enforced through the licensing system.

9. Financial and Capital Markets

14. The Government owns 27 of the 96 commercial banks, and they hold about 75% of all bank assets. These state-owned banks typically were established as development finance institutions (DFI), which gradually have been commercialized. Despite these changes, all state-owned banks must lend 40% of advances to sectors such as agriculture and small businesses, and an additional 12% to exporting firms. The Government recently allowed private competition to emerge by issuing a limited number of licenses to new private banks, while starting to relax restrictions on foreign banks. As a result, deposits and bank credit have been growing over the past decade at more than 15% per year. However, the benefits of improved access to finance have been offset by an associated rapid increase in nonperforming loans (NPL), leading to undercapitalization of banks. NPLs, which peaked in 1994 at 25% of bank assets, have been declining slowly, reaching about 13% in 2001 and 5% in 2005. Bankruptcy procedures are ineffective, and the state banks have been recapitalizing and issuing shares through initial public offers to access additional equity.

15. The Government has extensive ownership interests in nonbank financial institutions (NBFI) operating in areas such as housing development and microfinance. Municipal and state governments are experimenting with local infrastructure funds that pool finance from different sources and issue rated bonds. The Government is a major shareholder in venture capital funds (VCF) through its ownership of banks. VCFs focused on the ICT have expanded rapidly, especially in the past 6 years. The state is a dominant owner in financial institutions, such as Life Insurance Corporation, General Insurance Corporation, and Unit Trust of India. These are an important source of long-term investment funding. Similar to banking, foreign ownership restrictions in the insurance sector have been relaxed in recent years.

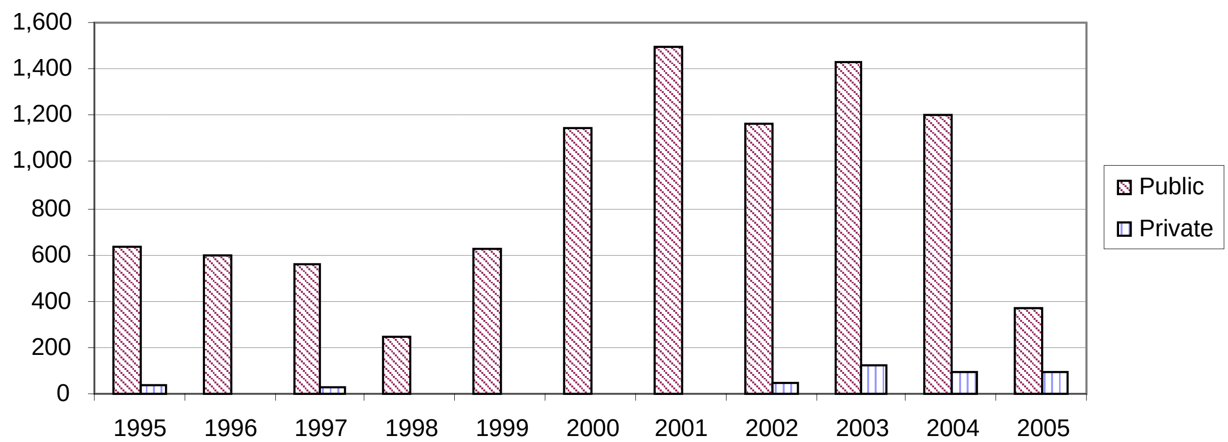
16. Capital markets are going through a rapid transformation. A group of large institutional investors established the National Stock Exchange in 1994 using a corporate ownership structure. This operation is based on an electronic trading platform that was used successfully to break the oligopoly of the 22 state stock exchanges operating across the country. Apart from the Bombay Stock Exchange, the state stock exchanges are now defunct, although they continue to exist on paper. The size of the Indian stock market has increased significantly in recent years, fueled in part by foreign portfolio investors, and corporate bonds have become an increasingly important source of funding.

B. ADB's Country Strategy and Development Program

1. Overview

17. India began to borrow from Asian Development Bank (ADB) in 1986. In India, ADB has traditionally funded public sector infrastructure projects (power, gas, and roads) and finance reforms (NBFIs and capital markets) identified in country strategies. Public and private sector financing levels have been volatile (Figure A5.1).

Figure A5.1: Asian Development Bank Financing, Annual Approvals in India
($ million)



Source: Asian Development Bank records.

18. Public sector lending fell because of the nuclear testing sanctions in 1998. Demand for public sector funds to finance national road projects was high during 2000–2004. In 2005, no lending occurred outside the natural resource sector. Private sector operations (PSO) have been minor relative to public sector lending, although it has become more significant since 2002. During the period reviewed, only one project involved a complementary finance scheme (CFS) for $5 million.[1]

2. Country Strategies

19. From the mid-1990s through early 2000, ADB changed its strategy in India. It began decentralizing some assistance from the national to the state level, targeting Gujarat, Kerala, and Madhya Pradesh. PSD was major theme of the country strategy and program (CSP), which identified the following possibilities: (i) providing credit enhancements to mobilize private resources using ADB's guarantee operations, (ii) providing Government-guaranteed public sector loans to support private investments in infrastructure, and (iii) pooling ADB funds with private investors in funds or credit facilities to finance infrastructure. These instruments were to be used to help pursue sector strategies. In the power sector, the focus was on creating new generation and transmission capacity, and privatizing existing power stations. The CSP also envisioned establishing telecommunications facilities, and developing highways and ports, in part by mobilizing the private sector.

20. As envisaged, ADB would support industrial liberalization programs that increased competition and corporate restructuring programs, and establish financial facilities to support SMEs in agro-based industries. ADB also would help identify ways of developing the long-term

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[1] While this study only examines PSO during 1995–2005, six additional PSO projects in India, with a total value of $347.6 million, were approved in 2006, bringing the cumulative total approvals to $975.6 million by September 2006. These recent approvals include three projects in energy and power, two in financial institutions focusing on infrastructure financing, and one in a capital markets institution. In addition to these direct ADB facilities, PSOD mobilized two loans from third party commercial banks with a total value of $225 million under CFS.

debt markets. Financial markets would be strengthened by supporting interest rate liberalization, developing new private sector banks, restructuring state banks, and strengthening the regulatory framework. In the capital markets, the focus would be on developing an integrated national market; developing depositories; reforming stock exchanges; facilitating FDI in financial institutions; freeing up long-term sources of capital from insurance companies and pension funds; developing credit enhancement and loan securitization instruments; and strengthening capital market regulation.

21. In 2001–2002, ADB prepared a new CSP for 2003–2006 to reflect the new overarching goal of poverty reduction, and presented a program that was consistent with the Government's Tenth Five Year Plan (2002–2007). The primary focus of the revised ADB strategy was on growth, supported by social development and environmental protection programs. The main sector and thematic priorities of the CSP included fiscal consolidation, infrastructure development, PSD, agriculture and rural development, state-level operations, regional cooperation, social development, environmental protection, and good governance. In 2003, ADB commissioned a Private Sector Assessment[2] to help sharpen the PSD emphasis in its economic sector work, as well as in the overall CSP process. This document did not form part of the CSP process, and was used primarily as a discussion document. In 2004, ADB issued a local currency bond that raised Rs5 billion (equivalent at the time to $110 million) to help alleviate problems with local currency risks for large infrastructure projects. IFIs, such as ADB, increasingly have sought local currency since the Asian financial crisis, when many foreign sponsors ran into difficulties servicing financial structures denominated in foreign currency while project receipts were denominated in local currency. With dramatic depreciations in currency, project sponsors needed to increase project output prices to maintain their return on investment.

3. ADB Assistance

22. As illustrated by the breakdown in public sector lending relevant to PSO in Table A5.1, infrastructure, especially in transport and power sectors, has been the primary focus of the regional departments.

Table A5.1: Sector Allocation of Public Sector Lending (1995-2005)
($ million)

Year	Public Administration	Power and Energy	Transport	Urban Development	Finance	Total
1995		275		105	250	630
1996	250	100			250	600
1997		150	113		300	563
1998				250		250
1999	250			375		625
2000		600	180		120	900
2001		350	450	500	200	1,500
2002	200	150	814			1,164
2003		250	980	200		1,430
2004	150	400	650			1,200
2005						0
Total	**850**	**2,275**	**3,187**	**1,430**	**1,120**	**8,862**

Source: Asian Development Bank records.

[2] Prepared by CRISIL.

23. ADB has pursued institutional reforms to strengthen PPP procurement capacity in the infrastructure by providing technical assistance (TA) to help create PPP units at the state level, as well as in National Highway Authority of India (NHAI). Contrary to proposals in some of the earlier country strategies and the PSA, ADB exited the telecommunications and ports sectors in the mid-1990s, and has focused on power, roads, water, and urban infrastructure since then. The public sector side of ADB has been engaged consistently in the power sector. Successful ADB-supported reforms are starting to create conditions for private sector investment, and possible increased Private Sector Operations Department (PSOD) deals in the power sector. Public sector operations in the gas sector contributed to strengthening the framework for the private sector to enter the industry. Assistance from the public sector side of ADB in the transport sector has been oriented mostly to roads and, to lesser extent, railways. Some TA was provided in 2000 and 2001 to support private sector participation for road maintenance. After pursuing a substantial public sector lending program up to 2004, PSO-related lending ceased in 2005. PSO has not been involved in the transport sector, even in ports[3] where it would seem feasible to support private projects.

24. The finance sector has been the other strategic focus with a PSO orientation. ADB assistance has been designed to help channel funds to infrastructure in sectors such as power, roads, and urban facilities. TA in the finance sector was unrelated to the lending program and appeared to lack focus. TA was targeted at the stock exchange, dispute resolution, housing finance, pension and insurance reform, and use of mortgage-backed securities in the capital markets. The public sector loans provided to the Government were essentially infrastructure and housing credit lines. Two large sovereign guaranteed private sector infrastructure facility (PSIF) loans ran into difficulties due to the high cost of funds and denomination in foreign currency, which reduced demand, and there were problems finding attractive projects.

25. ADB approved its first PSO investments in India in 1987. Initial PSO investments in the 1980s were targeted at the manufacturing industries. Throughout the 1990s, the finance sector was emphasized with many relatively small capital market equity investments. After the approval of the Private Sector Development Strategy (PSDS) in 2000, the emphasis on infrastructure increased, particularly in energy and power, with one power plant approved in 2003. By the end of 2005, 39[4] projects had been approved for $478 million, making India the largest recipient of ADB's PSO. The average investment size was $13.7 million. During the period of analysis, only one CFS facility was issued for $5 million. At the end of 2005, outstanding PSO commitments were $289.3 million, with most of these funding facilities directed to the finance sector.[5]

26. Finance sector interventions have been the main source of assistance provided by PSOD, initially by taking equity interests in banks, then moving to equity funds and providing banks with Tier 2 capital funds (secondary bank capital such as subordinated dent). In recent years, PSOD has had difficulty obtaining central bank approval for bank-related transactions due to concerns about ADB crowding out commercial operations because of its potential to provide funds at below-market rates. Central bank concerns about ADB's involvement in the Indian finance sector also have affected infrastructure operations. PSOD has experienced problems obtaining access to competitively priced local currency through mechanisms such as the swap market due to perceived risks that ADB's involvement might distort that market.

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3 While the Petronet LNG facility had a port that formed part of the overall plant, it could be used only for conveying LNG to the shore. As such, it falls under the classification of an energy rather than transport facility.
4 Including one line of equity of $5 million, from which 15 small equity sub-investments were made by 1994.
5 While the study covers 1995–2005, six more projects with a total value of $347.6 million were approved 2006, bringing cumulative approvals to $975.6 million by September 2006.

4. PSO Transactions in India

27. During 1995–2005, 22 PSO transactions were approved for India, totaling $459.85 million (Table A5.2). The dominant focus was on finance sector and capital market projects. Possibly due to inadequate due diligence or premature processing, ten of the 21 approved projects subsequently were canceled for reasons such as regulatory restrictions, lack of demand, or uncompetitive pricing. Taking into account these cancellations, the portfolio shrinks by $353.2 million, or 58%, to $258.4 million. The resulting portfolio has a disproportionately large amount of equity, totaling $126.4 million (49%), compared to $132.0 (51%) in senior debt. This is a high-risk portfolio structure. Dividing the non-canceled approvals according to sectors, $136.9 million (53%) was invested in financial and capital markets interventions, $71.5 million (8%) in two infrastructure projects, and $50 million (19%) indirectly target infrastructure through local financial institutions.

Table A5.2: PSO Investment Approvals in India (1995–2006)

		ADB Financing ($ million)						
Name	**Sector**	**Loan**	**CFS**	**Equity**	**PCG**	**Total**	**Date**	**Status**
Equity Management	Finance	–	–	0.1	–	0.1	1995	–
Sectoral Equity Fund	Finance	–	–	15.0	–	15.0	1995	–
Securities	Finance	–	–	4.3	–	4.3	1995	Canceled
Capital Markets	Finance	–	–	21.2	–	21.2	1995	–
Finance Company	Finance	–	–	4.5	–	4.5	1995	–
Power Company	Power	25.0	100.0	15.0	–	140.0	1996	Canceled
Infrastructure Finance	Finance	–	–	15.5	–	15.5	1997	–
Mortgage Guarantee	Finance	–	–	10.0	–	10.0	2002	Canceled
Healthcare Institute	Services	20	–	–	–	20.0	2002	Canceled
Infrastructure Fund	Finance	–	–	15.0	–	15.0	2002	–
Transmission	Power	62.3	–	–	–	62.3	2003	–
Bank (supplementary)	Finance	–	–	0.7	–	0.7	2003	Exited
Housing Finance	Finance	20.0	–	–	–	20.0	2003	–
Home Finance	Finance	20.0	–	–	–	20.0	2003	Canceled
LNG	Energy	–	65.3	–	–	65.3	2004	Canceled
Power Generation	Power	54.4	–	20.6	–	75.0	2004	Canceled
Private Equity	Finance	–	–	20.0	–	20.0	2004	–
Asset Reconstruction	Finance	–	–	5.6	–	5.6	2005	Canceled
Infrastructure Finance	Finance	50.0	–	–	–	50.0	2005	Canceled
Bank	Finance	23.0	–	–	–	23.0	2005	Canceled
Private Equity	Finance	–	–	15.0	–	15.0	2005	–

– = not applicable, ADB = Asian Development Bank, CFS = complementary financing scheme, PCG = partial risk guarantee, PSO = private sector operations.
Source: Operations Evaluation Department staff compilation.

28. An OED evaluation of the PSO projects in India, based on a mixture of desk-based reviews and company visits, derived the indicative project performance results shown in Table A5.3.

Table A5.3: Summary of Evaluated Project Performance in India (1995–2005)

Project	PSD	Investment Performance	Comments/Issues
Equity Management	Satisfactory	Satisfactory	–
Sectoral Equity Fund	Excellent	Satisfactory	–
Securities	Canceled	–	Lack of demand
Capital Markets	Satisfactory	Satisfactory	–
Finance Company	Satisfactory	Satisfactory	–
Power Company	Canceled	–	–
Infrastructure Finance	Excellent	Excellent	–
Mortgage Guarantee	Satisfactory	Satisfactory	Regulatory issue
Bank(supplementary)	Unsatisfactory	Unsatisfactory	Almost bankrupt
Healthcare Institute	Canceled	–	–
Infrastructure Fund	Satisfactory	Satisfactory	–
Transmission Limited	Satisfactory	Satisfactory	–
Housing Finance	Satisfactory	Satisfactory	–
Home Finance	Canceled	–	Price not competitive
LNG	Satisfactory	Excellent	
LNG	Canceled	–	Price not competitive
Power Generation	Canceled	–	Price not competitive
Private Equity	Satisfactory	Satisfactory	–
Asset Reconstruction	Canceled	–	Regulatory issue
Infrastructure Finance	Canceled	–	Price not competitive
Bank	Canceled	–	Regulatory issue
Private Equity	Excellent	Satisfactory	–

– = not applicable, LNG = liquefied natural gas, PSD = Private Sector Development.
Source: Operations Evaluation Department staff compilation.

C. PSD Issues in India

29. India has grown more than 8% per year over the past 3 years, primarily due to three factors: (i) a robust global economy, (ii) the delayed impact of liberalization measures initiated in response to economic crisis in 1991, and (iii) a substantial boom in consumer lending. While interest rates are starting to rise, growth appears to be sustainable in sectors such as manufacturing, where macroeconomic stability coupled with increasing competition is improving quality and cost-effectiveness. Nevertheless, overall progress and balanced growth will depend upon reforms to modernize infrastructure for power, ports, and roads. The benefits of reforms in the infrastructure are starting to become apparent only now, and most private sector participation continues to be limited to PPPs in the road sector and some captive ports and power generation projects. While the finance sector is liquid and consumer credit growth is booming, long-term corporate debt and access to foreign credit and FDI continues to be limited.

30. Traditionally, India has not had a policy of pursuing PSD. It has been focused on developing its industrial sector through regulatory protection and directed lending programs. The economy for the most part has been closed, which helped insulate it from the effects of the Asian financial crisis. Recently, the Government has started to liberalize the economy, and is pursuing investment in infrastructure, particularly in the power and transport sectors. The Government continues to maintain a highly centralized approach to economic reform, especially in the infrastructure and finance sector development where development programs are articulated in five-year plans. Liberalization is modest, with high trade barriers and regulatory constraints by international standards, though much improved relative to historical conditions. In critical infrastructure sectors, such as power and water, tariffs continue to be set at levels substantially below cost. The Government's lack of control over state governments in the power sector has meant reform has been extremely slow, although moving in the right direction. While

progress is more apparent in the road and ports sectors, funding needs are substantial. Infrastructure still needs to be developed to improve access to water and support more inclusive growth in semi-urban manufacturing and service initiatives. A key constraint has been the lack of access to long-term finance. The Government appears to have made good progress in this area, although credit availability at affordable rates continues to be quite low despite high levels of savings.

31. The Prime Minister recently estimated that $155 billion[6] is required over the next 5 years to support infrastructure development, and this figure could rise as high as $250 billion if infrastructure investment reaches 9–10% of GDP. Assuming the public sector provides about 80% of this funding, the private sector would have to provide up to $50 billion over the next 5 years. In practice, the total financing figure seems optimistic, and only a fraction of this amount is likely to be raised without substantive reforms. In the power and water sectors, cost-based tariffs administered by independent regulators are the key issue. For roads and infrastructure, acquisition of land is the primary constraint. The substantial gap between demand for resources and the low levels of FDI and modest growth in local sources of corporate finance indicates the Government also needs to pursue reforms in the finance sectors to help mobilize the necessary funding. Critical areas of reforms involve strengthening the municipal and corporate bond markets, removing investment restrictions on local savings vehicles, and freeing up of the capital account to improve access to long-term foreign sources of finance.

32. ADB's CSP issued in 1996 signaled a shift in focus from the national to state level. Private sector development was a core priority of the country strategy, and ADB intended to focus on power infrastructure, and government guaranteed private infrastructure credit lines. In 2003, the CSP shifted emphasis toward poverty reduction and social and agriculture projects. A draft PSA was issued in 2003 that highlighted the importance of issues such as privatization and resolving NPL problems, although it did not form part of the country strategy. In line with ADB's country strategic programs, public sector support for power sector reforms has been reasonably constant throughout the period of analysis, occurring initially in Gujarat, followed by Madhya Pradesh, and then Assam. In 1998, PSO-related public sector lending almost stopped due to India's nuclear testing, and then grew rapidly to peak in 2001 due to substantial incremental demand to help finance national road projects. Lending for urban development has been reasonably constant over the review period, with emphasis on housing and urban water. Financial assistance has occurred primarily in the form of four private sector infrastructure facilities (PSIF) and seven housing loans.

33. Despite being the single largest country exposure in PSOD's portfolio, India's level of PSO over the period of analysis has been surprisingly limited given the size of the country. The size of the PSO portfolio at $289.3 million, or 17% of the portfolio as of 31 December 2005, is small given the number of transactions and effort expended over a 10-year period. The PSDS approved in March 2000 does not seem to have had a material impact on the scale and focus of PSOD's operational activities. While the public sector provided assistance to help strengthen the enabling environment in selected states in power infrastructure, reforms have been slow to materialize. As such, the Board has approved only three significant transactions. This lack of progress reflected in part the serious constraints present in the energy sector in the form of insolvent state electricity boards and noncommercial tariffs. PSOD also has made surprisingly little progress is the transport sector, especially in subsectors such as ports that can finance operations without having to hedge currency risks. ADB's public sector operations provided assistance to the NHAI as early as 2000 to help facilitate PPPs in the road sector. However, it

[6] 18 August 2006. Editorial. *Financial Times.*

was directed mainly at maintenance contracts, and only a few privately financed concessions have been put in place successfully.

34. The weak enabling environment has been reflected in the poor performance of the Government-guaranteed PSIF provided by ADB's public sector operations. The PSIF loans were not particularly successful as suitable projects were hard to find. The Government, which appears to accept the need for fundamental reform to support private investment, has indicated that it does not consider the PSIF consistent with its policy on PPP. The Government's shift toward viability gap funding, and general progress on unbundling the power sectors and putting in place independent regulators, suggests that circumstances are starting to improve for PSO in India. This change has been reflected in the scale of PSOD's operations, as approvals have started to accelerate since 2003. Four approvals were recorded in 2005, followed by five approvals midway through 2006. These transactions are occurring increasingly frequently in the infrastructure sector in line with the PSDS priorities.

35. Despite these encouraging trends, obtaining central bank approval to access local currency finance in the swap market continues to be a serious problem. Thus, ADB is likely to experience increasing difficulty providing financial assistance to banks in India. In most cases, sponsors and borrowers praised ADB's commercial processing procedures. However, several complaints were heard about unnecessarily complex legal documentation requirements that were slow to process compared to those of competing IFIs, such as International Finance Corporation. Social safeguard project processing requirements might be another issue, especially in the road sector, although this is difficult to confirm given the lack of PSOD involvement in this sector. The National Highway Authority has been negotiating with ADB's public sector operations over whether squatters should receive compensation, and whether this should be paid at market rates. The Government has expressed concerns about PSOD's low level of engagement in infrastructure reforms. The resident mission in Delhi has only one PSOD staff member who does not have any support staff. This scale of operation appears seriously inadequate given the scale of opportunities within the country, the complexity of the environment, and the need to be on the ground establishing relationships with the Government and the private sector.

COUNTRY CASE STUDY: VIET NAM

A. Investment Climate

1. Background

1. Following decades of war, Viet Nam adopted a socialist political system at the time of unification in 1976. In 1986, the Government launched the *Doi Moi* (economic renovation) policy that permitted a role for the private sector. Initially progress was slow, but the Government launched dramatic reform measures following a famine in the northern provinces of Viet Nam in 1988. These measures included (i) abolition of the commune system in agriculture, (ii) removal of subsidies from state-owned enterprises (SOE), (iii) reduction of price controls, (iv) liberalization of external trade, (v) establishment of a central bank, and (vi) devaluation of the Vietnamese dong. Most importantly, the economic strategy relied heavily on private sector growth and foreign direct investment (FDI), and the basic foundations for a market economy were in place by 1992. As a result, Viet Nam has achieved economic growth of more than 7% per year over the past 10 years. While the share of private sector participation (PSP) has more than doubled during this time, it remains low by international standards at 50–60%.

2. Over the past decade, Viet Nam has pursued a policy of accommodating, rather than encouraging, private sector development (PSD). The Government has maintained a policy of heavy regulation, and ownership and management of more than 4,000 SOEs that account for 29% of gross domestic product (GDP). The Government has pursued a highly centralized approach to economic reform, especially in infrastructure development, that is articulated in long-term plans of 10–20 years duration. Similar to other socialist economies, such as India, the ultimate objective of the Government's development program has been industrialization. Recently, the Government has pursued opportunities to encourage public-private partnerships (PPP) in power generation.

2. Macroeconomic Stability

3. At 1.9% of GDP in 2005, the fiscal deficit is low by international standards, and it is supported by a low level of external public sector debt. Tax reforms have been successful. Tax revenue as a proportion of GDP in 2005 was 21.8%, which is reasonably high relative to other developing member countries (DMC). The central bank has had limited success in maintaining economic stability through monetary policy. Following a period of low inflation through the 1990s, inflation started to accelerate as the central bank accommodated the Government's growth objectives and permitted an expansion in credit. The dong is not a freely convertible currency, and the exchange rate is managed. The high level of control over the currency helped insulate Viet Nam from the worst effects of the Asian financial crisis.

3. Competition and Trade

4. While Viet Nam's economy is reasonably open to trade by international standards, further reform is required to increase competitiveness. Quotas and tariffs are highly variable and provide significant protection to selected sectors, such as car assembly, sugar, steel, and cement. Viet Nam is implementing tariff reductions under its Association of Southeast Asian Nations (ASEAN) Free Trade Agreement (AFTA) obligations, and it is in the final stages of joining the World Trade Organization (WTO). The Government is liberalizing the domestic economy—it has a policy of cutting administrative interference in business and nominally does not discriminate between socialist and non-socialist enterprises. In practice, SOEs continue to gain access to subsidized inputs, and the Government still administers prices of strategic items

such as cement. The State Pricing Committee sets prices for utility services such as water. Nevertheless, reforms are continuing. In 2005, the Government introduced the Competition Law, a new Unified Enterprise Law, and the Common Investment Law. The Unified Enterprise Law is meant to level competitive conditions between SOEs and private firms. The Common Investment Law harmonizes requirements for foreign and domestic investments.[1]

4. Privatization

5. The Government has a program to restructure and divest SOEs, although very little progress has been made on privatization in Viet Nam. Privatization does not receive much support from management and staff due to the preferential access rights held by SOEs to state contracts, licenses, land, and finance. Viet Nam does not have a system of private property, and the Government issues land use rights that cannot be purchased, sold, inherited, and mortgaged. The scarcity of land and legal complexities associated with its use has been viewed as probably the most significant constraint to PSD in Viet Nam. The development of supporting infrastructure, such as property registries, is needed urgently. (footnote 1)

5. Public Private Partnerships

6. A build-operate-transfer (BOT) law is in place, which has been revised on several occasions. Despite these reforms, very little private sector participation has been seen in publicly financed infrastructure projects, and no limited recourse projects without the support of international financial institutions (IFI) such as the Asian Development Bank (ADB). During 1990–2003, $3.2 billion, or 15% of infrastructure investment, was sourced through PPP facilities. Of this amount, 81% is associated with two Phu My power projects. Project finance has not taken off in Viet Nam due to factors such as (i) foreign exchange controls; (ii) absence of guarantees on minimum returns; (iii) inadequate loan security (no mortgaging of land use rights, lack of step-in rights, and underdeveloped dispute resolution procedures); (iv) corruption; and (v) lack of common procedures and standardized contracts. Due to the absence of long-term commercial funding denominated in dong, all project finance is denominated in hard currency, mostly United States dollars. A further constraint has been Decree 155, which was introduced in 2004 and precludes private ownership of infrastructure in sectors such as ports, roads, and water.

6. Foreign Direct Investment

7. The Government's FDI program has been very successful. Between 1988 through to September 2006, Viet Nam attracted $56 billion in commitments, with half of this amount disbursed. FDI peaked in 1996–1999 at more than 4% of GDP, subsequently declining to 2% of GDP in the early 2000s in the aftermath of the Asian financial crisis. Following a slow recovery, FDI has accelerated since 2003 and again reached 4% of GDP in 2006.

7. Infrastructure

8. The Government has invested heavily in infrastructure at an average annual rate of almost 10% of GDP during 1997–2003. Despite this high investment rate, private sector firms still consider the quality of transport and, to a lesser extent, electricity infrastructure some of the most important constraints on growth in Viet Nam.

[1] ADB. 2005. *Private Sector Assessment*. Manila.

9. The telecommunications sector has been growing rapidly. While the Vietnam Post and Telecommunication Corporation has lost its monopoly and is facing increasing competition, especially in the mobile market, most participants are SOEs. Although private sector participation currently is limited, Viet Nam's accession to WTO will help increase competition from private operators.

10. Electricity of Viet Nam (EVN), which operates a vertically integrated power system, dominates the power sector. Rapid urbanization and industrialization has been increasing the pressure on the power sector, resulting in a series of peak period outages in 2004 and 2005. Independent Power Producers (IPP) account for about 21% of Viet Nam's generating capacity. This capacity is derived from the ADB-supported Phu My 2.2 and 3.0 gas plants, which were the first projects constructed under Viet Nam's BOT Laws. The Electricity Law, which was passed in 2005, calls for unbundling the sector and creating a competitive supply market, initially with EVN as a single buyer. Eventually a spot market will be set up, and an electricity regulator that reviews tariffs and reports to the Ministry of Industry will be established. Delays in preparing and issuing supporting regulations have hindered the implementation of this legislation.

11. The Government continues to control the transport sector, dominating the provision of services and infrastructure. The Government owns the airports and the national airline, and competition is limited. Apart from three minor seaports that have been developed under BOTs, the Government owns all of the major seaports. The Government also owns all of the roads, although SOEs administer several roads and charge tolls to use them. The development of the inner city metros for Ho Chi Minh City, Hanoi, and Da Nang have become a high priority and the Government is considering private sector participation for these facilities.

12. Water services are sourced primarily from municipalities. The State Price Committee sets maximum tariffs for water, which typically cover only direct operating costs. Tariffs set at levels below full costs of production effectively have precluded private sector participation, except in areas such as small-scale retailing of water and some wastewater removal businesses. In some cases, private sponsors have sought to provide bulk water supply under a BOT, but an agreement could not be reached on the tariff. In 2000, the Government issued a decree prohibiting BOT water projects that involved foreign investors. A second decree was issued in 2004 confirming it would retain more than 50% ownership of large urban water companies (footnote 1).

8. Small and Medium-Sized Enterprises

13. In November 2001, the Government officially recognized small and medium-sized enterprises (SME) by issuing Decree 90, which provides a framework for public sector support and development. The decree covers the establishment of (i) an SME promotion council with cross-ministry membership that acts as an advisory body to the Prime Minister; and (ii) an agency for SME development that coordinates SME-related activities. The Government has created the Viet Nam Chamber of Commerce and Industry and the Viet Nam Cooperative Alliance to interface with commercial operations. Hundreds of other business-related representative bodies exist at the national and provincial level.

9. Financial and Capital Markets

14. Four state-owned commercial banks that hold about 75% of outstanding bank credit dominate the banking sector. These banks extend approximately 45% of their loans to SOEs at subsidized rates (footnote 1). The central bank has proposed that the state banks be partly

privatized starting with Vietcombank, possibly in 2007. The private sector is involved through 34 private joint stock banks and 26 foreign bank branches, which together supply 17% of commercial credit. In 2005, two foreign banks, ANZ Bank and Standard Chartered, purchased minority shareholdings in the two largest commercial banks in Viet Nam.

15. As a result of years of directed lending, nonperforming loans (NPL) held by state banks were equivalent to approximately 50–70% of their loan portfolios in 2003. The Government has had limited success restructuring insolvent SOEs, as the legal framework remains inadequate. The Government has been taking steps to facilitate the use of collateral, and it has established a Secured Transactions Registry and revised the Bankruptcy Law. However, without an effective foreclosure regulatory framework, the results have been limited.

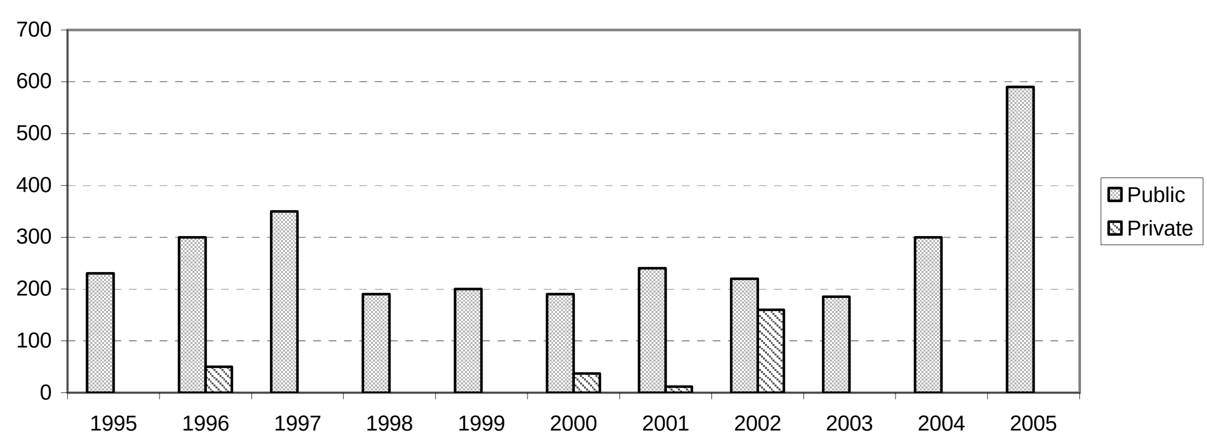
16. The Government has established special purpose nonbank financial institutions (NBFI), such as the Development Assistance Fund, to help overcome limits on credit availability. This fund, one of the largest financial institutions in the country, does not act as a commercial bank, allowing it to provide loans to SOEs on concessional terms. The Government also created a Central Credit Fund and approximately 60 microfinance banks. Viet Nam's capital market is small and underdeveloped.

B. ADB's Country Strategy and Development Program

1. Overview

17. ADB's operations in Viet Nam, which resumed in 1993, have focused on (i) public administration reform; (ii) rehabilitation of physical infrastructure in the agricultural, energy, and transport sectors; (iii) finance sector reform, with a focus on the nonbank sector; and (iv) preventative health care and secondary education. The public side of ADB has undertaken the following activities to support PSD: (i) public administration reforms to improve transparency in the interface with the private sector; (ii) SOE Reform and Corporate Governance Program; (iii) formulation of the Electricity Sector Development Plan; and (iv) SME Development Plan. ADB public sector lending has been relatively stable, apart from in 2005 when a large loan was provided to help develop the power system (Figure A6.1).

Figure A6.1: Asian Development Bank Financing, Annual Approvals in Viet Nam
($ million)



Source: Asian Development Bank records.

18. Viet Nam is a comparatively new entrant into the realm of ADB private sector operations (PSO). The first investments in a leasing company and a cement factory were approved in 1996. Since then, five additional investments were approved in the water, education, health, and power sectors. PSO approvals in Viet Nam totalled $168.5 million, and they were bolstered by a $26.5 million complementary financing scheme (CFS) and a $60 million partial risk guarantee (PRG). The Private Sector Operations Department's (PSOD) exposure at the end of 2005 was $136.7 million, of which about two thirds involved the two Phu My power projects approved in 2002. PSO activities in Viet Nam have been sporadic, with approvals in only 4 of the 11 years under examination. ADB has not approved any PSO investments in Viet Nam since 2002, although a follow-up investment in the power sector was approved in late 2006.

2. Country Strategies

19. The 1995 country strategy program (CSP) equivalent provided a framework that built on the liberalization reforms embodied in Doi Moi. The strategy included geographic links between three growth zones of northern, central, and southern Viet Nam, as well as links with other countries in the Greater Mekong subregion. ADB was to focus its operations on transportation corridors and related development zones to support economic growth. This strategy had the potential for increasing links between public and private sectors, and facilitating private sector participation in infrastructure. ADB was to strengthen the legal and regulatory framework for the private sector, finance sector reform, and support progress on equitization and privatization of SOEs. Proposed strategic initiatives included: (i) policy and institutional development, with a particular emphasis on strengthening the banking sector under a finance sector program loan that was being prepared at that time and strengthening the public sector; (ii) infrastructure development, especially transport, followed by power and other facilities; (iii) rural development, targeting rural credit and irrigation facilities; (iv) human development in health and education; and (v) natural resource and environmental management.

20. The 2001 CSP[2] for the period 2002–2004 sought to strengthen ADB's focus by targeting (i) sustainable growth through rural and private development (improving the business environment, catalyzing private sector participation in infrastructure, strengthening the finance sector); (ii) inclusive social development; (iii) good governance in areas such as public administration reform, decentralization, and legal reforms to the extent these factors affect PSD; and (iv) geographic focus on the Central Region that is relatively more impoverished than other regions. Aid agency activities would be coordinated through the Comprehensive Poverty Reduction and Growth Strategy agreed with other development partners. PSD was a major theme of the CSP and it was envisaged the business environment would be strengthened by addressing policy constraints at the national level in areas such as taxation, regulation, and licensing using a sector development loan. At the local level, ADB sought to alleviate land and credit constraints. Private sector participation in infrastructure would be supported by unbundling the power sector, creating an independent regulator, and supporting transactions with a significant demonstration role. Policy dialogue would be held with the Government to help address regulatory constraints on the use of BOT instruments. In the finance sector, the focus was on (i) restructuring state banks; (ii) providing housing finance; (iii) strengthening SMEs; and (iv) developing NBFIs, such as leasing and insurance entities and capital markets over the medium term.

21. ADB published a private sector assessment (PSA) of Viet Nam in 2005. Like most other PSAs, the review and recommendations were comprehensive. The recommendations in the

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[2] ADB. 2001. *Viet Nam: Country Strategy Program (2202-2004).* Manila.

PSA addressed all three thrusts of the PSDS. To improve the enabling environment, it suggested that ADB provide support for improving financial intermediation, specifically through insurance and pension products. SME development assistance also could be expanded. ADB could help develop the policy, legal, and planning framework needed for private sector participation, particularly in the power sector, where a new electricity law had been passed and private investment was needed to increase generating capacity. In the transport sector, support was needed to define future sector structures and development programs, including private sector investment for ports, airports, and roads. To generate business opportunities, the PSA proposed that project development facilities be created and private sector access to public procurement contracts improved through better dissemination of information on opportunities and revision of tendering procedures. The PSA called for PSO investments with demonstration impacts in infrastructure, and supported the creation of investment funds and other financial instruments that improved domestic firms' access to long-term funding.

3. ADB Assistance

22. Table A6.1 shows the breakdown in public sector lending relevant to PSO (about 70% of total public sector lending).

Table A6.1: Sector Allocation, Public Sector Lending
($ million)

Year	Public Administration	Power and Energy	Transport	Water and Urban Development	Finance	Total
1995		80	30	66		176
1996			120		140	260
1997		100		72		172
1998			130			130
1999	100					100
2000					80	80
2001			70	60		130
2002					80	80
2003	45			134		179
2004		120			95	215
2005		360	101	74		535
Total	**145**	**660**	**451**	**406**	**395**	**2,056**

Source: Asian Development Bank records.

23. ADB's public sector operations have focused on strengthening core public sector functions. However, ADB has not been engaged in activities such as privatization or creation of public-private partnership (PPP) units. The regional department was active in the power and energy sectors. The sector restructuring programs supported by ADB provide a basis for private sector participation, including two 2002 PSO transactions in power generating facilities. In the transport sector, the focus has been directed almost exclusively to roads. Apart from a public sector loan to the Port of Saigon in 1995, ADB has not been involved in rail, airports, or seaports. Almost all of the transport-related technical and financial assistance has been project-specific. No work was done to establish a road fund, a regulator, or a PPP unit to procure and manage private roads or ports. In the water sector, assistance was provided to help develop a water resource management system. ADB did not assist with corporatization, PPP procurement, or the creation of an independent regulator.

24. Despite the weak enabling environment, PSOD did participate in a successful negotiation of a private water concession. Unfortunately, the sponsor abandoned this project

before implementation due to difficulties reaching an agreement on the tariff. The public sector side of ADB has been active in the finance sector, with a diverse, seemingly unfocused, technical assistance (TA) program. While ADB provided assistance to help put in place a secured transaction framework in 1997, it has not followed through and the framework is not yet effective. ADB did not do any work in areas such as creating asset management companies or generally putting in place mechanisms to resolve the NPL problem, or to strengthen banks in anticipation of market liberalization. Apart from a lease project approved in 1996, and subsequently canceled in 1999 due to sponsor concerns following the Asian financial crisis, the finance sector has not had any PSO operations.

4. PSO Transactions in Viet Nam

25. Viet Nam had seven PSO transactions during 1995–2005 (Table A6.2). The total value of the PSO portfolio is $257.0 million, including $170.5 million on ADB's own account, $26.5 million under CFS, and $60 million as PRGs. The approvals are distributed across the finance, cement, water, education, health, and power sectors.

Table A6.2: PSO Investment Approvals in Viet Nam

Name	Sector	ADB Financing ($ million)					Date Approved	Status
		Loan	CFS	Equity	PRG	Total		
Leasing	Finance	2.00	–	–	–	2.00	1996	Canceled
Cement	Cement	30.00	26.50	–	–	56.50	1996	–
Water	Water	31.00	–	–	–	31.00	2000	Canceled
University	Education	7.50	–	–	–	7.50	2001	–
Medical	Health	10.00	–	–	–	10.00	2001	–
Energy	Power	50.00	–	–	25.00	75.00	2002	–
Power	Power	40.00	–	–	35.00	75.00	2002	–

– = not applicable, ADB = Asian Development Bank, CFS = complementary financing scheme, PRG = partial risk guarantee, PSO = private sector operations; Univ = University.
Source: Operations Evaluation Department staff compilation.

26. While ADB did not approve any direct equity investments for Viet Nam, it has made two PSO investments in regional funds that primarily target Viet Nam. ADB invested $4 million and $9 million, respectively, in the Mekong Enterprise Funds I and II. The PSO performance in Viet Nam suffered from the cancellation of the investment approvals for Viet Nam Leasing and Lyonnaise Viet Nam Water Ltd. These cancellations occurred primarily because of the Asian financial crisis, which negatively affected Viet Nam's FDI performance, and the Argentinean financial crisis that affected the sponsor. Given Viet Nam's strong economic performance and pace of liberalization since 2001, the absence of new PSO investment approvals since 2002 is surprising.[3]

27. An Operations Evaluation Department (OED) evaluation of the PSO projects in Viet Nam, based on a mixture of desk-based reviews and company visits, derived the indicative project performance results in Table A6.3.

[3] A follow-up investment in the power sector is in the pipeline.

Table A6.3: Summary of Evaluated Project Performance in Viet Nam (1995–2005)

Project	PSD	Investment Performance	Comments/Issues
Leasing	Canceled	–	Canceled by client
Cement	Satisfactory	Satisfactory	–
Water	Canceled	–	Canceled by client
University	Excellent	Satisfactory	–
Medical	Satisfactory	Unsatisfactory	–
Energy	Excellent	Satisfactory	–
Power	Excellent	Satisfactory	–

– = not applicable, PSD = Private Sector Development.
Source: Operations Evaluation Department staff evaluation.

C. PSD Issues in Viet Nam

28. Viet Nam, strategically located next to the People's Republic of China, is following a similar program of economic reform that is producing dramatic results. Due to the closed nature of the economy in the 1990s, Viet Nam avoided the worst effects of the Asian financial crisis, and the economy has been growing more than 7% per year over the past 10 years. Despite this impressive performance, and important reforms to the policy, legal, and regulatory framework, private sector participation still represents only 50% of GDP—very low by international standards. Over the past decade, Viet Nam has followed a policy of accommodating, rather than actively supporting PSD. The Government has maintained a policy of heavy regulation, and retained ownership and management of more than 4,000 SOEs that account for 29% of GDP. The Government continues to pursue a highly centralized approach to economic reform, especially in infrastructure development, which is articulated in long-term plans of 10–20 years duration.

29. ADB's level of public sector lending has been relatively low over the review period, averaging about $200 million per year from 1998 through 2003, before starting to rise rapidly in 2004 and 2005 due to a series of large power sector projects. Apart from the two power projects in 2002, PSO in Viet Nam has been limited. Although PSD was a stated CSP priority, the country plans over the review period did not present any details on forecast PSO, indicating a lack of focus and awareness of private investment opportunities within the country. Public sector operations provided assistance in the late 1990s to corporatize SOEs. The power sector has seen a substantial amount of activity, and public sector operations have been involved heavily in the developing a reform program for power and energy. The Government is taking steps to unbundle the sector. EVN is still the single buyer of power, while the Ministry of Industry is responsible for tariffs, providing some independence in tariff administration.

30. PSOD has not been involved in the transport sector, which continues to be dominated by SOEs. However, the planned metro lines in Hanoi and Ho Chi Minh City are expected to have private sector participation. Despite efforts on the part of PSO to put in place a water concession in Ho Chi Minh City, financial difficulties experienced by the sponsors following the financial crisis in Argentina undermined the successful implementation of the project. ADB's public sector operations have been active in the finance sector, providing assistance to help develop a secured transaction framework. However, this framework is not yet effective due to problems enforcing collateral. The level of NPLs in the sector is high, and foreign participation is limited due to legal restrictions, although these are being relaxed gradually and some of the large international banks are taking minority shareholdings. Given the developments in the banking sector, and the high level of interest from international investors, the lack PSOD investment in the sector since a leasing company transaction was approved in 1996 is surprising.

PSOD OPERATIONAL REVIEW

A. Business Development

1. The Private Sector Operations Department (PSOD) business development function needs to be strengthened. Business development draws direction from prevailing institutional policies and strategies, the availability of resources, and a distinct and continuous business function. This capacity should build on experience and be fully up to date with market developments. PSOD needs to maintain regular personal contacts with potential investors, business associations, financial institutions, authorities, and other stakeholders. In terms of direction and priorities, prudent business development needs to guide the evolution of the portfolio exposure in terms of country, sector, type of client and instrument, and the resulting risk profile.

2. Apart from improving productivity by allowing transaction-oriented officers to focus on deal processing, the adoption of this type of function by PSOD would help to set the operational priorities in accordance with the strategic objectives in the country strategic plans (CSP). This approach would reflect the business procedures of other private sector operations (PSO)-oriented institutions, such as International Finance Corporation (IFC), which have assigned the main responsibility for business development to the local IFC offices. The European Bank for Reconstruction and Development (EBRD) has gone even farther, with a substantial proportion of the staff being located in local offices, where they perform the mainstream private sector operations (PSO) business activities.

3. The Asian Development Bank (ADB) has 19 resident missions. The *Resident Mission Policy*[1], approved in 2000, states that resident missions will provide the primary operational interface between ADB and the host developing member countries (DMC). Further, the resident missions are to strive to maximize the efficiency, effectiveness, and impact of ADB operations in the DMC. In handling relationships with stakeholders and players in the development process, the resident missions were meant to take the lead. In practice, however, PSOD staff from headquarters almost exclusively handles private sector operations. PSOD staff have been placed in only three resident missions—India, People's Republic of China, and Thailand. The PSOD staff is classified as being "independent" of public sector staff. As a result, they are isolated from the mainstream operation of the resident mission and left to deal independently with relationship management and business development. This arrangement is not effective and leads to the dilution of the already limited and overextended PSOD staff at headquarters. Resident missions need to be staffed with professionals who possess appropriate backgrounds and PSO skills. To optimize PSO opportunities, appropriately staffed resident missions should take the lead in private sector operations business development and the preparation of country strategies.

4. Another important means of enhancing business development is the creation of productive strategic alliances. While some projects involve cofinancing with other PSO-oriented international financial institutions (IFI), which might be considered a form of strategic partnership, this approach can be expanded to include other local and international organizations that are involved in business and investment in DMCs. These organizations might include financial institutions or businesses that specialize in certain types of operations. For example, in the emerging area of sub-sovereign municipal financing, some companies and

[1] ADB. 2000. *Resident Mission Policy*, Manila.

project developers specialize in certain types of projects and services, and can repeat similar investments in different countries. PSOD could develop strategic alliances, possibly initially by investing directly in suitable project developers, holding companies, or special purpose vehicles. PSOD then could participate in subsequent repeat investments alongside the developer(s), which would result in a cost-efficient and productive business development process, even if the individual projects are relatively small.

5. Strategic investments can be considered that have a dual purpose, such as providing financial support to an investment recipient who is then required by an agreement to perform a certain role on behalf of ADB. For example, in countries without resident missions, strategic investments in local banks could serve as a form of local presence. The resulting proximity to the market, as well as the improved access to business intelligence, would be useful for future ADB PSO in that market.

B. ADB's Strategic Planning Processes

6. The difficulties defining coherent programs of reform and identifying bankable projects suggests the strategy program and project feasibility procedures require a substantial overhaul. ADB needs to consider developing a systematic framework for assessing the impact of its activities on PSD. EBRD and IFC have formulated development effectiveness methodologies that ADB could use as models. ADB needs to focus more clearly on ways to measure and monitor development impact in the design and monitoring frameworks. For example, when ADB makes privatization investments, its impact can be measured as a proportion of total privatizations made in the DMC. The same philosophy could be applied for public-private partnership (PPP) projects. When ADB supports the project of a foreign sponsor in a DMC, ADB's role can be evaluated in the context of overall foreign direct investment (FDI). These aspects are sufficiently complex to justify a study in its own right. ADB needs to put in place systems and procedures that create incentives to reward staff for project outcomes rather that project approvals.

7. Productive collaboration between the private and public sector windows of ADB was an explicit objective in the 2000 *Private Sector Development Strategy*[2] (PSDS). Essentially, the market drives private sector operations. PSOD needs to support ADB's strategy planning process and position itself strategically vis-à-vis the market. The derived programs need to be reflected in country business plans (CBP) for PSOD. The CBP would help business development and resource allocation, as well as provide a basis for ex post performance appraisal. While an overall PSDS is needed to lay out the basic parameters and establish the rules for ADB's internal handling and division of accountability for various tasks, the country partnership strategic plans (CPSs) business planning process and the CBPs should determine the PSO strategy in a given DMC. A key lesson from country assistance program evaluations (CAPE) is that sector focus, engagement for a decade or more, and appropriately qualified staff in ADB are important requirements in achieving development results. These general observations apply to PSD and private sector operations. Within clearly defined risk management parameters, a reasonable amount of flexibility is required in terms of how PSOD operates.

8. ADB recruited private sector specialists and assigned them to regional departments to help implement PSD and provide a productive link with PSOD. This approach did not work, as the assignment of full accountability for PSD to regional departments meant PSOD was

[2] ADB. 2000. Private Sector Development Strategy.

detached from this objective. Further, the regional departments diverted the private sector specialists to serve broader public sector objectives. The preparation of sector road maps was not required in CSPs based on PSD objectives. Given this outcome, the reassignment of the responsibility and accountability for PSD to PSOD, along with the private sector specialists who were recruited, should be considered. The specialists could be placed in a new PSD department within PSOD with the responsibility to focus exclusively on developing PSD within a strategic context. This structure would create an incentive for ADB to orient strategic planning toward private sector operations, and encourage PSOD to make better use of the CPS process, which is the established mechanism for high-level policy dialogue with DMCs. This division could be made responsible for processing and administering technical assistance (TA) within the PSD priorities established in the CPSs.

C. The Credit Process

1. Overview

9. The credit process refers to the flow of measures and steps involved in bringing a project from initial screening, through investment documentation and signing, to ADB's full exit by divestment and/or loan repayment. It involves many activities with responsibilities across several departments, and with reviews and decision points at various levels in the organization. The objective of a well-structured credit process is a logical sequence of events, documents, and meetings that provide for reviews and assessments, leading to corrective measures on a timely basis. A well-designed credit process will ensure that appropriate corporate governance procedures are adopted, and a reliable and accurate audit trail of all key documents and decisions is created. Typically, the credit process is divided into four functions:

(i) **Credit approval.** The steps and measures from project identification through its analysis, evaluation, and Board approval, including documentation and signing with the objective of facilitating credit decisions based on solid, reliable, and well-researched information.

(ii) **Credit management.** Systematic credit monitoring of projects being implemented, board representations, periodic reviews and reassignment of credit ratings, provisioning for potential losses, and overall portfolio monitoring for credit worthiness and risks until exit.

(iii) **Credit workouts and recovery.** Reappraisal and restructuring of projects in distress with the objective of improving their credit ratings and prospects for recovery, including foreclosure and liquidation.

(iv) **Credit information systems.** A complete database on all projects in the project cycle, from identification, through project completion, and final exit. Typically, these types of databases are full online applications that provide for decentralized inputs into a secure centralized database, and facilitate instantaneous production of reports. This function also includes the maintenance of a comprehensive centralized credit file containing all key documents of the credit process, and provides an accurate audit trail.

2. Credit Approval

10. The current PSO credit approval process contains some features that might not result in an acceptable level of rigor, and creates unnecessarily time-consuming report writing requirements instead of constructive and prompt face-to-face discussions. The project appraisal

procedures could be strengthened to capture more effectively the value for money (VFM) for client DMCs, derived from ADB's various types of assistance.[3] Agencies, such as the Treasury of the United Kingdom, have developed a comprehensive three-stage evaluation processes that encompasses program-, project-, and procurement-level assessments. These assessments are used to determine where private sector participation adds value to a project by improving long-term efficiency and or effectiveness, relative to a public sector comparator.

11. When considering a project that might be financed by ADB, the first question that should be asked is the whether ADB could finance the project with nonsovereign instruments. In most cases, this would be a more efficient solution for the population within a country than sovereign guaranteed projects due to benefits from competition, innovation, and risk transfers. If the answer is no, the next question should be whether the project could be broken in parts to allow some of the components to be financed with nonsovereign instruments. If the answer is still no, then a sovereign product will be the most appropriate instrument. These tradeoffs can be explicitly captured in VFM procedures that contrast public sector provision with private sector provision under various risk-sharing arrangements. ADB's internal staff incentives, which focus on project approvals, mean that the public sector side of ADB does not systematically look for opportunities to turn public sector loans into PSO. Strong leadership from the Vice-Presidents would be needed to change ADB's culture in this area.

12. ADB's PSO occasionally has experienced difficulties competing on price, which is surprising given ADB's financial strength. This suggests PSO pricing procedures should be reviewed. Among other things, procedures need to be systematized and should distinguish between country risk bands. A close working relationship between PSOD, RMU and the Treasury Department is necessary to ensure an appropriate cost of funding is taken into consideration when performing due diligence. This requirement is particularly important when local currency needs to be raised for back-to-back financing. In many cases, guarantees might be a more efficient instrument than providing direct finance. Procedures and incentives need to be put in place to ensure effective dialogue between PSOD and the Office of Cofinancing Operations (OCO). Ideally, both operations should report to the same Vice President.

13. More sophistication and flexibility could be introduced in deal pricing and structuring, such as the use of progress- and performance-linked fee structures and interest margins that act as performance incentives. ADB also could provide more flexibility by introducing mechanisms, such as amortization schedules, that are linked to cash flows. These could include features such as cash sweeps and claw backs that allow for accelerated loan recovery. When designing these project structures, effective input is required from the Office of General Counsel (OGC) and some departments, such as Regional and Sustainable Development Department (RSDD), which is responsible for environmental and social safeguards. Safeguards, documentation requirements, and costs must be within commercially acceptable limits and consistent with ADB policies. For the application of safeguards, ADB should harmonize its standards and documents with IFC. The potential to develop standardized documents, guidelines, and procedures, as well as training programs that can be used to streamline the use of PSO instruments is substantial. The recent addition of a safeguard specialist to PSOD's staff should facilitate this work.

14. PSOD project approval procedures could be streamlined. For example, the project concept approval is obtained by circulating a Concept Clearance Paper for written comments, which are sought from various departments. Because this type of procedure solicits comments,

[3] HM Treasury. 2006. *Value for money (VfM) Assessment Guidance*. London: HM Treasury.

it does not create any direct "ownership." Further, it tends to result in superfluous reviews and provision of comments for the sake of procedural compliance, rather than to improve the substance. Such a procedure causes delays. More importantly, however, it precludes the benefit of simultaneous awareness of views expressed by other interested parties that would be facilitated by open frank discussion in a Private Sector Credit Committee (PSCC) meeting.

15. Once a concept clearance paper has been approved and due diligence has been performed, the project under consideration is discussed for the first and only time at the PSCC as a draft Report and Recommendation of the President (RRP). At this stage, all major decisions have been made, and the sponsor and concerned ADB staff already have agreed upon the transaction. This procedure precludes a critical review and discussion of issues, such as the deal structure, use of alternative instruments, and other problems that might have emerged during due diligence. Presenting a project at concept clearance paper stage to the PSCC has the additional benefit of providing project stakeholders with prior awareness of potential issues that need to be addressed during the due diligence process. Other ADB departments should provide their input further upstream in the project processing cycle. This would help to improve project quality and avoid surprising sponsors with new requirements late in the process.

16. For a PSCC-based procedure to work in a smooth, productive, and professional manner, a number of requirements must be met. An effective credit committee is a working group of professionals that have been empowered by senior Management to make certain decisions in accordance with its terms of reference on credit issues in projects brought to its attention. While the chair of the committee should be a representative of senior Management independent of PSOD, its members need not all be line managers. The committee should include members who are professionals with strong hands-on private sector investment experience. The committee should meet regularly (at least every two weeks) to discuss openly ongoing private sector operations issues. Regularity of meetings helps create continuity, an essential feature for a productive and effective credit committee. The committee needs a strong professional secretariat with the skill to synthesize and consolidate the key points and decisions made, and disseminate this material to concerned parties.

17. An important milestone in the credit approval process is the formal commitment of ADB to a financing agreement by signing the legal documents. Based on a review of PSOD project completion reports (PCR), the processing time for ADB's financing from due diligence to documentation and signing tends to be lengthy. In exceptional cases, it has taken years. While such delays are frequently due to reasons other than inefficiency, they raise another concern. During such long periods, certain changes are likely to have occurred in project scope and design; perhaps the financing plan; and, most importantly, market circumstances. It would be inappropriate for ADB to sign and commit to a project without ensuring that nothing of substance has happened since project appraisal that would jeopardize successful implementation. Therefore, a formal procedure might be considered where the responsible officer issues a closing certificate that is approved by the director general of PSOD. This certificate would be issued immediately before signing, stating the project parameters are still substantially in accordance with the estimates and findings presented for Board approval, and no material adverse events have taken place in the enabling environment that would raise concern for successful implementation.

3. Credit Management

18. PSOD traditionally has handled credit management, a system that has created some conflicts of interest. The Risk Management Unit (RMU), which is independent from PSOD, was created in 2005 to resolve this issue. While the location of RMU outside PSOD is appropriate and in line with normal practice in financial institutions, the RMU's precise terms of reference are still being discussed and its business systems and working procedures developed. Specific concerns that arise concerning the credit management function include the procedure for carrying out periodic project credit reviews, credit rating, project provisioning, portfolio monitoring, workouts, and recoveries. While the input for these assessments will emanate from PSOD's periodic project review missions, monitoring consultants' reports, and client's progress reports, the findings and feedback must be presented at an appropriate forum for consistent attention and follow-up. The RMU should be the only department empowered to assign a risk rating for proposed and existing projects, and it will require adequate resources to perform this function.

19. A dedicated and appropriately skilled risk management team needs to be created to oversee the PSOD portfolio risk profile. Best practices for handling these matters and developing reporting systems can be developed based on models used by other similar institutions. For example, EBRD applies central portfolio management concepts and individual risk reviews with a frequency (annual, biannual, quarterly, or more frequently for watch list or problem loans) that depends on risk ratings assigned by an independent RMU. Project reviews within EBRD are then prepared, led, and minuted by the RMU.

20. In addition to addressing organization issues, there is need to revise the portfolio management reporting systems. An important intermediate milestone in the credit management process is physical project completion. Typically, physical completion is defined in the legal documentation, and for example it could trigger an event such as a reduction of the interest margin. As such, a system is needed to formally record when a project is physical completed. ADB needs to record how the project arrived at physical completion, starting from appraisal, through Board approval and signing, and physical project implementation. Brief notes should be available that identify any issues such as delays, cost overruns, and contractors' performance.

21. These types of matters should be reported in PCRs. To date, only a few PCRs have been prepared for PSOD projects, typically a few years after start of commercial operation. This self-evaluation has covered only 35 of 119 PSOD projects. In addition, Operations Evaluation Department (OED) has prepared only 13 project performance evaluation reports (PPERs) for PSOD projects, together with one special evaluation study (SES) on funds. This level of self-evaluation and independent evaluation is insufficient to meet the information needs of ADB's Board and Management. However, clearing the backlog by preparing PCRs in their current format for all PSOD projects is not feasible, given PSOD's staff complement and consulting budget. The use of a project completion certificate can be considered to help address the backlog. Such reports would briefly and concisely describe the events in project implementation until physical completion, and state whether it was successful. The certificate then would form part of the quarterly, biannual, and annual reporting systems used to help administer loans and monitor portfolio performance.

22. PSOD prepares a range of quarterly and annual reports. The structure and content of the documents need to be reviewed. These documents do not provide a clear view of consolidated performance, and focus primarily on new approvals rather than disbursements.

The link between development impacts and financial performance relative to country, sector, and project targets is missing. Ideally, the structure of the project reports should be harmonized in accordance with an agreed set of performance indicators, such as those used in the OED guidelines for private sector operations. In this way, a common reporting framework can be established for concept clearance papers, RRPs, PCRs, and PPERs. Under such a framework, a common set of performance standards would be used for the entire project cycle. The additional work requirements for each report in the cycle can be standardized in a format that is known and uses indicators that are easily accessible.

4. Credit Workouts and Recovery

23. The workout function is performed by staff in the division of PSOD that is responsible for finance sector-related PSO. This could lead to conflicts of interest. Following the practices of IFC and EBRD, this function should be established in a special purpose unit or attached to the Office of Cofinancing (OCO). Projects that have been assigned to this unit require reporting systems that monitor progress continuously. This is an area where staff in the resident missions could be integrated more tightly into the credit management process than they are currently.

5. Credit Information Systems

24. PSOD uses a number of data and information dissemination systems and procedures. These systems have evolved from manual systems with gradual modifications, expansions, and the development of parallel systems for specific purposes. The credit information systems include:

(i) **Private sector investment management (PSIM)**. This system produces a report that is based on a manually prepared compilation of all projects under administration. PSIM identifies project performance, credit rating, and operational issues, as well as pertinent data on the structure of the portfolio. PSIM is circulated quarterly to the Board for information.

(ii) **Comprehensive loan administration servicing system (CLASS).** This computerized system records all board approvals, signed commitments, disbursements, loan repayments, and divestments. It is maintained for the use of the Controllers Department and PSOD. This system provides information for PSIM. A CLASS report is compiled annually for internal use.

(iii) **Private investment securities management system.** This computerized system records all ADB investments in funds, and the subinvestments made by the various funds. The system is used for internal purposes by PSOD.

(iv) **Private sector project processing report.** This manual compilation of all projects in the pipeline serves the purpose of reviewing project progress in a monthly internal PSOD meeting.

(v) **Private sector portfolio assessment report.** This is a manual compilation of all projects under administration with a risk rating of RR4 (marginal) or worse. It is discussed quarterly in conjunction with PSIM in a meeting chaired by PSOD with RMU, OCO, OGC, Treasury Department, and Central Operations Services Office in attendance.

(vi) **Project processing information system.** This is an ADB-wide system of all pipeline projects. Once a project is approved, its data is transferred into CLASS.

25. These information systems are typically manual. They have limited means of controlling access, are slow in providing information, are prone to errors, and are not secure. The credit information system needs to provide participants in the credit process with timely access to accurate information on projects at various stages in the project cycle—exploration, Board approval, signature, disbursement, completion, and closure. The information systems need to be consolidated under one comprehensive online application. This facility should enable the instantaneous and secure generation of various reports structured to reflect the specific decision making needs of eligible recipients, such as the Board, Management, and staff.

MANAGEMENT RESPONSE TO THE SPECIAL EVALUATION STUDY ON PRIVATE SECTOR DEVELOPMENT AND OPERATIONS: HARNESSING SYNERGIES WITH THE PUBLIC SECTOR

On 22 June 2007, the Director General, Operations Evaluation Department, received the following response from the Managing Director General on behalf of Management:

I. General Comments

1. We welcome OED's Special Evaluation Study (SES) on Private Sector Development and Operations. The private sector indeed plays a vital role in development as the engine of growth and poverty reduction, and the study provides a solid analysis of the role of private sector in ADB's operations.

2. We note the SES findings that ADB's private sector development and operations have been satisfactory overall. Having private and public sector operations under one roof is a unique strength of ADB and this provides an excellent basis for collaboration between private and public sector operations with the aim to increase development effectiveness of ADB's operations. We agree with the suggestion that synergy between public and private sector operations is the key to ADB's success in promoting the private sector. We have been taking several initiatives to foster synergies between various operations in ADB such as the adoption of the new Country Partnership Strategy (CPS) processes.

II. Comments on Specific Recommendations

3. **Assessment of the Need for Changes in Organizational Structure**. We note the recommendations for changes of the organizational structure and operational arrangements, including further strengthening of the Risk Management Unit. As a matter of fact, some of them are under discussion, but any further view on them will be taken up in the context of the ongoing review of the Long-term Strategic Framework including the resource implications of these changes.

4. **Corporate Management Plan**. We believe that an additional medium-term corporate management plan will add little value since there is already a well-established system for planning and budgeting in place. The long-term and medium-term strategies set strategic and operational priorities. These strategies are implemented with a country focus through CPS, operationalized and resourced through the annual work program and budget framework. Private sector operations are fully integrated in this planning process.

5. **Country Business Plan**. We agree with the suggestion that the CPS and the Country Operations Business Plan should be the common business basis for both the public and private sector operations at ADB. We note that the new CPS processes were adopted in August 2006 to ensure smooth

coordination between the Private Sector Operations Department (PSOD) and regional departments.

6. **Medium-term Strategic Plan**. We agree with the SES suggestion that a medium-term strategic plan for private sector development and operational activities needs to be developed. However, we note that such a strategic plan has ADB-wide implications and therefore, should be jointly prepared through an ADB-wide initiative rather than by PSOD alone. A separate strategic plan for PSOD would not foster the envisaged synergies but rather emphasize a silo structure within ADB.

7. **Due Diligence Guidelines**. We agree with the suggestion that procedures need to be codified to ensure that private sector transactions comply with integrity due diligence guidelines that form part of ADB's Anticorruption Policy Framework. Work is already ongoing on revising the Operations Manual section on private sector operations, expanding its coverage to the processing of non-sovereign operations.

DEVELOPMENT EFFECTIVENESS COMMITTEE

Chair's Summary of the Committee's Discussion on 27 June 2007

Special Evaluation Study (SES) on Private Sector Development and Operations: Harnessing Synergies with the Public Sector

1. The SES is the first of four related studies which provide a comprehensive assessment of ADB's private sector operations and its efforts to improve the business climate in DMCs.

2. The SES shows that PSOD's portfolio is profitable and its quality is satisfactory. The 92% project success rate for PSOD projects substantially exceeds the 64% success rate for public sector projects and the 80% standard that ADB uses as a benchmark defining satisfactory performance. Overall, ADB's Private Sector Development and Operations were rated "satisfactory". The rating was mainly due to a lack of synergy between the public and private sector areas.

3. ADB is uniquely placed to provide the required combination of services because its public and private sector operations are both under one roof, but the evaluation found that ADB had not yet fully developed the synergies between the public and private sector parts of ADB, which were not always working together as a team.

4. Despite strong growth in the size of PSOD's portfolio, many DMCs complain that ADB is not responding adequately to this demand. Responding to this demand however, requires changes in (i) ADB's organizational structure; (ii) the level and type of resources; and (iii) roles, products and responsibilities. This type of change will not be easy, since ADB has struggled to find ways of merging public and private sector operations for some time. It is a challenge to introduce a private sector culture into an organization like ADB that is dominated by a public sector culture.

5. In OED's view, some organizational changes are needed to fully exploit the public/private synergies. The SES only highlights this fact rather than providing any concrete solutions at this stage. OED agrees with the Management's response that organizational changes need to be taken up in the context of the review of the Long Term Strategic Framework (LTSF).

6. In sum, the two main findings of the report could be summarized as (i) the need for closer and more structured public-private synergies and (ii) the need to include close collaboration between public and private sectors in the CSP.

7. Director General, PSOD and Director, SPMS presented the Management's Response which agreed with the general findings and recommendations of the SES and raised a few concerns on the specific recommendations.

8. DG, PSOD noted that the dramatic shift in the Asia Pacific region over the last four decades, where it has changed from a capital deficient to a capital abundant region. In addition, societies have realized that the private sector is more apt at providing goods and services and that economic development needs to include private sector development. Thus private sector assistance is becoming an increasingly important role of ADB and all the MDBs. The increasing demand for private sector work from ADB's DMCs requires an internal paradigm shift towards private sector. However, current resource limitations constrain PSOD's capability to deliver in the face of an increasing portfolio. Director General, PSOD considered that a 92% success rate

is a very good result given PSOD's constraints. While the PSOD is supportive of the report and its overall thrust, the classification of the Department as "satisfactory" with a 92% rating was the subject of intense discussion with OED. The explanation provided by OED that this was as a result of circumstances outside of the PSOD's control was not considered a satisfactory explanation by PSOD.

9. While ADB's competitive advantage is to have both public and private sector areas under one roof, this was also a challenge, since many of ADB's procedures are based around public sector work. In comparing with other private sector focused organizations, it was noted that, for example, IFC has broken away from the public sector area of the World Bank, and in EBRD, the private sector prevails over any public sector interventions. Thus, in choosing a strategy which includes Public-Private Partnerships (PPP) as ADB's core product, PSOD has adopted a more difficult but also more comprehensive strategy.

10. There is currently no reward structure in place to stimulate public sector cooperation with the private sector area of ADB, since incentives are still focused on lending volume. While there are successful examples of close collaboration between PSOD and Regional Departments, such as in energy related projects, these occur thanks to positive working relationships between staff rather than as a result of any existing structure promoting cooperation. PSOD strongly advocated a reward structure that would facilitate closer cooperation.

11. DEC commented on the following key points, to which OED and the Management responded.

12. **Private Sector Development.** DEC agreed that indigenous private sector development (PSD) is essential, and the focus of private sector operations (PSO) should not be limited to encouraging foreign direct investment (FDI). PSOD agreed with this perspective, while at the same time noted that ADB should continue to be involved in promoting FDI in DMCs, as it can provide a catalyst for investment.

13. Similarly, ADB should not only focus on privatization but should also support governance issues in the corporitization process of state-owned enterprises (SOE). PSOD fully agrees adding that the ADB can play an invaluable role in such privatizations by leveraging off the risk management theme that underscored all PSOD operations. With respect to both SOEs and private sector companies, PSOD reminded DEC that it only works with sound companies in order to avoid undue financial risks.

14. DEC indicated that since the majority of DMCs agree with the importance of PSD, CPS and CAPEs should devote a section to PSD, providing a framework for the public and private sectors to work together effectively. Staff agreed to include PSD and PPPs in future reports.

15. A DEC member raised the issue of monitoring income generation resulting from PSOD activities. PSOD noted that results of PSOD operations must be profitable in order to attract others into transactions.

16. **Resource Issues**. DEC agreed that PSOD is both under-resourced and over-stretched. To support PSOD's requests for additional resources, it would be useful to illustrate the large volume of project requests. For example, it would be useful for DEC to see figures on PSOD's activities broken down by country and by sector, and to know which projects are rejected and why. PSOD agreed to provide the figures upon DEC's request. PSOD clarified that only one in every eight transactions is selected by PSOD, and that projects are rejected for reasons such as the project is not financially viable, it has limited development impact, or it is in a sector that PSOD has chosen not to work in. While not disagreeing, DG PSOD stated that he hesitated to

create more internal reports (unless so requested), favoring instead the evidence provided by the very rapid growth of private sector operations.

17. **Overall Institutional Framework**. DEC agreed that any changes regarding private sector operations should be addressed during the review of the LTSF. However, one DEC member expressed disappointment that Management would like to consider any organizational changes during the LTSF review. Director, SPPI reiterated that the LTSF was the appropriate framework to consider the organizational issues raised in OED's report.

18. A DEC member expressed concern over the satisfactory rating, and considered that improvements were required, particularly with regard to development impact of PSOD's interventions and PPP interventions. He agreed with the need for a culture change within ADB at the institutional and operational levels, but this change needs to be driven by Management. He recommended that Management responds to the DEC on this issue.

19. A DEC member noted that, while this SES is the first of four reports and its conclusions may only be preliminary, he would have like to read about how other organizations are doing private sector work, what models are used by others, and if others were achieving better outcomes, and if so, why. He agreed with the proposal for structural changes and revised operational plans, but indicated that these were not enough, and changes in culture, incentives and managing for results with maximum impact were required. He noted that resources and accountabilities need to be addressed first in order to deliver on development outcomes. He emphasized that Management could have been more proactive in its response to the report by providing some indication of a future direction or vision.

20. PSOD indicated that ADB has a model that works well, and other organizations such as AfDB and IADB would like to adopt the same model. As opposed to IFC and EBRD, ADB works with financial institutions on the ground, which helps keep costs under control and at the same time contributes to developing the financial sector in the country of intervention. DG PSOD considered the strategy adopted by the other MDBs less effective. Evidence to support this included the success enjoyed by PSOD, the low level of underperforming assets and the benchmark studies of both OED and CTL showing PSOD far ahead of the other private sector arms of other IFIs.

21. OED explained to DEC how IFC and IADB are set up in terms of public and private sector departments: IFC is based on a commercial bank model using a scorecard tool and with 50% of its staff in the field, and IADB is based on a development bank model but with a newly revised organizational structure.

22. A DEC member noted that other organizations such as IFC have large and well resourced offices in client countries such as PRC and India, while ADB has only one staff in each Resident Mission (RM). He noted that clients will not wait for ADB and will approach other institutions which can meet their demand. If ADB agrees that it wants to service the demand for private sector interventions, then resources need to be allocated to the RMs. The member also noted that PSOD is not a member of the steering committee on the review of the LTSF and found this inadequate if the synergy between public and private sector areas of ADB is to be improved.

23. **PSOD Portfolio.** A DEC member indicated that given the demand for private sector work, the one roof model ought to be attractive, and noted that the current PSOD portfolio showed innovative elements with some good results. In his view, ADB is more successful in delivering and completing projects than in terms of development impact.

24. Another DEC member raised the issue of the relationship between PSOD and the Office of Cofinancing Operations (OCO). DG, PSOD indicated that given their current structures, OCO was better positioned to focus on public sector work and PSOD should use its own syndicating capabilities.

25. The issues on the acceptable level of risk with regard to the non-sovereign portion of PSOD's portfolio, the harmonization of safeguards with IFC, and counterpart risks and conflicts of interest were also raised. A DEC member suggested that a balance scorecard for PSOD could be a useful tool for measuring achievements in the future.

26. Another DEC member indicated that the limitations with regard to risk may need to be reviewed to allow PSOD to enter into more projects. He also suggested that PSOD diversify into other areas such as SMEs, agriculture and clean energy, and that PSOD consider regional cooperation projects in future. DG, PSOD indicated that PSOD is already indirectly active in these areas through its funds activities and is considering some of these other areas.

27. Finally, DEC Chair indicated that DEC generally endorsed the key findings and recommendations of the SES. DEC would look forward to the completion of the other three related evaluations by OED, in order for DEC to have a comprehensive assessment of ADB's private sector operations.