ASIAN DEVELOPMENT BANK

R-Paper

PRIVATE SECTOR OPERATIONS

STRATEGIC DIRECTIONS AND REVIEW

August 2001

ABBREVIATIONS

ADB	–	Asian Development Bank
CFS	–	complementary financing scheme
DMC	–	developing member country
EBRD	–	European Bank for Reconstruction & Development
ECA	–	export credit agency
IADB	–	Inter-American Development Bank
ICT	–	information and communication technology
IFC	–	International Finance Corporation
IFI	–	international financial institution
LTSF	–	Long-Term Strategic Framework
MDB	–	multilateral development bank
OCR	–	ordinary capital resources
PCG	–	partial credit guarantee
PRC	–	People's Republic of China
PRG	–	partial risk guarantee
PSD	–	private sector development
PSG	–	Private Sector Group
PSO	–	private sector operations
RM	–	resident mission
SME	–	small and medium-sized enterprise
TA	–	technical assistance

NOTE

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

CONTENTS

PRIVATE SECTOR OPERATIONS:
STRATEGIC DIRECTIONS AND REVIEW

I. INTRODUCTION

1. The founders of the Asian Development Bank (ADB) envisioned a role for private sector operations (PSO) in the region's development. ADB's Charter mandates ADB to promote investment of private capital in the region for development and empowers it to invest in equity, provide loans without government guarantees, guarantee loans, and facilitate financing to enterprises operating in its developing member countries (DMCs). ADB made its first equity investment in 1983, and provided its first loan without a government guarantee in 1986. Since then, ADB, through PSO, has supported some 146 private sector projects worth a total of $18 billion. In March 1995, ADB's Board of Directors approved a more focused operational strategy for PSO.[1] That strategy required a country focus in project selection and accorded high priority to two sectors (infrastructure and financial sector) in which ADB had had long experience through its public sector operations. Industrial and other projects were given low priority. The responsibility to implement the PSO strategy was assigned to the Private Sector Group (PSG), which was created in January 1995 to consolidate PSO into one office.[2]

2. The first comprehensive ADB-wide private sector development (PSD) strategy,[3] which was approved by the Board in March 2000, confirms the role of PSO in catalyzing private investments through direct financing and risk mitigation instruments. Under the new PSD strategy, PSO will continue to support infrastructure projects, funds, and financial intermediaries; however, PSO will now be oriented toward achieving greater development impact and/or demonstration effects.

3. This paper (i) assesses PSG's past performance; (ii) elaborates on an updated operational strategy for PSO in the context of the broader ADB strategy for PSD; and (iii) analyzes the operational and resource implications of the updated PSO operational strategy.[4] The paper makes a number of recommendations and seeks Board approval for them.

II. ASSESSMENT OF PAST PERFORMANCE

A. Country and Sector Coverage

4. Since its creation in 1995, PSG has successfully implemented the 1995 PSO strategy to support investment in projects that met country-specific development needs in the two priority sectors (infrastructure and financial sector). Of the 46 new projects approved between 1995 and 2000, 15 were infrastructure projects and 29 were financial intermediaries, including funds.[5]

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[1] R56-95: *Strategy for the Bank's Assistance for Private Sector Development*, 17 February (the 1995 PSO strategy).
[2] A review paper, WP3-98: *Review of Private Sector Operations, 1995-1997*, 31 March, covering the first three years of PSG operations was provided to the Board in March 1998, but did not propose any major shift in strategy.
[3] R78-00: *Private Sector Development Strategy Paper*, 9 March.
[4] WP6-00: *Private Sector Operations: Strategic Directions and Review,* 10 July, reported on PSG's past operations and elaborated on an updated operational strategy for PSO. The Board discussion on WP6-00 on 31 July 2000 raised certain questions relating to the role of PSO in ADB's overall operations and strategy, and the appropriate scale for PSO, given that role. These questions were addressed in the Addendum 1 to WP6-00 which was submitted to Board on 2 February 2001 and discussed on 26 March 2001. This paper is based primarily on WP6-00 and the Addendum to it.
[5] The remaining two projects were a hotel and a cross-border import-substituting infrastructure related manufacturing plant.

These projects have supported ADB's country-specific operational strategies for infrastructure and financial sector development; leveraged ADB's financial resources by catalyzing funding commitments from other investors and lenders; complemented, not substituted for, commercial sources of finance; provided a model for private sector participation in delivery of basic services; and/or enabled ADB to add value and influence project design to improve the development impact.

1. Country Coverage

5. Project approvals in PSO have been concentrated in DMCs with environments receptive to private investment. These DMCs have generally large markets that offer attractive opportunities for business. Thus, while ADB has approved $1.9 billion of funding commitments for some 146 private sector projects[6] in 14 DMCs since PSO started in 1983, over 60 percent of the total amount approved has been for projects in six DMCs: Bangladesh, People's Republic of China (PRC), India, Indonesia, Pakistan, and Philippines.[7] Also, the 21 regional projects approved so far—mostly funds and accounting for about 21 percent of all approvals—have assisted subprojects that are mainly in four DMCs among the same group. Evidently, most of the existing client DMCs are being served intermittently. During 1995-2000, PSG sought to extend the country reach of PSO but, due to difficulties in the environment and resource constraints, private sector investments in only three "new" client countries—Bhutan, Samoa, and Viet Nam—were added, and these constituted only about 3 percent of approvals during the period. PSO assistance has yet to reach over 20 DMCs, mostly those in Central Asia and the Pacific.

2. Sector Priorities

6. Up to the early 1990s, ADB was assisting private sector projects in a wide range of sectors (including manufacturing, agriculture mining, infrastructure, and financial sector) with no specific prioritization. The 1995 PSO strategy, however, sharpened the sector focus by giving priority to infrastructure and financial sector projects and downplaying projects in manufacturing, agriculture and mining sectors. ADB realized that, with constrained resources, it had limited ability to assess manufacturing, agriculture and mining projects and modest capability to add value to them. Most of its manufacturing projects turned out to be problematic. Thus, ADB repositioned its PSO in favor of infrastructure projects, where PSG has concentrated expertise in project finance, supplemented by organization-wide expertise in infrastructure development. The 1995 strategy also continued to give priority to financial sector projects (including capital market institutions, financial intermediaries and investment funds), which had been important planks in PSO from the start. With the sharpening of sector focus, ADB was able to direct its PSO to the challenges faced by DMCs in infrastructure and capital market development, challenges that must be overcome to achieve sustained growth. During 1995-2000, the share of infrastructure in the total PSO portfolio[8] increased substantially from 27 percent to 47 percent.

[6] Counting of PSO projects is based on the number of distinct companies assisted. Additional loans to or equity investments in existing client companies are not counted separately. The count of 146 companies is net of cancelled projects that did not achieve financial closure. This number includes 23 companies in which ADB made equity investments under the Board-approved lines of equity.

[7] The other eight existing client DMCs for PSO are Bhutan, Republic of Korea, Malaysia, Nepal, Samoa, Sri Lanka, Thailand, and Viet Nam.

[8] At the end of 2000, the financial sector exposure was 37 percent of the total PSO portfolio. About half of this was in funds and fund management companies.

This increase was matched by a decline in the share of manufacturing and other sectors from 27 percent to 16 percent.[9]

7. **Infrastructure.** PSG's infrastructure projects approved during the past six years reflected the 1995 strategic priority to help address infrastructure bottlenecks in DMCs. The catalytic effect and value added of ADB's direct participation in these projects proved essential in attracting commitments from other foreign lenders and investors. Most of the projects were pioneering public-private partnerships that were expected to deliver significant development impacts and demonstrate the private sector's ability to help meet supply shortages in infrastructure services. Among these were power generating plants of various fuel types, bulk water treatment plants, a water distribution concession, a rural cellular telephone network, a container port, an international airport terminal, and a major toll road, typically in countries or sectors where no major build-operate-transfer projects had been executed previously. Hands-on experience across a broad range of subsectors in infrastructure, especially where ADB has been involved at the design phase of a project, is a strength that has made ADB a reliable partner for project sponsors and lenders.

8. **Financial Sector and Capital Markets.** The financial projects approved during 1995-2000, in particular, dovetailed with the relevant country strategies and programs, and complemented ADB's public sector operations in the concerned DMCs. For instance, ADB invested in a newly established commercial bank with a nationwide presence in the PRC, to complement a government-guaranteed loan from ADB's public sector operations. This first foreign investment in a PRC state-owned commercial bank supported the broadening of the bank's ownership base and its strategic plan to transform itself into a shareholding bank grounded on "best practice" principles. Another important PSG intervention was a loan without government guarantee to a development bank in Sri Lanka. This ADB loan was combined with a syndicated loan that gave the bank funding access to international commercial banks and provided resources for onlending to small- and medium-sized enterprises (SMEs). The syndicated loan was covered by a partial credit guarantee provided by ADB under its public sector operations against a counterguarantee from the Government of Sri Lanka.

9. **Investment Funds.** As part of its focus on the financial sector and capital markets, PSG has promoted various types of investment funds to help transfer scarce, long-term risk capital from capital-rich countries to the DMCs and, to some extent, mobilize domestic capital for financing private investment. Such funds help stimulate and broaden emerging securities markets and function as proxies for overseas investors wanting to invest in DMC portfolios. PSG has supported regional funds that tap huge amounts of investible savings from pension funds, insurance companies, and other institutional investors in developed countries. PSG has also found investment funds to be a flexible vehicle for mobilizing resources and for reaching out to relatively small private sector projects that would not be cost effective to assist directly. Investment funds have been used to introduce DMCs to new instruments, such as "mezzanine" capital, to facilitate infrastructure development.

[9] In terms of number of projects, the PSO portfolio at the end of 2000 comprised 100 projects: 19 infrastructure companies, 64 financial entities (including 26 funds and 9 fund management companies), 16 manufacturing firms and a hotel.

B. Impact of Private Sector Operations

1. Development Impacts[10]

10. When measuring the performance of ADB's private sector portfolio, the tendency is to focus on financial performance. While the financial results are reported quarterly, less attention has been given to assessing the development impact of PSO, partly because this is difficult to measure and often involves subjective judgment. However, recognizing the importance of assessing the development impacts of PSO, in 1999 PSG reviewed 24 selected projects. This review found that all these PSO projects contributed to development.[11]

11. ADB's experience shows that development impacts of PSO can be most readily captured by the project economic rate of return, but can also be observed and at least qualitatively assessed in terms of project impacts, such as: (i) job creation, (ii) skills training and management development, (iii) growth in upstream and downstream businesses, (iv) transfer of technology and sound business practices, (v) social development through provision of social services, (vi) environmental protection, (vii) expanded financing options, and (viii) sound corporate governance.

12. ADB should be particularly proud of its impact, through PSO, on corporate governance throughout the region. ADB has placed much greater emphasis on sound corporate governance among its private sector clients. This is a key feature of recent ADB investments. ADB has insisted on high standards of corporate governance in project design and is guided by similar principles in the appraisal, negotiation, and implementation of private sector projects. Requiring clients to adopt best practice in corporate governance is a powerful tool to help mitigate risk in PSO.

2. Financial Leverage

13. ADB's catalytic role in PSO enables it to leverage its own funding and facilitate resource commitments from other lenders and investors. During 1995-2000, ADB used just over $1 billion of its own funding commitments to support private sector projects with aggregate costs of over $9 billion. This represents a leverage ratio of eight times. Discussions with project sponsors, financiers, and others indicate that ADB's investments in private sector projects has been, and will continue to be, a significant factor in their decisions to invest in or lend to particular projects. This has certainly been the case with investment funds, where ADB's small equity investment has been able to attract substantial commitments from institutional co-investors. In the case of individual infrastructure projects, ADB's direct lending has usually served as a source of comfort for commercial lenders because ADB shares the same risks as the cofinanciers. In addition, ADB's Complementary Financing Scheme (CFS) has also offered significant risk mitigation for commercial lenders, particularly during the 1995-2000 period when the CFS lending for PSO amounted to $575 million, three times the total CFS lending for PSO up to 1994.

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[10] A detailed analysis of the development impacts of PSO projects is given in paragraphs 12-14 and Appendix 1 of WP6-00: *Private Sector Operations: Strategic Directions and Review,* 10 July.

[11] This review of development impacts was based on a staff consultant's study done in 1999 on a sample of 24 completed private sector projects. The study relied primarily on information provided in 24 project completion reports and 8 project performance audit reports. The sample comprised 6 manufacturing projects (textile, fertilizer, and steel); 5 infrastructure projects (power and telecommunications); and 13 capital market/financial sector projects.

C. Financial Performance

14. Starting with relatively small, stand-alone equity investments in 1983, and followed by larger loans without government guarantee from 1986, ADB has built a private sector portfolio of over $1.24 billion in outstanding disbursements and undisbursed commitments to 100 companies[12] as of the end of 2000. Of this total portfolio, 64 percent is in loans, and 36 percent is in equity investments.

15. Performance of the PSO portfolio was adversely affected by the financial crisis that hit Southeast and East Asia in July 1997, just like the portfolios of commercial banks and other financial institutions operating in the region. The "contagion effect" of currency depreciation and the economic slowdown in other DMCs exacerbated the negative impact (para. 24).

16. The Asian crisis dramatically exposed key weaknesses in the structure and performance of the private sector, and in the role of government with respect to the private sector. In general terms, the crisis showed the failure of government to carry out some of its key roles, particularly financial sector regulation and supervision. At the same time, the crisis was the consequence of poor decisions of individual private sector enterprises, both domestic and foreign. The challenge is to learn lessons from the crisis, while creating conditions to accelerate the role of the private sector in development in a manner that is responsive to the needs of the DMCs.

17. **Profitability.** The main objective of PSO is to achieve a significant impact on economic development while maintaining profitable operations.[13] With ADB's development goals being integrated in PSO, profit maximization is not the main financial objective. However, ADB should generate sufficient profit in PSO to (i) sustain PSO without any cross-subsidy from other ADB activities, and (ii) demonstrate the financial viability of private sector investments in DMCs. Thus, the profitability of PSG operations must be measured adequately and in a transparent manner through a financial reporting system that identifies the costs and income of PSO separately from those of the public sector operations. For a fair measure of PSG's profitability under this system, costs incurred by PSG for "noncommercial" activities or "semicommercial development" activities would have to be identified and excluded from PSG's profit calculations, or funded with a separate budget allocation. For example, PSG staff participate in country programming missions, contribute to country strategy formulation, review public sector projects and sector policies, and prepare policy papers, all of which are noncommercial or semicommercial and need to be segregated out of PSG's "commercial" activities to have a fair accounting. Similarly, the reimbursements received by PSG from project sponsors for out-of-pocket expenses (e.g., mission travel) need to be captured and credited to PSG. To be able to measure the financial performance of PSO independently from the public sector operations, ADB needs to establish an appropriate accounting and financial reporting system for PSO (para. 104).

18. There is also a need to review certain policies that affect the measure of PSO's profit performance. For instance, an 8 percent general loss provision is booked against all investments which do not have readily available market values and for which no specific loss provision has been made.[14] This fixed charge is made regardless of the actual risk profile of

[12] Of the 146 companies that received ADB assistance, 100 companies remained in the PSO portfolio as of the end of 2000. The 49 companies that were no longer in the portfolio included those whose loans from ADB had been fully repaid or settled through foreclosure, and/or those in which ADB's equity investments had been fully divested, written down, or written off.

[13] In measuring the profitability of PSO, a number of variables such as direct costs, cost of funding, allocated overheads, and the market value of equity investments that have not yet been realized, have to be determined with accuracy and precision. The methodology for such determination has yet to be agreed on and adopted.

[14] R15-94: *Provisions for Investment Losses in the Bank's Private Sector Operations,* 10 January.

each investment. Such a provisioning policy tends to understate profitability, especially as the portfolio has been growing.[15]

19. **Loans.** Loan collection was adversely affected by the Asian financial crisis. The number of borrowers in arrears increased from 7 to 10 between 1996 and 1997. By 1999, the number increased further to 13 (out of 41 borrowers with outstanding balances) and remained at that level in 2000. All the 13 delinquent borrowers represent projects that were processed prior to the creation of PSG in 1995 (i.e., when PSO projects were undertaken in ADB departments engaged in public sector activities as well) and 10 of them are manufacturing projects (textile, tomato paste, seaweed, chemicals, and rubber tires)—projects that PSG no longer undertakes.[16] The value of loans with arrears has also leveled off by late 2000 at about 21 percent of outstanding loans, as the effects of the crisis diminishes and the measures taken to improve collections takes effect. The loans in arrears are close to fully covered by the 19 percent loss provision on loans outstanding at the end of 2000. The ability of the loan portfolio to absorb loss provisioning is expected to improve significantly with the widening of ADB's lending spreads, in line increased risk perceptions, for the post-crisis loan approvals. Undisbursed loan commitments of $376 million, mostly to infrastructure projects and accounting for about half of the total loan portfolio at the end of 2000, have such wider spreads.[17] When drawn, these higher-margin loans are expected to improve the profitability of the PSO loan portfolio.

20. **Equity Investments.** Since 1994, the equity component of the total PSO portfolio has increased steadily, reflecting the increased demand for risk capital in the region. The portfolio share of equity investments[18] increased from 25 percent in 1994 to nearly 42 percent in 1997, but have slowly dropped to 36 percent by 2000 following a deliberate decision by PSG to reduce exposure to equity risk by, for instance, avoiding investments in the equity capital of borrowing infrastructure projects. ADB's equity investments are often in the currency of the host DMCs but funded mainly with and accounted for in United States (US) dollars, so these investments are vulnerable to exchange rate fluctuations.[19] The rapid depreciation of the local currencies during the Asian financial crisis, coupled with a general decline in market prices of listed securities, adversely affected the value in US dollar of ADB's equity portfolio (in common with other investors in the region). While the depreciation of local currencies against the dollar has slowed, it is unlikely to reverse significantly in the near term; however, eventually the unrealized exchange losses may be offset by gains in the value of the underlying investment.

21. Overall, losses incurred in weak and failed equity investments have been amply compensated for by substantial capital gains and dividends that ADB enjoyed on its profitable ventures. For instance, during 1983-2000, ADB realized net capital gains of $77 million on divestments[20] and received dividends amounting to $67 million from well-performing investee companies. These totaled $144 million, which was more than sufficient to offset the $55 million

[15] As a result of discussions between PSG and the Controller's Department, the policy of applying a general provision of 8 percent will be reviewed against the requirements of generally accepted accounting principles.

[16] The other 3 of the 13 delinquent borrowers are 2 finance companies in one of the crisis-affected countries and a hotel project.

[17] Out of the $376 million of undisbursed loan commitments, $306 million represented loans to eight relatively large infrastructure and infrastructure related projects that were approved mostly during the past two years and have yet to achieve financial closure.

[18] ADB's equity investment in the Asian Finance and Investment Corporation Limited is included in the equity component of the PSO portfolio.

[19] PSG is in discussion with the Controller's Department, Office of the General Auditor, and Treasurer's Department on alternative mechanisms for managing the exchange risks associated with ADB's existing equity investments.

[20] The $77 million was net of $7 million capital loss due to the write-off/write-down of 13 small equity investments (mostly in manufacturing), which were processed prior PSG's establishment in 1995.

in net unrealized losses[21] and $50 million in specific provision on the equity portfolio at the end of 2000. However, against the cost of funding, ADB's equity investments have so far fallen short of providing sufficient returns.

22. **Investment Funds.** Based on a review completed in early 2000,[22] ADB had achieved a compounded annual rate of return of 6 percent from investment funds up to the end of 1999. This return includes dividends received and net realized capital gains made on redemption or divestment of ADB's shareholdings, as well as net unrealized gains due to both regional currency movements against the US dollar and asset price fluctuations in capital markets.

D. Risk Exposure

23. In PSO, ADB faces the possibility of financial losses brought about by a failure to fully recover loans and equity investments. These losses can be due to risks that are either "systemic" or project-specific. Systemic risks arise from the general exposure of ADB's private sector projects to country risks in terms of the overall investment climate. These risks are exacerbated by the lack of effective fiscal, monetary, and exchange rate policies; weaknesses in the corporate governance framework and practice; and deficiencies in the regulatory environment. In this regard, the countries targeted by ADB for PSO are mostly seen as "high risk." Very few of these countries have an investment grade rating for cross-border obligations from the international rating agencies, and many are not rated at all. ADB's exposure to systemic risks could thus be quite significant. Sector diversification within a country and country diversification across the region may, to a limited extent, help mitigate these risks.

24. Regionwide systemic risks are also a concern in PSO. As the recent Asian financial crisis has shown, a sudden outflow of capital from one country could become a regionwide phenomenon due to "contagion effects" and could result in a wholesale devaluation of currencies in the region with serious consequences. The crisis, for instance, has adversely impacted ADB's equity investments in all affected countries. ADB automatically suffered an immediate decline in the US dollar value of these local currency denominated investments as local currencies devalued, regardless of the inherent strength or weakness of the underlying investee companies. In some cases, projects that were already experiencing market and financial difficulties have lost the chance of recovery as a result of the rise in interest cost or currency losses during the crisis.

25. Project-specific risks are those that are peculiar to individual projects. In infrastructure projects, these could range from weaknesses in sponsorship and management, construction delays, and cost overruns to failures to meet performance standards. With proper analysis, project-specific risks can usually be mitigated and are thus more easily manageable than systemic risks.

26. The degree of risk borne by ADB could also be affected by its explicit strategy, e.g., to give preference to pioneering projects.[23] ADB's policy of providing loans with significantly longer tenors than its commercial cofinanciers, also increases risk exposure. As a development institution, ADB should be prepared to assume the risks associated with its development objectives and manage these risks accordingly.

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[21] These net unrealized losses on the equity portfolio at the end of 2000 included net unrealized exchange losses and net unrealized holding losses.

[22] IN. 77-00: *Analysis of the Asian Development Bank's Investments in Funds*, 21 March.

[23] For example, ADB approved a loan, Loan 7169/1827-VIE: *RMIT International University Vietnam,* for US$7.5 million, approved on 26 April 2001, the first private technical university in Viet Nam.

27. No doubt, ADB has to contend with a much greater risk in PSO than in public sector lending where there is recourse to the host government in case of "project failure." Precisely because of this, ADB requires a dedicated unit such as PSG to identify, assess, and mitigate risks associated with private sector investments and to manage these investments as a portfolio. In PSO, the due diligence exercise in project processing and the implementation and supervision work after project approval are all geared to risk management. The prudential limits observed by ADB on PSO exposures to a single project, business group, sector, and country also help control risks. Finally, analytic exercises, such as, Operations Evaluation Department's project performance audit reports and PSG's review of investment funds,[24] provide lessons that help enhance risk mitigation measures in future project design.

E. Portfolio Administration

28. The overall quality of the portfolio, the impact of significant new events, the risk rating of individual projects and the levels of specific provisioning for individual projects, are under constant administration by ADB and are formally reviewed each quarter.[25] Quarterly reports on PSO are furnished to the Board.

29. PSG has a proactive approach to portfolio management and, since the Asian financial crisis, has taken steps to strengthen credit risk management by reorganizing its staff functions and closer credit monitoring. Nevertheless, the PSO portfolio has shown some deterioration in asset quality since 1997 as nonperforming assets have increased, largely as a result of currency devaluation and economic slowdown related to the crisis. In 1998, PSG initiated detailed annual reviews for all projects utilizing a comprehensive checklist of matters to be considered in the review. A risk management unit was also created with two main functions: special assets management, to give special attention to the most vulnerable investments; and credit review, to evaluate and give an independent credit judgment, separate from the dealing officer's judgement, on each project. These initiatives have improved risk management. More recently, PSG took the first steps to implement a credit committee as part of the staff decision-making process to strengthen risk management.

1. Project Classification

30. Risk management was further upgraded in 1998 with a revised project classification system to provide early recognition of problems and achieve more consistent and effective portfolio monitoring (Box 1). PSO projects are classified by four separate ratings: (i) risk rating, (ii) operational status, (iii) disbursement status, and (iv) recovery status. These classifications are designed to readily identify the status and condition of each project and provide a guide for any specific loss provisioning. The risk management unit of PSG determines whether the classification is appropriate.

[24] Footnote 22.

[25] On a quarterly basis, projects rated "satisfactory" or better are reviewed at a private sector investment management meeting and those rated "marginal" or worse are reviewed by a private sector portfolio assessment meeting. Representatives from the Office of the General Counsel, Treasurer's Department, Controller's Department, and Central Operations Services Office attend the meetings.

Box 1: Project Classifications

The Private Sector Group (PSG) tracks all of its loans and equity investments along four dimensions: risk rating, operational status, disbursement status, and recovery status. Performance of the portfolio is monitored quarterly by a formal interdepartmental committee (comprising of representatives from PSG, Office of the General Counsel, Treasurer's Department, Controller's Department, and Central Operations Services Office) and reported to the Board on a quarterly basis.

(i) Risk rating is a proxy for probability of nonpayment and is assigned to each project or investment according to its financial strength. There are seven classifications from 1 (strong) to 7 (loss). Loss provisioning is indicated from category 4 (marginal) to 7 (loss), but the level of specific provisioning depends on the circumstances of each project.

(ii) Operational status consists of 10 categories, aligned to follow chronologically operating stages from implementation to liquidation. Subcategories indicate whether the project is problem-free, experiencing problems, or in severe distress.

(iii) Disbursement status comprises four classifications reflecting problems with disbursement and further implementation.

(iv) Recovery status reflects the repayment status of loans and the divestment status of equity investments.

2. Investment Recovery Operations

31. The effects of the Asian financial crisis reinforced the need for active management of ADB's portfolio. Restructuring specialists have been hired since 1997 to intensively manage PSG's portfolio of problem and vulnerable projects. Investment recovery operations generally are conducted on the basis of one of two strategies: (i) work-out, perhaps involving operational and/or financial restructuring; or (ii) foreclosure, which may include liquidation action. The special assets function has been particularly active in attempting to maximize recovery from problem projects, particularly those in Indonesia, Pakistan, and the Philippines.

32. In 1999, ADB, for the first time, exercised its foreclosure rights jointly with the International Finance Corporation (IFC) under a loan for a manufacturing project. Mortgaged assets were auctioned under an extrajudicial foreclosure procedure.[26] This action sent a clear message to borrowers that ADB will take all appropriate action to protect its investments and to pursue its remedies as a creditor. Similar legal action is being considered for other problem projects. Any such decision will only be taken after ADB's Office of the General Counsel reviews the situation and Management approves the action.

3. Portfolio Management through Divestments and Sales

33. ADB first divested equity holdings in 1990. Since then, ADB has divested holdings in over 40 companies. While PSG has continued to dispose of its investments on a regular basis, there has not previously been a strong emphasis on this aspect of portfolio administration. However, PSG has recently focused critically on ADB's role in each investment and now actively seeks to recycle funds in existing investments as quickly as possible after ADB's

[26] ADB and IFC recently exercised the power of sale to dispose of equipment and machinery held as security in this distressed company.

development role in such investments has been fulfilled. Divestments are carried out in a manner consistent with good business practice and without destabilizing the concerned investee companies. PSG's quarterly portfolio review meetings now include a specific review of the exit strategy for each equity investment. In future, opportunities for recycling funds committed in loans may also be considered. One way to do this is to sell participation in ADB's direct loans while keeping ADB as the lender of record; another is to arrange for borrowers to refinance such loans with domestic borrowings or bond issues.

4. The Important Role of Resident Missions

34. The recent analysis of ADB's resident mission (RM) policy emphasized the important role of RMs in implementing PSO in the field.[27] For example, the analysis noted the active promotion of PSO and liaison with local stakeholders, including chambers of commerce. ADB has found that in-country officers with appropriate skills may be better placed to administer private sector projects in the country, particularly those where the investment has been fully disbursed and the project is operating satisfactorily. RM-based officers can make regular site visits, interact more frequently with sponsors and local colenders, assess whether changes in local conditions are likely to affect a project, and represent ADB as directors in investee companies in which ADB has the right to a Board seat. The RM policy also stressed the often critical services RMs provide for resolving problem loans. Successful delegation to the RMs depends on the availability of RM-based staff with appropriate skills and dedicated to PSO. At present, ADB has a total exposure of close to $1 billion to assets at risk in DMCs with RMs that can actively assist PSG in project administration. A handful of RMs currently have national officers with suitable private sector experience providing PSG with some support for PSO implementation and portfolio administration. But for good risk management of the existing portfolio and effective marketing of PSO, it is critical that a PSO-dedicated professional staff member, responsible to PSG, is maintained in each RM at DMCs where ADB has significant and/or growing PSO exposures (para. 99). These include PRC, India, Indonesia, and Pakistan.

F. Lessons Learned[28]

35. A number of lessons have been learned from ADB's experience with PSO in the infrastructure and financial sector (including capital markets and funds). Lessons have also been learned from ADB's discontinued involvement in the manufacturing sector. Most lessons relate to project selection, formulation, and appraisal, particularly the financial capability, technical experience, and management strength of project sponsors, and the accuracy of market assessments. Specific lessons include the following:

(i) Sponsors with significant sector experience, strong financial capability, and firm commitment to the host country are essential to project success.

(ii) Effective project management comes from teams with a long and sound track record in the business, committed to transparency, and supported by corporate governance structures.

(iii) Market prospects are a key determinant of success. Thus, project appraisal requires thorough and often specialized assessment of market conditions, and,

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[27] R57-00: *Resident Mission Policy*, 27 January.

[28] This review of lessons learned was based mainly on the staff consultant's study done in 1999 (footnote 11), the analysis of ADB's investments in funds (footnote 22), and the experience with its PSO portfolio.

where necessary, ADB must augment its in-house capability to be able to undertake or supervise such assessments.[29]

(v) It is important for ADB to remain engaged in investing in financial intermediaries and capital market institutions in order to develop a good understanding of the financial sector for effective policy work.

(vi) In the case of infrastructure projects, early participation by ADB is helpful in encouraging sound contract structures. Government support is needed to facilitate financial closure. Such support is ensured if the project is priority in the host country's development strategy.

(vii) For exclusive infrastructure concessions, competitive bidding for the selection of concessionaires is one way to ensure competitive tariffs and sound assessment of demand.

36. In the area of project administration, (i) regular attendance and active participation by ADB's nominee directors at board meetings of investee companies are critical to maximizing development impact, (ii) RM involvement significantly contributes to effective project monitoring, and (iii) ADB needs better internal systems to effectively monitor project compliance with environmental standards. PSG has identified these areas for improvement.

37. Other lessons highlight the importance of a conducive policy environment, especially a well-established regulatory framework to mitigate political and commercial risks. Project experience points to the importance of better coordination among all ADB departments and offices, including PSG, to fully understand government policies and their impact on sector growth and competitiveness. ADB's experience in PSO is an important input to its own policy dialogue related to sector reform and restructuring for greater private sector involvement.

38. In the case of investment funds, the lessons learned[30] include the following: (i) Fund performance is predominantly dependent on the competence of the contracted fund managers. Selection of such managers is best done through a transparent and/or competitive process based on objective evaluation criteria. (ii) Disclosure procedures for related-party transactions ensure transparency and alignment of investment objectives to maximize shareholder value. (iii) Independent valuation of fund investments provides a more reliable basis for tracking financial condition and performance of a fund. (iv) Regular performance evaluation of fund managers facilitates detection of early warning signals. (v) Bonuses for fund managers is best based on long-term performance over the life of the fund, not on interim results, as this ensures continuing support for ADB's long-term development objectives.

39. The foregoing lessons have been taken into account in the selection, appraisal, structuring, and administration of private sector projects involving ADB assistance.

[29] This was especially true for manufacturing projects, which ceased to be a priority for ADB, in part because ADB had limited market expertise and could add relatively little value in this sector.
[30] Based on the analysis of ADB's investments in funds (footnote 22).

III. RATIONALE AND ROLE

A. The Private Sector and Poverty Reduction

40. As articulated in the PSD Strategy, development of the private sector is crucial to sustained, rapid economic growth, a necessary condition for achieving ADB's overarching objective of poverty reduction. The Asian development experience has shown that growth, complemented with direct intervention, is one of the most powerful weapons in the fight against poverty. Growth creates jobs that use labor, the main asset of the poor, and represents the primary path out of poverty for those at the bottom of the economic ladder. As growth proceeds, private sector employment becomes the major source of economic support for the majority of workers and their families. Growth also increases the tax base enabling governments, acting on good governance principles, to finance labor market programs and provide basic social services such as health and education that are also a necessary part of any direct poverty reduction programs.[31]

41. Private sector funding for public utilities and infrastructure also relieves pressure on public budgets, enabling governments to direct more resources to social spending. Governments with limited spending or borrowing capacity are able to utilize such capacity for expenditures that the private sector cannot make. Moreover, since well-designed private sector projects within sound regulatory environments typically operate more efficiently than public sector projects, private sector concessions for utilities and infrastructure services, awarded on a transparent or competitive basis and properly regulated thereafter, often result in lower prices, improved services, and expanded access for the poor, and may speed up economic growth.[32] PSG's second core thrust, the broadening and deepening of capital markets, has been associated with reduced vulnerability and financial sector distress given the bank-dominated systems of Asia, and is therefore a powerful tool for avoidance of crisis and the economic hardship it brings, especially for vulnerable population groups.[33]

42. ADB's long-term strategic framework (LTSF)[34] also recognizes the central role of the private sector and of markets in the development process. Thus, under the LTSF, promoting the role of the private sector in development has been adopted as one of the key elements in ADB's strategic agenda.[35]

B. Rationale for and Role of Private Sector Operations

43. PSO activities do not stand alone in ADB, but are an important component of ADB's operations. Both the PSD Strategy and the LTSF mandate ADB to support private sector development through both public and private sector operations in ways that are tailor-made to country needs and conditions. Through its public sector operations, ADB helps DMC governments to create an environment conducive to private sector investment. For many reasons, including country risk perceptions or the quality of the enabling policy and regulatory environment, the setting is not always adequate for private investment to materialize. Often, the investment has to be catalyzed and the perceived sovereign risk mitigated by the participation of a multilateral development bank (MDB) to give comfort or enhance credit. Through PSO, ADB is

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[31] A detailed discussion on this topic is given in paragraphs 7-13 of the PSD Strategy Paper (footnote 3).
[32] Public-Private Infrastructure Advisory Facility.
[33] Keynote address by A. Greenspan at the World Bank-IMF Annual Meeting, October 2000.
[34] Doc.Sec.M17-01: *Moving the Poverty Reduction Agenda Forward in Asia and the Pacific, Long-Term Strategic Framework of the Asian Development Bank (2001-2015),* 21 February.
[35] Paragraph 6 of the LTSF paper (footnote 34).

able to play such a catalytic and risk mitigating role, designed to facilitate private capital flows. ADB participation sends a signal of market confidence, which can "crowd in" private investment.

44. ADB's "dual capability" of having public and private sector operations under one roof offers important synergies. Direct involvement in PSO gives ADB hands-on experience regarding impediments to PSD that can inform its public sector policy dialogue and the design of its public sector operations. This hands-on experience strengthens ADB's credibility as a public policy adviser to governments on the enabling environment for private investment. At the same time, by financing pioneering private projects in a particular sector, ADB through PSO can test the soundness of the regulatory environment for private investment or demonstrate the feasibility of innovative financing structures by actually taking risk along with private investors and lenders. Thus, PSO can have a significant "bottom-up" influence on improving regulatory frameworks to help governments open the sector to private investment, domestic and foreign.

45. PSO and public sector activities are mutually reinforcing. The combination of PSO and public sector activities enables ADB to deliver a "comprehensive development solution" to a DMC within the context of the relevant country strategy. For instance, ADB's risk mitigating role in PSO has a market facilitating effect that can instigate developmental private sector projects even before conditions for private investment are fully appropriate. This enables ADB to lead the private sector in delivering development impacts in a timely manner to satisfy the need for critical infrastructure services (e.g., power, water, and transport), freeing up government budgets to concentrate on investments that are truly "public" in nature. In the long run, the appropriate mix of public and private sector operations should be decided on a country-by-country basis, based on whether development impact can best be achieved through public sector interventions or private sector projects.

46. The LTSF institutionalizes ADB's commitment to PSO in the following terms:

> *Although private sector operations are a very small part of ADB's total portfolio at present, involvement with the private sector is expected to increase substantially in the years to come, as a consequence of the increasingly important role of the private sector in the development process. For ADB's private sector operations to have a meaningful and relevant impact, it must undertake a critical mass of private investment.*[36]

IV. OPERATIONAL STRATEGY

47. ADB's strategic objective for PSO is to increase the flow of capital into and within DMCs and, more importantly, to broaden the flow into more countries and sectors. Private capital flows have dramatically increased and now dwarf official flows. In the past five years, average annual private capital flows to developing countries reached nearly $270 billion per annum, while average annual official capital flows were only about $40 billion.[37] However, most of the private capital goes to only a few emerging markets, only a handful of which are ADB's DMCs. Moreover, over 70 percent of the capital flows to infrastructure projects benefit only two sectors: energy and telecommunications. Other infrastructure sectors such as water, ports, airports, and roads, receive relatively less.[38]

[36] Paragraph 49 of the LTSF paper (footnote 34).
[37] The World Bank Group. *Global Development Finance,* 2001.
[38] Private Participation in Infrastructure Database, The World Bank.

48. While the need is to broaden the reach of the private sector, the proposed PSO operational strategy will build on ADB's existing strengths and capabilities while innovating in response to development needs. The strategy also contemplates improvements in PSO, including a sharper focus on development impact and the further strengthening of risk management. The strategy has four main elements.

(i) focus primarily on existing strengths in infrastructure and capital markets;

(ii) extend country and sector reach and pursue projects in new areas on a pilot basis;

(iii) make wider use of innovative financial instruments such as guarantees; and

(iv) build strategic alliances and partnerships with other institutions.

49. The PSO operational strategy will be responsive to the particular needs and conditions of individual DMCs, taking into account external factors, such as the level of demand from private project sponsors for ADB's assistance, and the sectors in each country that are sufficiently ripe for private sector involvement. Thus, the strategy will be implemented at the country level with respect to the sectors and/or subsectors to be targeted within the sector priorities for PSO and the specific approach to PSO in any DMC will be an integral part of ADB's overall country strategy in the DMC. To ensure such integration, PSG will participate in country strategy formulation and programming, but on a selective basis and to the extent resources will allow. While desired PSO sectors will be indicated in country strategies and programs, it should be recognized that PSO cannot be "programmed." For private sector projects to proceed, able and willing sponsors are needed, and basic elements of the enabling environment must be in place. In the absence of technical assistance (TA) funds, PSG cannot "make projects happen" either. PSG can only respond—albeit in a strategically selective manner (e.g., consistency with ADB's country strategy and PSG's operational strategy and core competencies)—to available opportunities and in light of country needs. Taking on a "developer role" selectively to instigate projects requires TA funds for PSO (paras. 100-102).

A. Focusing Primarily on Existing Strengths

50. The PSO operational strategy capitalizes primarily on the established strengths of PSG in infrastructure and capital markets (including financial intermediaries, securities market institutions, and investment funds), where PSG has built a core mass of expertise and a successful track record and where there is strong demand for ADB's involvement. Since available resources will always be small in relation to the needs of the DMCs, the guiding principles in defining the core business activities of PSO are selectivity and excellence for a given level of capital and human resources. Seeking excellence in a limited number of areas (primarily infrastructure and capital markets) will contribute to a more focused development impact and better risk management, and will highlight PSG's comparative advantage in these sectors.

51. Over the past six years, PSG has delivered successful, developmental PSO in (i) large and medium-scale infrastructure projects; and (ii) capital market investments, including funds. Experience in large and medium-scale infrastructure has built a high level of expertise in project finance within PSG.[39] This strength is enhanced by PSG's access to and use of sector and country-specific expertise in other ADB departments and offices. Clearly, the strength in

[39] Illustrated by the "Deal of the Year" citations for PSG's Chengdu water and Meizhouwan power projects in the PRC.

infrastructure is an ADB-wide competency. The accumulated project finance skills within PSG are applicable to medium- and large-scale investment projects in different sectors and give ADB flexibility to meet the changing demand for project finance services. With these PSG skills, ADB is in a position to consider not just “greenfield” (new) projects, but also “brownfield” (rehabilitation and/or expansion) projects in the infrastructure sector, as well as service contracts, leases, management contracts, and privatization transactions.

52. Privatization programs in various DMCs, particularly those covering state-owned utilities and other infrastructure facilities could be a major source of activities for PSG in the medium term: many ADB client countries are now planning to divest their public utilities after unbundling them—often with ADB support. As these divestiture programs ripen—Pakistan expects to privatize Karachi Electric Supply Corporation in 2003, for example—ADB support through PSG should be available to facilitate specific transactions. It is important for PSG to collaborate with the concerned public sector departments in these exercises. PSG staff engaged in project finance are developing the capability to evaluate and structure privatization transactions. Work in these areas will have natural linkages with the promotion of public-private partnerships.

53. The strength of PSG in capital markets has been built over close to two decades of generally successful project work in the sector. Since 1983, PSG (including its predecessor units) has helped launch more than 30 investment funds of diverse types, operating in many countries and regionally. As a result, PSG has established close relations with a number of institutional investors, beginning in North America and now also in Asia and Europe. PSG has also accumulated expertise in fund structuring and governance, fund manager selection, and fund risk management. In addition to funds, PSG has delivered financial projects in such areas as banking, insurance, leasing, securities trading, and credit rating. These activities will be continued, to ensure effective inputs to PSD interventions of ADB as a whole in capital market and financial sector reform. Development of well-functioning capital markets and banking systems in Asia is key to reducing vulnerability to crisis and therefore contributes to poverty alleviation.

B. Extending the Country and Sector Reach

1. Country Reach

54. PSG will build on its accumulated country experience, continuing to operate in DMCs where it has been most active during the past six years. These include the “middle-tier” and larger DMCs (e.g., PRC, India, Indonesia, Pakistan, and Philippines) where the demand for PSO continues to be strong, particularly in the wake of the Asian financial crisis. These DMCs are home to most of Asia’s poor and need ADB’s support for catalyzing investment, especially in new sectors and subsectors that (i) are now opening up to the private sector, through changes in national-level or subnational regulatory regimes; and (ii) can benefit from ADB’s catalytic and value-added role (para. 86). In addition, PSG has resumed operations in Thailand, where it has been relatively inactive during the past few years but which, following the crisis, again needs ADB’s support to catalyze the return of private investment. In these middle-tier and larger DMCs, PSG will seek to increase operations and help channel private capital to less-developed regions or to subsectors that are newly opened to private sector participation or where the private sector is re-testing its involvement, post-crisis. The degree to which PSG can raise the level of PSO in these DMCs will depend, among other things, on the allocation of additional staff and resources for PSO.

55. Extending PSG’s reach to the transition economies (such as Cambodia, the Central Asian republics, and Mongolia) and the smaller countries (such as the Lao People’s Democratic

Republic and the Pacific DMCs) remains a challenge for a range of external and internal reasons. Doing business in these “frontier” countries[40] involves very high transaction costs and risks. Given adequate resources, PSG would be prepared to extend its reach to these frontier countries in tandem with ADB's public sector departments, through which ADB is helping create the necessary framework for private sector investment. However, PSG will undertake such work on a very selective basis given current staff and resource constraints. Based on the experience of other MDBs, a proactive, sustained program in the frontier DMCs is not feasible without the allocation of the necessary, additional resources.[41] PSG will also seek to leverage existing resources by working in partnership with other international financial institutions (IFIs) that are already active in these countries. This collaboration can reduce the cost of transactions through joint due diligence, joint TA programs, and shared supervision (para. 70). Pooling resources with other IFIs may also enhance the impact of efforts to help create the enabling environment and build local institutions. The creation of regional projects, facilities, or funds to invest in smaller DMCs is another possible way to extend country reach under current resource constraints. Country reach would most likely be extended first in sectors and subsectors where PSG has strong prior experience.

56. The specific role of PSO is to help mobilize domestic and foreign resources that contribute to private sector-led growth. This role is particularly important as many DMCs have yet to benefit from the growing flows to emerging markets. At the same time, capital market access remains limited for most of the DMCs. ADB’s aim is to extend the reach of its PSO to frontier countries and help spread the benefits from these private flows, while continuing to play its catalytic and risk mitigating role in middle-tier countries where it has hitherto concentrated. The long-run goal for PSO is to serve all DMCs[42] on a more regular, continuing basis across a range of sectors in accordance with specific country needs and conditions.

2. Sector Reach

57. While the PSO operational strategy is focused primarily on enhancing the core business in the infrastructure sector and capital markets, an important additional dimension is responsiveness to the changing needs of DMCs and private investment opportunities in new sectors. Accordingly, pilot projects are being launched in new areas, as opportunities and resources allow.

58. These pilot projects will initially be quite limited in number and modest in scope and the results will be carefully analyzed before any decision is made for an expanded involvement. ADB will collaborate with other IFIs in these pilot projects to pool resources, exchange lessons learned, and strengthen risk management (paras. 69-70). Among the promising areas to be considered are the following:

(i) **SME Support.** The financial health and growth of SMEs are key to the economic prospects of most DMCs. Because of transaction cost and risk management issues, it is not envisaged that ADB will provide direct assistance to individual SME projects as a normal part of PSO. More cost-effective mechanisms to support SMEs will be pursued, through investment funds or local institutions.

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[40] In this paper, “frontier country” means any country in which the necessary enabling environment, including legal, regulatory, tax, and good governance regimes, does not exist or is at a nascent stage, and where ADB has limited PSO experience.

[41] IFC launched its Extending Reach Program in 1996, with a separate budget of $18 million over a three-year period. The approach and budget reflect IFC’s expectations of the likely cost of doing this type of work: extra time and resources for due diligence, the need to develop a knowledge base, the effort to “learn” the country or sector setting, and the high overheads of embarking on such a program.

[42] Either directly or through funds/intermediaries.

PSG will also examine other appropriate models, with the ultimate aim to support SMEs. New commercial approaches to microfinance may provide opportunities for PSG to participate in the sector. ADB's strategy for microfinance development also envisages a role for PSO.[43] An enhanced TA capability for PSO would be required for an effective PSO intervention in SMEs and private sector microfinance (paras. 100-102).

(iii) **Information Technology.** The use of information and communication technology (ICT) has tremendous potential in helping DMCs "leapfrog" development and combat poverty. The Internet, for instance, could improve access to global markets for smaller companies in DMCs and facilitate job creation. ICT has been used successfully to improve efficiency in delivery of social and other government services and to reduce corruption through transparency in government transactions. Other IFIs are considering this new area, and some initiatives have been launched in the banking sector (e.g., for supporting SMEs) and through investment funds. A regional fund aimed at various segments of the ICT industry, for instance, could provide ADB a vehicle to extend support for smaller ICT projects in a broad range of DMCs. Opportunities will be pursued where there is a clear role for ADB and alternative sources of funding are not available. Availability of TA funds for PSO could help PSG develop more innovative approaches (paras. 100-102).

(iv) **Social Infrastructure.** The provision of healthcare and education is an area that seems to have potential for increased private sector participation. These sectors can benefit from private financing because public funds are insufficient to meet requirements and private sector involvement often increases operating efficiency. Mobilizing private capital for these sectors could be highly developmental, allowing the public sector to focus finance on the "nonbankable" parts of the healthcare and education systems. PSG will consider healthcare and education projects where cost-recovery is feasible. However, the "right" partners will be key to ensure financial viability, sustainability, and development impact. TA funds for project development (paras. 100-102) and staff resources with appropriate skills will also be needed to enable PSG to play an effective role.

C. Wider Use of Innovative Financial Instruments

59. While loans in foreign currencies and equity investments will continue to be the two most widely used instruments in PSO in the short-to-medium term, more innovative financial instruments are needed to leverage ADB's capital to address the needs of DMCs more effectively. One difficult challenge is dealing with exchange risk in project finance.

60. Until recently, foreign currency financing of infrastructure projects was the rule in Asia, mostly in US dollars. However, this practice exposed projects dependent on local currency revenues to a large currency exchange risk. The Asian financial crisis showed the danger of this currency mismatch. The major, sustained fall in domestic currencies impaired the financial health of highly leveraged projects with such mismatches. Contracts allowing such projects to "pass through" financing costs, including losses from exchange fluctuations, to offtakers and end users resulted in unsustainable, high tariffs. Some of the recent build-operate-transfer power projects in Indonesia are examples of this phenomenon. To the IFIs and commercial

[43] R106-00: *Finance for the Poor: The Microfinance Development Strategy,* 16 May, particularly paragraph 60 of the paper.

banks that provided financing in foreign currencies to such projects, the exchange risk became credit risk and as a result of loan defaults, these lenders ultimately took losses in their books.

61. The preferred solution to the currency mismatch problem is to increase the proportion of local currency debt financing for projects dependent on local revenues. However, in most DMCs, such financing is not readily available in adequate amounts and in sufficiently long tenors to meet the requirements of long-payback infrastructure projects. ADB is therefore continuing to help DMCs develop local capital markets. But this is a long process. To be proactive in the interim, ADB would consider assistance to individual private infrastructure projects in raising local currency debt in the domestic market. Credit enhancement through guarantees is one form of such assistance (para. 67). Local currency financing represents the future of infrastructure project finance. Without such capability, ADB will not long retain a credible role in project finance in the region.[44]

1. Complementary Financing Scheme

62. The CFS will remain an important tool for sovereign risk mitigation, but it will not be useful for all types of projects and in all DMCs. The CFS is typically used for relatively large projects that have (i) substantial cross-border financing requirements, and (ii) a structure (e.g., security package and syndication potential) that is attractive to international commercial lenders. The CFS tends to be most attractive for lower-risk projects and lower-risk countries in which commercial banks feel sufficiently comfortable to participate without explicit guarantee or insurance cover against specific political risks. One aspect that has tended to diminish the attractiveness of the CFS, from the perspective of commercial lenders, is the extent to which such lenders are asked to delegate their loan supervision rights to ADB, which acts as "lender of record" in CFS transactions. ADB has sought to widen the use of the CFS by relaxing its claim with respect to certain of these rights, provided that this does not compromise the principle that the CFS loan is an ADB loan and as such is accorded preferred creditor status.

63. Since the CFS relies on ADB's preferred creditor status, and is designed to ensure preferred access to scarce foreign exchange reserves, it is not a suitable mechanism to provide cover for domestic lenders, nor is it useful for mobilizing local currency loans.

64. It is ADB’s policy not to blend or overlap the CFS with political risk covers offered by third parties, such as private insurers or official export credit agencies (ECAs). However, the CFS is often packaged, on a parallel basis, with other credit enhancements. While respecting the policy not to extend ADB’s preferred creditor status to official ECAs, as well as the policy not to blend the CFS with credit enhancements offered by private insurers, we need to explore ways by which project lenders can take advantage of the benefits of the CFS provided by ADB and the credit enhancements available from third parties, provided that these products complement each other to more effectively catalyze commercial financing that would not otherwise be forthcoming.

2. Guarantees

65. Wider use of guarantees under ADB’s existing guarantee policies will also facilitate commercial cofinancing. Guarantees allow ADB to selectively cover risks that are of concern to lenders, and to achieve better leverage than possible with direct loans. They can be extended on a wide range of underlying debt instruments, including bonds, and can be structured to offer

[44] European Bank for Reconstruction and Development, Inter-American Development Bank, International Finance Corporation and various bilateral financial institutions and export credit agencies have all introduced some form of support, including guarantees, to facilitate local currency financing.

significant access and/or cost improvements in funding projects. Guarantees can also provide flexibility to ADB in its choice of modalities used to finance private sector projects. The two basic types of ADB guarantee available for PSO are the partial credit guarantees (PCG) and the political risk guarantees (PRG). PCGs provide cover against all risks (commercial and political) for a portion of debt service on commercial borrowings. PCGs can be designed to extend the tenor of a financing instrument particularly where longer-term project funding is not available unless credit enchanced. On the other hand, PRGs cover defaults by borrowers due to specifically identified political risks. ADB intends to pursue the use of guarantees more actively as part of PSO. The wider use of guarantees, however, particularly PRGs, also depends on appropriate staff resources for PSO.

66. The PRG is deemed by international lenders to provide a much more effective protection against sovereign risks than the CFS. Last year marked the first time that ADB used the PRG to support the debt financing of two private sector power projects, one in Bangladesh and another in Sri Lanka. With the recent Board approval of improvements in the PRG features,[45] ADB is now in a better position to use the PRG for catalyzing commercial debt finance for private sector projects, particularly in countries with no ratings or with ratings below investment grade. A more active promotion of the product by ADB would also help attract clients.

67. The PCG has so far been used for public sector projects in which there is a financing gap that requires funding from international commercial sources. The PCG would be a useful instrument for PSO if used to enhance credit of private sector borrowers from the domestic market. Under the existing policy,[46] ADB can issue PCGs denominated in US dollars or another foreign currency to cover local currency loans or bond issues.[47] Judiciously applied to cover later maturities of loans and bonds, PCGs could encourage domestic lenders and investors to agree to longer tenors on debt needed, particularly for infrastructure projects. By providing credit enhancement through PCGs, ADB would likewise be able to help augment the local supply of attractive, long-term debt instruments needed to stimulate the development of domestic capital markets.

D. Building Strategic Alliances and Partnerships

68. ADB has worked on PSO with various groups including sponsors, commercial lenders, and IFIs (bilateral aid agencies, ECAs, and other MDBs). Each group brings its own skills and experience and appetite for particular risks to the individual project. PSG already has well-developed abilities to foster alliances and will strengthen alliances that have worked successfully in the past and forge new ones as appropriate. To obtain the maximum benefit from these relationships, PSG must first identify ADB's unique capabilities for any project and then bring in partners that complement rather than duplicate those capabilities.

69. ADB has long enjoyed constructive partnership with other MDBs in financing private sector projects and this will continue, especially (i) in frontier markets, large projects, and sectors where another MDB has relevant experience but ADB has relatively less; (ii) in piloting projects where neither party has experience and the risks can reasonably be shared; and (iii) in

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[45] R299-00: *Review of the Partial Risk Guarantee of the Asian Development Bank,* 1 December, introduced improvements in the features of the PRG, including the change of name from "partial risk guarantee" to "political risk guarantee".

[46] Paragraph 18 of R135-99: *Review of the Bank's Guarantee Operations,* 31 August.

[47] In the event of a call on a US dollar-denominated PCG, the liability of ADB will be limited to the US dollar amount of the guarantee. Correspondingly, the borrower's obligation to indemnify ADB for guarantee payments made will be denominated in US dollars. So there will be no currency mismatch in ADB's books.

smaller DMCs such as the Central Asian republics, Pacific DMCs, and possibly others, and in small projects, where the transaction costs are high.

70. Joint efforts and joint support by multiple MDBs in a single project will also provide a stronger signal to the market of the MDBs' confidence and commitment to a particular sector or undertaking, as well as a signal of confidence in the overall "country environment." As partners and co-investors, MDBs can learn from each other: regional knowledge and sector expertise can be complementary, especially in frontier countries or sectors. Portfolio risk or charter considerations can limit an MDB's investment appetite. Joint participation of multiple MDBs allows risk sharing and can make a project bankable. Indeed in large infrastructure projects, joint financing among MDBs may be key. When joining together in a small project, the MDBs typically combine their knowledge and skills to share preparation costs and make the size-cost tradeoff less acute.

71. ADB will continue discussions with the European Bank for Reconstruction and Development (EBRD), IFC, Multilateral Investment Guarantee Agency (MIGA), and increasingly, European Investment Bank (EIB), as well as with key bilaterals, on building strategic alliances and seeking joint participation in private sector projects in Asia.

72. One initiative to foster this kind of increased cooperation among the IFIs is the two-year old policy impediments database that collects inputs from MDBs, bilaterals, and ECAs regarding obstacles encountered by private sector projects in developing countries. The simplest function of the database is to share practical experiences and lessons learned among the institutions, and with all departments and offices in ADB, to support active coordination to help overcome these impediments. While some impediments may be hard to overcome because they reflect deep-seated legal or structural problems, others may be more easily removed by the simple expedient of bringing practical examples of the problem to the attention of policy makers.

V. OPERATIONAL IMPROVEMENTS

73. To enable ADB to effectively carry out PSO under the proposed operational strategy as part of the broader mandate under the PSD Strategy and the LTSF, some operational policies and procedures governing PSO must be improved.

A. Single Project Exposure Limit

74. Under the current PSO policy, ADB may provide the lower of $50 million or 25 percent[48] of total project cost. ADB established the exposure limit of $50 million in 1990[49] for the types of project proposals handled by ADB at that time. However, a number of significant changes have happened since that time. The investment requirements of many ADB-assisted private infrastructure projects have increased in the last decade.[50] With inflation, the $50 million ceiling no longer represents the same real value as in 1990. ADB needs to maintain the value of its participation to be able to play an effective role in a project (para. 86). Given the range of project proposals considered for assistance, ADB should have the flexibility to consider a somewhat larger amount of assistance, particularly if it furthers ADB's development objectives.

[48] 33 percent for projects under $5 million is allowed pursuant to item c(ii) of paragraph 220 of R146-90: *Second Review of Private Sector Operations,* 5 October.
[49] Increased from $30 million pursuant to item c(i) of paragraph 220 of the second review of PSO (footnote 48).
[50] Large infrastructure projects can have a total investment cost of $500 million to $1 billion and above.

75. Other MDBs observe similar prudential norms in PSO. Indeed comparator MDBs, such as EBRD, Inter-American Development Bank (IADB), and IFC, have a higher single project exposure limit than ADB (Box 2).

Box 2. Single Project Exposure Limits of MDBs

ADB	EBRD	IADB	IFC
The lesser of 25 percent of project cost or $50 million (equivalent to less that 0.46 percent of ADB's paid-in capital and reserves at end-2000)	The lesser of 35 percent of the long-term capital of the obligor or 5 percent of EBRD's paid-in capital and reserves (equivalent to about $225 million at end-2000)	The lesser of 25 percent of project cost (or 40 percent for small countries) or $75 million (equivalent to 0.6 percent of IADB's paid-in capital and reserves at end-2000)	The lesser of 25 percent of project cost or 3 percent of IFC's paid-in capital and reserves (equivalent to about $170 million in 2000)

ADB = Asian Development Bank, EBRD = European Bank for Reconstruction and Development, IADB = Inter-American Development Bank, IFC = International Finance Corporation.

76. Given the foregoing factors, a single project exposure limit of the lesser of $75 million or 25 percent of total project cost[51] would be more appropriate for ADB's current business orientation and client need.[52] Equity participation will continue to be subject to two restrictions: (i) ADB's share is not to exceed 25 percent of the issued capital of any investee company,[53] and (ii) ADB is not the largest single shareholder in the company.[54]

B. Providing for Smaller Interventions

77. The most important constraints faced by ADB in smaller direct interventions[55] (e.g., those in support of pilot projects, projects in smaller countries, or small-scale infrastructure projects) are staff resources and processing procedures, which remain inflexible regardless of the size of investment involved. PSG cannot realistically expand its reach to small projects or small DMCs with its current staffing. The high transaction costs and heavy use of staff time for completing due diligence and preparing documents for Board approval, generally mean it is more efficient for PSG's relatively small staff to focus on larger transactions, which typically are more visible and have greater demonstrational and catalytic impacts than do smaller ones. Small projects, moreover, are often more staff-intensive than larger ones, being in small

[51] The PRG Paper (footnote 45) provides for a PRG limit at twice the PSO single project exposure limit. If the proposed increase in the PSO single project exposure limit is approved, the PRG limit will correspondingly increase from $100 million to $150 million, but not to exceed 50 percent of total project cost. Since a PRG cannot be issued on a stand-alone basis, it will normally be combined with a direct exposure (loan and/or equity investment). For determining combined compliance with the PSO single project exposure limit, the PRG exposure to a project will normally be given a risk weight of 50 percent, while the loan, equity investment, and/or the present value of a PCG will have a weight of 100 percent. The risk weighting of PRG will be subject to the guidance of the Guarantee Committee, which may increase the 50 percent risk weight depending on the specific risks covered.

[52] The increased PSO single project exposure limit would be useful for, among others, improving the financial sustainability of large projects, where ADB's long-term funding can further lengthen the average tenor of debt.

[53] Items (ii)(a) of paragraph 97 of R70-88: *A Review of Private Sector Operations,* 7 June (the first review of PSO).

[54] To be applied flexibly for justifiable reasons pursuant to item (ii)(b) of paragraph 97 of the first review of PSO (footnote 53). For instance, the shareholding of the sponsor group as a whole may be taken into account instead of the individual shareholdings of the sponsors.

[55] Indirect interventions through investment funds or financial institutions will continue to be the main approach in PSO for assisting SMEs and microenterprises.

countries or new sectors where ADB may have little prior experience, or having sponsors who often do not have the benefit of professional advice. Simplified PSO-oriented project processing procedures, different from those applied to ADB's public sector projects, have to be developed to enable efficient consideration of small projects and to match the private sector's time frames (paras. 87-90).[56] Alternatively, additional resources would allow PSG to address this mandate.

78. PSG is nonetheless already considering smaller investments that meet the PSD Strategy objectives, but has been able to do so only through partnerships within and outside ADB. For instance, PSG collaborates with other projects departments in ADB such that a small PSO investment is processed as a component or adjunct of a larger public sector project. PSG also works with ADB's development partners (e.g., other IFIs) and leverages off their resources and skills in performing due diligence work.

79. A modality for smaller interventions in the infrastructure sector, used by EBRD, is the so-called "multiproject" facility, which ADB could also adopt. In this form of cooperation, ADB would combine its risk sharing and mitigation role with the experience, know-how, and risk-taking ability of a sponsor—usually a well-established company (e.g., an international water developer or operator) that has a strategic commitment to the target countries. The sponsor's role is to assume the responsibility for development, financing, and management of each individual project to be done under the facility. ADB, in turn, would provide an agreed share of cofinancing, normally in the form of loans. ADB's value added to the facility would come initially from the influence ADB can exert over the sponsor's choice of target market. Value added would also derive from ADB being able to enhance the development impact of the individual projects, as by imposing minimum standards of environmental compliance and introducing better corporate governance (para. 86). The multiproject facility is similar to an investment fund where the fund manager is a strategic investor as well and therefore has a significant financial stake in the outcome of investments made.

80. Multiproject facilities would normally involve the following elements: (i) a commitment by ADB to finance a defined program of investments embodied in a framework agreement that would support PSG's target sectors and countries; (ii) reliance on the sponsor's appraisal of individual projects and on its due diligence; (iii) full recourse to the sponsor in the event of loss due to certain events within its control as developer and manager of the projects or covered by its due diligence; and (iv) standard documentation in the form of sponsor support provisions embodied in the framework agreement. As with fund managers, the degree of reliance on the sponsors makes their selection particularly important. It is necessary that the sponsors have operational experience in the target countries, follow sound project appraisal and due diligence procedures, and have a good track record in the business lines proposed.

C. Conflicts of Interest

81. A core strength of ADB's approach to PSD emerges from its ability to deliver both public sector and private sector assistance. The increased focus on synergistic and cooperative efforts may result in increased potential for conflicts of interest, Such conflicts could arise, for example, where ADB, through a public sector department, is advising a DMC government in relation to the reform or restructuring of a sector and, at the same time, ADB, through PSG, has or is considering a private sector investment in the same sector. In this situation, the objectivity of ADB's policy advice may be adversely affected or perceived to be adversely affected because ADB has a direct financial stake, through the private sector investment, in the outcome of the advice to the government. While this type of conflict of interest has almost always been

[56] Delegated authority is not contemplated to the extent that this is inconsistent with the ADB Charter.

regarded as more theoretical than real, the PSD Strategy recognizes the importance of managing conflicts of interest.[57]

82. The risk of conflict of interest materializing in ADB is minimized because the public and the private sector activities are conducted by separate units. This strict separation within the organizational structure ensures separate handling of confidential information from clients and the professional management of conflict of interest issues.

83. In addition, disclosure of potential conflicts of interest will reduce the likelihood of such conflicts coming to a head. Detailed and open disclosure among all stakeholders—concerned ADB departments, host government, project sponsors, consultants, and other financiers—of the different interests represented in a situation will minimize actual conflicts. The new emphasis on public-private partnerships and ADB's comprehensive approach to PSD will generate greater disclosure and discussion of likely private sector investments, and such investments may be designed as an integral or complementary part of the policy dialogue from the outset, though carried out as a part of PSO.

84. The potential for conflicts of interest is a reality that must be recognized as a necessary incident of ADB's public and private sector operations. Such conflicts exist in EBRD, IADB, and the World Bank Group, and each has developed, within the existing organizational hierarchy, mechanisms to deal with conflicts that do not deter close collaboration to achieve synergy between the public and the private sector staff. A positive approach to dealing with conflict of interest issues will help defuse potential problems. The approach includes education of staff, especially those involved in policy advice, on conflicts of interest issues. A set of staff instructions will also be helpful to guide resolution of any such conflicts. These guidelines will be prepared and subsequently refined as lessons are learned from ADB's experience and are drawn from the experience of other development partners.

D. Screening of Projects

85. As part of the strategy to sharpen focus on development impact, PSG will develop a scorecard that can be used to screen all prospective private sector projects against a set of development objectives, consistent with the PSD Strategy.[58] The scorecard will enable ADB to strengthen the development focus of PSO because it will have identified at the outset the development impacts of private sector projects it is considering for assistance.

86. In addition, the scorecard will be used for checking ADB's role or "value added" in private sector projects, as differentiated from the impacts of the projects themselves. Traditionally, the question often asked to test the need for ADB assistance is whether a project would go forward without ADB's participation. However, the more meaningful question is what value ADB adds to the project. It is difficult to tell if sufficient private sector financing would have been available had ADB not supported a given project. However, the special value-added contributions that ADB makes to the project can be easily identified. Indeed, ADB's participation in a project should be justified in terms of the contribution of such participation to ensure or enhance (i) the project's development impacts (e.g., improved economic returns and environmental and social impacts); and (ii) its ability to deliver such impacts (e.g., improved financial returns and sustainability). Examples of the value-added contributions ADB can make are listed below, but no one project should be expected to embody every one of them.

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[57] Box 4 of the PSD Strategy paper (footnote 3).
[58] Appendix 3, page 1 of the PSD Strategy paper (footnote 3).

(i) catalytic value in terms of the amount and terms of private debt financing and/or the types of private sector lenders mobilized;

(ii) improvements brought about in loan tenor and financial structure of the project making the project financially sustainable;

(iii) impact of those improvements on the project's long-term viability and on service quality and/or cost to the consumer over the long-term;

(iv) improvements to concession contracts (e.g., termination payment mechanisms, tariff adjustment formulas, government performance undertaking) so that the project becomes bankable;

(v) improvements in environmental and social risk mitigation, including public consultation;

(vi) improvements in the degree of consumer satisfaction with the services the project provides;

(vii) the value of ADB loan covenants to enforce long-term compliance with public objectives, including those included in concession contracts to enhance developmental benefits;

(viii) contributions to improving corporate governance in the project company; and

(ix) introduction of unique beneficial feature (e.g., socially responsible investment, clean technology, etc.) to the project.

E. Streamlining of Business Processes

87. Flexibility and responsiveness, while ensuring credit quality, are vital for successful PSO. Currently, the approval process for private sector projects is based largely on the procedures prescribed for public sector loans. The process involves well-defined steps based on the established planning cycles for ADB public sector operations. These defined steps, however, do not always have parallels in PSO. In PSO, for example, there is no real distinction between fact finding, appraisal, and negotiation. PSO project processing missions are all part of one complex "due diligence and structuring process" prior to Board consideration. To address credit risk, to better support the various facets of the due diligence process, and to be more responsive to the tight timetable of private sector clients, the approval process for private sector projects should be modified and streamlined. The redesign of business processes that is now under way to support ADB's new organizational structure offers an important opportunity to also formulate an approval process and other business processes that are specifically keyed to the particular requirements of PSO in terms of both control over credit quality and responsiveness to clients.

88. The approval process for private sector projects in the context of ADB involves two aspects: the "development" aspect and the "credit" aspect. The development aspect reviews the consistency of a proposed project with relevant ADB strategies and policies, and the justification for ADB's assistance to the project. The credit aspect reviews the bankability of the project, the risks associated with it, and the measures proposed to mitigate these risks. As at present, there would normally be just one formal interdepartmental discussion of a project after concept clearance—the equivalent of a Management Review Meeting, where major issues related to the project are examined and resolved by the ADB Management. After receiving Management

approval and guidance, PSG would complete project processing with bilateral consultations with relevant departments and offices to ensure project quality.

89. One source of processing delay currently is the possibility of a project's eligibility for ADB assistance being questioned repeatedly throughout the approval process. To avoid this, today's concept clearance procedure would be used to endorse and confirm up front, key "development" concerns, particularly (i) the consistency of the project concept with ADB's relevant country and sector strategies, and (ii) the rationale for ADB's participation. This initial screening would also flag environmental and social issues, if any.

90. Quick approval of small equity investments, particularly for rights issues that are subject to short deadlines, is facilitated through the approval authority delegated to the President for supplementary equity investments not exceeding $2 million each in existing investee companies that are performing and are expected to perform satisfactorily, subject to prompt reporting to the Board.[59] This practice will continue. PSG's new streamlined Report and Recommendation of the President (RRP) under ADB's *Guidelines on Operational Procedures,*[60] has already facilitated the Board approval process for PSO. The approval process would be further streamlined through more efficient use of the summary procedure, which is allowed under existing policy.[61] In line with the recent paper on further streamlining of the Board approval process for public sector loans,[62] the requirements for use of the summary procedure in PSO would be reviewed in the course of PSO strategy implementation.

F. Strengthened Risk Management

91. ADB's private sector investments are not backed by government guarantees. Thus, these investments are exposed to the full range of commercial and political risks. As such, managing risk is a key priority for PSO and further strengthening the credit culture within PSG will continue to be an important objective. Developmental considerations in PSO are necessary but not sufficient: credit must also play a key role in the selection, analysis, approval, and administration of projects. By ensuring quality standards in credit risk management, PSG can avoid adverse impacts from PSO on ADB's triple-A credit rating.

92. A number of initiatives are under way to strengthen and improve the risk management function. For example, a PSG credit committee is beginning to review projects at key stages of the due diligence process. A credit and risk management manual is being prepared to document the policies and procedures for credit review of new projects, portfolio management, and resolution of problem projects. PSG is also improving its information management and internal control systems to facilitate decision-making. Project supervision is being enhanced through more frequent visits to projects by the assigned officers from PSG, and by regular attendance by ADB-nominated directors and representatives at board meetings of investee companies. While the RMs have also played a critical role in project supervision hitherto, sound risk management in the context of a portfolio involving over $1 billion in PSO exposure means there is a need to install or maintain PSO-dedicated professional staff responsible to PSG, in the RMs in DMCs to which ADB has a large or growing PSO exposure (e.g., PRC, India, Indonesia, and

[59] Item (iii) of paragraph 91 of the 1995 PSO strategy paper (footnote 1).
[60] Paragraph 17 of Section 7 of the guidelines provides that for private sector investment proposals, the RRP will be limited to 10-15 pages of text with only essential appendixes.
[61] Item (iv) of paragraph 91 of the 1995 PSO strategy paper (footnote 1) provides for the adoption of the summary procedure for equity investments and/or loans not exceeding $5 million per enterprise (including any existing exposure to the enterprise), except where the investment/loan is the first PSO in the DMC concerned in that year.
[62] R110-01: *Streamlining the Approval Process of the Board of Directors through More Efficient Use of the Summary Procedure for Loan Proposals,* 26 July.

Pakistan). Risk management and the supervision of projects will continue to have significant implications on human and financial resources allocated for PSO.

93. Good corporate governance helps reduce risk (e.g., through timely and accurate financial disclosure) and brings with it financial benefits (e.g., reduced cost of capital) for the concerned company. With these advantages in mind, PSG now assesses all ongoing projects on the state of their corporate governance, and recommends remedial action where appropriate. All new projects are subjected to a similar corporate governance check.[63] To sustain this, PSG has continued to enhance its knowledge and skills on corporate governance. In addition, PSG has tapped into ADB's staff network on corporate governance, as well as into other relevant centers of knowledge.

94. Part of risk management is proactive management of the portfolio, including the timely divestment of equity holdings when ADB has fulfilled its developmental role. In addition, ADB can encourage early repayment of its direct loans by having them refinanced with domestic borrowings or bond issues, thereby allowing the market to assume the financing of a project when construction is completed and commercial operations are profitable. It may also be possible to sell participations in ADB's direct loans, without recourse, while keeping ADB as the lender of record. Proactive portfolio management will enable PSG to adjust its risk exposure profile and promote more efficient turnover of capital in order to assist new projects.

G. Strengthened Management of Nonperforming Investments

95. In pursuing—and hopefully, maximizing—recovery of nonperforming investments, fast action is often needed. Distressed companies typically have severe liquidity problems and face the threat of involuntary bankruptcy action by creditors pursuing remedies outside ADB's control. To maximize recoveries, timely decisions and smooth implementation are required in ADB's intensive negotiations with colenders, sponsors, and strategic partners.

96. The management of impaired assets is a normal part of banking, and of PSO. To maximize recoveries, it must be subject to a technical specialized decision-making process. Currently, the President approves decisions on exercise of creditors' remedies, including foreclosure, and all restructuring proposals currently require Board approval. This lengthy approval process for restructuring differs from good practices in other MDBs[64] and has, on several occasions, prevented ADB from responding promptly to crisis situations or from taking the lead to carry out recovery operations whose twin aims are to protect ADB's interests and to recover outstanding amounts owed to ADB. Maximum recovery has suffered as a result.

97. Approval for loan restructuring should be streamlined as follows: where the proposed restructuring of a private sector loan involves no additional funding ("no new money") from ADB and only involves revisions and amendments of the existing financing arrangements[65] and where all other alternatives to the proposed restructuring are less attractive to ADB's interests, the proposed restructuring may be approved by the President, and reported to the Board. All

[63] IFC has introduced a "corporate governance scorecard" which is a model diagnostic tool that can help investee companies address shortcomings.

[64] In IFC, most decisions on the management of an existing portfolio, including operations to resolve problem investments, are made at the Management, Director, and/or Manager level with a brief report made later to the IFC board. The exception is for decisions requiring the injection of additional money (in excess of $25 million), which requires IFC board approval.

[65] For example, extension of principal repayment period, waiver of liquidated damages, provision of prompt payment rebate (maximum of 1 percentage point), and amendment of loan covenants as agreed among all lenders (provided ADB is not placed in an inferior position relative to the other lenders).

restructuring proposals involving new money will be submitted to the Board for approval on a "no objection" basis in line with the existing practice.

98. Investment recovery operations inevitably entail costs in order to protect mortgaged assets. These costs are often expended by lenders or investors but ultimately accrue to the account of the borrower. Examples include paying for (i) security personnel, caretakers, engineers, management staff of defaulting borrowers, and professionals, such as accountants and lawyers; and (ii) insurance coverage. The outlay of reasonable amounts of money for safeguarding operations or assets of companies in liquidation or restructuring is consistent with sound banking principles under Article 14(xiv) of the ADB Charter. Currently, the Board must approve all funding for outlays related to investment recovery. Because investment recovery operations to protect ADB's interests as a secured lender require swift decisions, ADB's failure to respond in a timely manner could impair the value of assets held as security. Thus, it is proposed that authority be delegated to the President for the use of funds from ADB's ordinary capital resources (OCR) up to a cumulative amount of $2 million to promptly finance costs and expenses related to investment recovery operations where the outlay improves the prospects of recovery and the borrower cannot currently cover such expenses.[66] The actual use of such funds will be reported to the Board quarterly. ADB will claim any amount disbursed for these expenses as part of the moneys owed to and recoverable by ADB under the original investment and security arrangements[67] and the amount so disbursed will be subject to loss provisioning. ADB will also clarify the status of such claims as part of the workout process. To the extent permitted by law, ADB will also claim a "super-priority" for such amounts. Recoveries will be credited against expenditures, allowing the earmarked funds to be used on a revolving basis.

H. Private Sector Operations at Resident Missions

99. PSG's experience, especially in the recent past, has demonstrated the critical importance to PSO of an effective local presence through ADB's RMs. There is simply no substitute for reliable, accurate, and timely local information and response when identifying, processing, and administering private sector projects. On this basis, and in line with ADB's policy on resident missions, local inputs for PSO must be bolstered by more appropriate arrangements to promote PSO in local markets, to assist with the processing of new projects, to undertake on-the-ground portfolio administration, and to address risk management issues. Such arrangements could include an enhanced PSO-dedicated headquarter staff presence, the wider use, on a selective basis, of highly PSO-qualified national officers, engagement of local expertise, and the use of experienced local nominee directors. For the latter, appropriate systems will be developed, in consultation with concerned departments, so that nonheadquarters staff supporting PSO are properly recruited and supervised, with particular attention to high standards of professionalism and good governance. The need for substantial RM support is critical in at least four DMCs: PRC, India, Indonesia, and Pakistan. In these RMs, the presence of a PSO-dedicated professional staff member from headquarters is critical to ensure close supervision of PSO activities in the concerned DMC.[68] PSG will continue to coordinate private sector efforts in the RMs will and provide support through inputs from investment officers based in headquarters.

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[66] Although $660,000 has been used for investment recovery operations to date (for Primo Oleochemicals), PSG anticipates that $2 million is an appropriate level based upon expected recovery efforts in PSG operations.

[67] Although such additional amounts would be "moneys owed" to ADB, they would not constitute a "loan", as contemplated by Article 14 of the ADB Charter (which requires all "loan proposals" to be the subject of a "report" to the Board). Therefore, a separate Board paper or RRP would not be required.

[68] In the interim, PSG-recruited staff consultants could be deployed.

I. Enhancing Technical Assistance for Private Sector Operations

100. ADB's existing policies and procedures permit TA to be provided for PSO[69], although this has rarely been used. Specifically, project preparatory TA may be provided, on a selective basis, initially by grant, but with full or partial recovery when the TA results in an ADB operation.[70] Use of TA funds for PSO would enable PSG to pioneer in new countries and new sectors. Such TA may be justified where significant barriers to private sector involvement exist and sponsors are not forthcoming, or where this form of assistance will allow ADB to play a valuable demonstrative or catalytic role. This enhanced capability could, for example, facilitate the preparation of pilot projects in innovative areas or in new countries.[71] Developing and designing such projects may be initiated by ADB, or conceptualized by sponsors who need seed money to prepare a feasibility study or finalize the project design. For instance, ADB has been requested to assist at the preparatory stage of interesting and deserving proposals that could bring the benefit of ICT to the DMCs. TA should be available to assist the promoters of these and similar projects, subject to reimbursement as and when the projects are successfully launched.

101. There are limits to the amount of resources that private companies can commit to nonrevenue generating, socially-oriented activities.[72] Grant support may sometimes be required to encourage and broaden the scope of activities to directly address the needs of the poor. For example, an occupational training program for handicapped war victims has been proposed to be incorporated into a commercial project in Cambodia, enabling war victims to learn marketable skills. A similar program has been proposed for a hotel chain to train abused girls in catering and other hotel skills. Neither can be incorporated without grant funding. To address issues of eligibility of such activities for TA funding, careful analysis has to be made to ensure ADB's TA is used to finance expenditures that involve advisory and training services.

102. For these activities, PSO will have access to TA funds. In addition, there may be good potential for establishing donor-funded trust funds for TA in PSO. IFC, for example, has several such trust funds and uses them for project preparation advisory services and as "foundation-like" grants to support non-core elements that have direct poverty impacts. PSG would explore these possibilities in collaboration with the Office of Cofinancing.

J. Active Outreach Marketing

103. Active marketing of PSO is important to inform a wide circle of private sector sponsors and cofinanciers of the value ADB can add to projects in DMCs, familiarize the marketplace with ADB's core competencies in PSO—infrastructure and capital markets, and apprise potential clients about new financial instruments and services as ADB develops them. With active marketing, PSG will be able to enhance the inflow of information on private sector investment opportunities and investor perspectives, thereby increasing deal flow and broadening the range of prospective private sector projects that are considered for possible ADB assistance. This should improve strategic selection of projects, since a wider choice allows PSG to use scarce ADB capital for the optimal projects in a country to maximize development impact. ADB must also maintain and strengthen external relations on PSO, particularly with other IFIs and the

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[69] *Operations Manual,* Section 18, paragraph 32, Technical Assistance for the Private Sector without Government Guarantee.
[70] Such a grant would be recovered through ADB's financial package or through composite pricing of the package as appropriate. Advisory TA and regional TA for private sector activities may be financed by outright grants.
[71] Box 5, page 21 of the PSD Strategy Paper (footnote 3).
[72] Private sector-oriented TA from ADB would encourage social projects by enabling them to generate adequate social returns for the target beneficiaries, while allowing the private sector investors to earn reasonable financial returns. As the project benefiting from the TA matures, it would pay ADB back over time for the TA cost.

financial press. Active marketing efforts represent additional demands on PSG and require additional resource allocation. Without such efforts, PSG will remain reactive to the market, with project selection restricted to a narrow range of walk-in proposals.

K. Establishment of a Financial Reporting System

104. To ensure sustainability, ADB needs to measure the financial performance of PSO. For this purpose, ADB will develop an appropriate accounting and financial reporting system for PSO.[73] As soon as the system is established, even though PSG is an integral part of ADB, a separate set of notional financial statements can be prepared for PSO. Based on such financial reports, ADB would be able to measure the financial performance of PSO independently from the public sector operations. This would, in essence, describe PSG as if it were a “mini bank” within ADB with its own balance sheet and income statement. With such notional financial statements in hand, ADB could then consider allocating a certain amount of its capital to support PSO lending, equity investment, and guarantee operations. (Under such a set up, PSG would use ADB’s actual cost of market borrowings as its imputed cost of funding.) The PSO mini bank would follow a set of financial policies similar to those of other MDBs with large private sector activities, e.g., EBRD, and IFC.

VI. RESOURCE REQUIREMENTS

105. The intensified work in the infrastructure sector and capital markets, with a heightened emphasis on development impact, the plan to extend PSO to more countries and sectors, and the need to strengthen risk management and enhance PSG’s field presence in project administration and other areas, will have capital and human resource implications that need to be addressed. Within PSG’s current resource allocation, which supports only intermittent PSO interventions in certain countries and sectors, PSG has failed to serve some clients at all and has served many client DMCs on a sporadic basis at best. This clearly falls short of what is needed to implement the proposed updated strategy for PSO, and arguably also, to support ADB’s PSD Strategy. Additional resources are required to enable ADB to undertake PSO in all its DMCs[74] on a more regular, continuing basis across a range of sectors in accordance with specific country needs and conditions. The following sections discuss proposals regarding capital and human resources required for PSO.

A. Capital Resources

106. Because PSO investments are not backed by sovereign guarantees, they are generally regarded as riskier than public sector loans and as such would require relatively larger equity capital backing compared with public sector operations. A review of ADB’s financial resources indicated that ADB currently has scarce equity capital resources. This was the very reason why ADB increased its loan charges in 2000: to improve its equity capital base relative to the risk arising from the OCR loan portfolio. Given the competing demands on the use of its scarce equity capital resources, ADB needs to develop objective criteria for determining the appropriate capital allocation between PSO and public sector operations.

107. In developing such capital allocation criteria, two inputs related to PSO are essential: (i) a risk assessment of the PSO portfolio for the purpose of estimating unexpected losses that would require equity capital backing (similar to that for the public sector portfolio); and (ii) a

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[73] The system does not require any changes in ADB’s existing accounting system, but rather will be developed on a standalone basis.

[74] Either directly or through funds/intermediaries.

financial reporting system for the purpose of measuring PSO profitability and sustainability in a transparent basis. ADB intends to undertake the risk assessment and develop the financial reporting system (as envisaged in para. 104) over the next two years. The results of these activities will form part of the basis for formulating the capital allocation criteria to be used by ADB.

108. Until such time that the new capital allocation criteria become operational, ADB needs a pragmatic approach to enabling continued PSO. The proposed interim arrangement is to allow PSO approvals in excess of the existing $1.5 billion PSO capital allocation.[75] Under this arrangement, ADB intends to pursue a gradual buildup in PSO volume over the medium term, not a rapid scaling up that cannot be supported by resource and prudential considerations. Based on past trends and extrapolating from recent PSO activity levels, ADB anticipates a PSO approval level of $200-400 million a year, or about $600 million over the next two years—approximately 7 percent[76] of the remaining OCR headroom of $9.2 billion.[77]

B. Human Resources

109. With the overall objective of enhancing operational efficiency in a tight resource environment, PSG was reorganized in 2000. This internal restructuring involved the formal establishment of three project teams (viz., Project Finance I, Project Finance II, and Capital Markets), and the Risk Management Unit. The new organization enables PSG to have more focused and innovative operations through (i) a more manageable span of control at the team level; (ii) a critical mass of sector-focused staff; (iii) closer mentoring, skills development, and knowledge sharing; (iv) more effective planning and use of resources; (v) improved external visibility; and (vi) better accountability. The three project teams are responsible for PSG's core operations of project processing, implementation, and supervision. The Risk Management Unit is responsible for undertaking a separate review of the credit quality of new and existing projects, as well as assessing risk in all aspects of PSG's operations.

110. PSG's budget currently provides for 20 professional staff positions.[78] PSG, however, already faces staff constraints as its workload has increased substantially following the approval of the PSD Strategy, and as a result of the need to focus on new instruments, new policy, and risk management. Some of these new, incremental responsibilities, not envisaged as recently as a year ago, includes:

(i) new responsibility for **policy formulation** (e.g., PSD, PSO, and PRG);

(ii) managing the **PSD network** and serving as co-chair of the core team to coordinate and implement the **PSD Strategy**;

(iii) mainstreaming of the **PSD Strategy** in PSO;

(iv) pilot PSO in **frontier countries** and **new sectors**;

(v) introduction of **new instruments** for PSO (e.g., PRG);

[75] The PSO headroom available at the beginning of 2001 was less than $170 million.
[76] The existing capital allocation for PSO represents 3.5 percent of ADB's $42.5 billion overall OCR portfolio (outstanding disbursements and undisbursed commitments) at the end of 2000.
[77] This $9.2 billion is based on the actual lending headroom at the end of 2000, adjusted to reflect allowance for adverse impact of exchange rate fluctuations. The allowance is based on historical long-term movement of ADB's major operational currencies compared with the US dollar, ADB's reporting currency.
[78] By comparison, the Private Sector Department of IADB has 55 professionals processing 7-10 project approvals a year.

(vi) substantial increase in number and complexity of **projects being processed** (4 projects in 1999, 9 projects in 2000[79], several pilot projects including those in the social sector being lined up for 2001), with this trend expected to continue;

(vii) a major thrust on **financial closure**, following the cumulative increase in the number of approved infrastructure projects (the very staff-intensive work to implement and bring each of them to financial closure being almost like a second project); and

(viii) significant challenges in **risk management** due to entry into frontier countries and sectors, as well as the Asian crisis fallout and the complexity of addressing the resultant problem loans.

111. Based on preliminary estimates, even *without* the increase in PSG's mandate proposed in the PSO operational strategy (e.g., extending country and sector reach), these recent additions to PSG's responsibilities represent a significant increase in workload that is now overtaxing current resources and require a commensurate increase in staffing, especially in project processing, project implementation and financial closure, and risk management.

112. In addition, the expanded mandate under the proposed PSO operational strategy and the increased number and complexity of operations require a regular review of PSG's staffing level. It is expected that additional PSG professional staff and consultants will be required in the short to medium term. The precise timing and quantum of such increments will be assessed in detail within the framework of the three-year rolling work program and annual budgets, as PSO implementation proceeds. Upgrading PSG to a department, as envisaged in the proposed reorganization of ADB,[80] would provide the necessary structure to house the increased staffing for PSO, address span of control issues, and respond flexibly to client needs.

113. A stronger field presence is also needed for PSO. Given a tight budget environment, the strengthening of RMs for PSO will need to be prioritized with initial priority being given to selected key RMs in countries with strong PSO growth potential and/or to subregional "hub" RMs.

VII. CONCLUSIONS AND RECOMMENDATIONS

114. The development of Asian economies hitherto has been driven to a large extent by the private sector, both domestic and foreign. In the transitional economies where private investment played virtually no role in the 1980s, the share of the private sector in fixed investments has grown significantly during the 1990s. While the recent financial crisis exposed certain weaknesses in the performance of the private sector and in the government's regulatory function, the recovery and further development of the region will continue to be driven by private sector investment.

115. ADB will continue to provide direct assistance to the private sector and focus primarily on its existing strengths in PSO, particularly in areas where it enjoys a comparative advantage—in the infrastructure sector and capital markets. In response to the changing needs of DMCs, new areas, such as social infrastructure and ICT, will be explored through pilot

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[79] PSG managed to process 9 project approvals in 2000 by partnering with other departments and institutions in doing several of these projects.
[80] WP4-01: *Review of the Organization of the Asian Development Bank,* 5 July.

projects. ADB will build on its accumulated country experience related to PSO, continuing to operate in the middle-tier and larger DMCs where it has been most active in the past while extending the reach to the transition economies and smaller countries. A more regular involvement in all DMCs is the long-run goal for PSO.

116. ADB will also enhance its PSO focus on development impact through the upgraded screening of private sector projects. The impact of PSO is expected to be enhanced by extending country and sector reach, piloting innovative projects, utilizing different financial instruments, building synergy, gaining knowledge, and leveraging resources through strategic alliances, particularly with other IFIs. Risk management will continue to be accorded the highest priority in PSO.

117. In addition to development impact, ADB is expected to generate sufficient resources in PSO to make these operations self-sustaining. A financial reporting system will be established to track the financial performance of PSO. This system will also be useful for the risk assessment of the PSO portfolio, which is needed in developing objective criteria for determining the appropriate capital allocation between ADB's public sector operations and PSO.

118. To meet the expanded mandate under the proposed PSO operational strategy, there is a need to allocate an appropriate level of staffing for PSO. This includes PSO-dedicated professional staff at resident missions in countries with ADB has a large and growing PSO exposure. In addition, TA funds have to be accessible for use in PSO to enable a more proactive role for ADB in the design of developmental private sector projects. The PSO approval process for new projects and for restructuring has to be streamlined, while ensuring credit quality and protection of ADB's interest.

119. The Board is requested to endorse the general thrust of the updated PSO strategy as outlined above. In addition, Board approval is sought for the following specific recommendations:

(i) adoption of an operational strategy for private sector operations with four main elements: (a) focusing primarily on existing strengths in infrastructure and capital markets; (b) extending country and sector reach and pursuing projects in new areas on a pilot basis; (c) making wider use of innovative financial instruments; and (d) building strategic alliances and partnerships with other development agencies (paras. 47-72);

(ii) allowing approvals in excess of the existing $1.5 billion capital allocation for private sector operations as an interim arrangement pending implementation of objective criteria for determining the appropriate capital allocation between public and private sector operations (paras. 106-107);

(iii) increase in the limit for single project exposure to the lesser of $75 million or 25 percent of project cost (paras. 74-76);

(iv) delegation to the President of approval authority for loan restructuring proposals where no additional ADB funding is involved and all other recovery alternatives are less advantageous to ADB, and Board approval on a no-objection basis for loan restructuring proposals which involve additional ADB funding (para. 97); and

(v) delegation of authority to the President for approving the funding of costs and expenses related to investment recovery operations, up to a cumulative amount not to exceed $2 million (para. 98).