

Support for Financial Intermediation in Developing Member Countries

- ADB has supported 476 projects totaling \$16.8 billion, or about 14% of its public sector lending, as of end-2007. ADB provides credit lines, policy-based loans, housing sector loans, and financial leasing lines in support of financial intermediation in its DMCs.
- This **evaluation update**¹ finds that ADB's program loan modality in support of financial intermediation for **private sector development** has generally been successful and should therefore continue.

Background

The credit line modality was designed by the **Asian Development Bank (ADB)** when most **developing member countries (DMCs)** were short of foreign exchange for the equipment imports of private enterprises. The credit lines were channeled mainly through government-owned **development finance institutions (DFIs)**. Credit lines totaling \$4.6 billion had been extended to 25 DMCs as of end-2007, with many of these supported by technical assistance (TA).

Despite these efforts, industrial development and economic growth continued to stagnate in most DMCs. The environment for business and for projects financed under the credit lines was unfavorable. Private industrial enterprises were often held back from importing equipment and raw material requirements by foreign exchange constraints. In addition, because credit lines were denominated in foreign currency, the recipient DMCs and DFIs were exposed to **foreign exchange risk**.

Credit lines were used when protection and support for infant industries was a dominant theme. Once markets became more open and tariff protection and barriers reduced, the industries were exposed to a more competitive market. Some DFIs transformed themselves into universal banks to access market for resources rather than continuously depend on government guaranteed funds. Their need for credit lines from ADB was reduced.

Summary of Findings

The report has reviewed the past experiences and evolving nature of ADB's practices in financial intermediation for private sector development, mainly through the establishment of **small and medium enterprises (SMEs)**. It also reexamined good practices in this area as adopted by various countries and other international development organizations.

Good Practices in Financial Intermediation Lending. ADB's financing modalities and practices in respect to financial intermediation for private sector development have changed and evolved over the years in line with the changes in the economic environment.

Credit lines could still be used for DMCs that have acute shortages of long-term resources for funding investment. The use should, however, be solely on the provision of long-term local currency resources to the private sector under swap arrangements. ADB's present guarantee facility should also be used to provide guarantees to local financial institutions to make the required long-term resources available in local currency. Financial institutions involved should agree to raise long-term resources on their own in the domestic markets.

ADB's reform-based program loan practices have generally been successful since they have helped to expand financial intermediation for private sector development. ADB could continue to use the policy-based lending practices, with appropriate TA support, to further diversify and expand its financial intermediation.

Initiatives. Various initiatives could also be taken to ensure an efficient and effective financial intermediation system: (i) improve the investment climate to encourage private sector development and foreign investment through strengthening of policies, procedures, and incentive frameworks; (ii) make the financial sector more broad-based, competitive, and efficient to reduce over-reliance on banking systems, which could be achieved through the development of the capital market; (iii) spread financial intermediation to outlying areas by developing rural savings and microfinance services; (iv) build institutions and enhance capacity in good governance, international standards for bank regulation and supervision, capital adequacy, loan classification and provision, accounting and auditing, self-regulation, risk assessment, and mitigation, including the use of risk-hedging instruments, liquidity management, debt collection procedures, and use of information technology and management information systems; (v) privatize and subcontract services of conglomerates to SMEs to promote further opportunities to promote private sector and SME development and expand financial intermediation; and (vi) develop skills, trades, entrepreneurship, and business development services.

Financial Assistance. Other forms of assistance to increase financial intermediation for the private sector may include (i) guarantee mechanisms for long-term deposit mobilization through guarantee facility and advisory TA to set up appropriate organizations, policies, procedures, products, training, and management information systems; (ii) guarantee mechanisms for corporate bond issues to promote investment; (iii) expanded support for housing finance by providing long-term funds to financial institutions and TA that specifically target mortgage underwriting and servicing for each bank to which ADB provides financial support; equity investments to start housing finance companies or banks, as well as provide funding for mortgage insurance companies which can help reach a broader base of the income segment; and guarantees on mortgage-backed securitizations which provide longer-term funding for mortgages; (iv) guarantee mechanisms for export financing to enable commercial banks to provide export financing to those SMEs that lack traditional forms of collateral to secure their export facilities; (v) further expanded lease financing operations through ADB guarantees to local financial institutions to raise medium- to long-term financing for leasing operations by providing advisory TA for the establishment of the necessary legal, regula-

tory, tax, and accounting and auditing frameworks; staff training in leasing operations; the strengthening of the management information systems, among others; (vi) an Asian bond guarantee corporation that could extend guarantees for the development of the bond markets in Asia and the Pacific; (vii) expanded non-performing loan (NPL) resolution and asset management corporations through guarantees on loans raised by local institutions to purchase the NPLs at discounted rates; (viii) asset securitization to develop the secondary mortgage finance markets and lay the foundation for this through an advisory TA; and setting up equity investments; and (ix) development of nonbank financial institutions to make the financial sector more broad-based, competitive and efficient through development of support in investment banks, venture capital companies, pensions and mutual funds and other forms of contractual saving schemes, credit cards, and other forms of electronic-based financial services complementing the services of development and commercial banks.

Issues

- **Integrated programmatic approach.** An integrated program loan modality had not been adopted in the DMCs until recently. ADB has begun to adopt an integrated and comprehensive approach to program lending through program clusters, while focusing on selected sectors.
- **Private sector development.** It would be useful to develop strategies for increasing financial intermediation for private sector development or DMCs and link these with its overall country partnership strategy.
- **Flexible modalities and continuous policy dialogue.** ADB's practices and modalities should be kept flexible and adaptable during times of volatile economic situation. Continuous dialogue with policymakers is needed to monitor early warning signs of economic and financial developments.

Feedback

ADB Management's response and the **Chair's Summary of the Development Effectiveness Committee Discussions** are not required for this evaluation. The study was completed in December 2008.

¹ ADB. 2008. *Support for Financial Intermediation in Developing Member Countries*. Special Evaluation Study Update. Manila. Available: <http://www.adb.org/Documents/SES/REG/SES-REG-2008-71/SES-REG-2008-71.asp>