

**MANAGEMENT RESPONSE TO THE PROJECT PERFORMANCE AUDIT REPORT
ON THE SECOND DEVELOPMENT FINANCE PROJECT IN INDONESIA
(Loan 1223-INO)**

On 1 March 2005, the Director General, Operations Evaluation Department, received the following response from the Managing Director General on behalf of Management:

1. Management finds the report well prepared and contains a thorough analysis. The issues and lessons are pertinent to development finance operations as a whole, not just those seeking to support the export sector.
2. The Project Completion Report rated this operation unsuccessful. The PPAR rates this operation partly successful (para. 53). It is noted that, in the context of the reduced size of the operation and the successive loan cancellations, at least 44 of the 50 enterprises that were assisted are still operational and generating export revenues. This is despite the intervening period of financial, economic, and political crisis, and represents some achievement. Nevertheless, it is acknowledged that there were deficiencies in both design and implementation, from which lessons have been taken.
3. The report points to inadequate initial analysis of the demand for such lending and the price competitiveness of the offered funds. There was indeed an optimistic view of the likely growth in demand for this product. Moreover, the operation was impacted when the financial crisis occurred half way through implementation, and sub-borrowers found difficulty in maintaining supplies from other affected enterprises. Though ADB was slow to act on the request of converting pool-based lending to LIBOR-based lending, it is now more keenly aware of the competitiveness of its products, with respect to both lending terms and other transactions costs, and is actively considering adjustments at the institutional level. Recent loan approvals are now routinely LIBOR-based, which takes account of the capital market access of borrowers at the global level, especially for middle-income countries.
4. The operation passed the foreign exchange risk onto the participating financial institutions (PFIs). However, PFIs (some of which underwent restructuring) have built up a revolving fund from sub-loan payments. The report points out (para. 65) that the re-lending agreements did not contain a clause for prepayment of loans, similar to the one in the loan agreement between ADB and the borrower. As indicated (para.67), ADB will follow up through the resident mission (IRM) on government internal discussions on possible arrangements for PFIs to prepay their remaining balances.
5. Analysis of the impact of this operation was inhibited by a lack of awareness by PFIs on the benefit monitoring and evaluation (BME) clause in the project agreements. Information kept on sub-borrowers was sufficient only to facilitate the commercial transactions with them, and did not cover impact indicators, such as job creation. The report notes (para. 64) that this is a common problem with development finance operations, partly because of the cost

implications. Paragraph 63 recommends that ADB should include a performance evaluation clause in a loan (rather than project) agreement to underscore the government's responsibilities for BME, and a clause in sub-loan agreements defining the responsibilities of sub-borrowers. However, as noted in Paragraph 64, the approach has been already taken in the ongoing Small and Medium Enterprise Export Development Project in Indonesia. In this project, BME is being undertaken by an oversight implementing bank based on sample subprojects, and the loan agreement specifies the minimum data to be collected. Management believes this is a practical approach to the BME, and paragraph 64 notes OED's support to this approach.