

IV. ADB EXPERIENCE WITH PRIVATE SECTOR DEVELOPMENT INITIATIVES IN THE PHILIPPINES

A. Overview

ADB has been one of the most important development partners in the Philippines since its inception in 1966. As of the end of 2001, ADB had approved \$7.9 billion in loans and \$120.0 million in technical assistance. In terms of public sector lending, the Philippines is ADB's fifth largest borrower. In terms of private sector operations, it ranks first among the developing member countries of ADB. During 1986–2001, ADB approved 86 projects and programs for the Philippines involving 109 loans with a total value of \$5.9 billion. Project loans accounted for 79% of total lending and program loans accounted for 21%. The share of program loans has been increasing in parallel with ADB's evolving role as a broad-based development institution with its emphasis on policy reforms. While program loans represented only 4% of lending during 1990–1997, they rose to 56% during 1998–2003. About 16 projects/programs involving 41% of loans went to the energy and transport and communication sectors, while 24 projects/programs involving 22% of loans went to the agriculture and natural resources sector (ADB 2003).

Average lending levels have steadily declined since the Asian financial crisis, from \$504 million during 1996–1998 to \$110 million during 2001–2003. This is explained by a combination of (i) lower absorptive capacity (especially the government's budget constraints), (ii) the pace of policy reforms,

and (iii) portfolio issues (the overhang of implementation problems with active loans affecting timing of new loans). Nontraditional support modalities have also been used in recent years such as credit enhancements (e.g., a partial credit guarantee of \$500 million in 2002), and mechanisms to mitigate foreign exchange risk for private borrowers (peso swap and financing project approved in 2004).

While the specific classification of private sector development as it relates to ADB interventions is relatively recent (2001), one can nevertheless review the broad portfolio and identify those ADB interventions that have (i) helped establish an enabling environment for the private sector, (ii) generated business opportunities in which the private sector can participate, and (iii) catalyzed private investments (ADB 2001) by mobilizing additional resources through cofinancing and guarantee operations. The first two have been pursued through ADB's public sector window with program loans and technical assistance operations and the third by direct investments in and loans to private individual companies. Broadly speaking, ADB's interventions in support of private sector development have focused on the infrastructure (transport, energy, water) and financial (capital markets, NBFS) sectors.¹⁴³

¹⁴³ Judicial reform, critical for reducing the risks of doing business and therefore facilitating private sector development, has also recently been added to ADB's Philippine assistance program, with the implementation of a \$1.2 million technical assistance project approved in 2001 to strengthen the independence of the judiciary.

B. Public Sector Operations: Program Loans and Technical Assistance Operations

From 1986 to 2001, ADB implemented nine program loans totaling \$1.5 billion, three of which were sector development programs with policy components. In each case, the policy components were intended to place the sectors on a positive growth footing allowing broad-based participation and, where necessary, strengthened regulatory oversight. ADB also implemented selected infrastructure projects that had policy components and a total of 210 technical assistance projects with a total value of \$104 million. The principal beneficiaries of technical assistance activities were the agriculture and natural resource sector (34%), social infrastructure (27%), and transport and communications sector (12%).

In the agriculture and natural resource sector, technical assistance was mostly for institutional strengthening and capacity building and for technology and transfer of “best practices.” The former focused on agricultural policy analysis and national and regional project and program formulation, implementation, monitoring and evaluation; on financial management, management information systems, and benefit monitoring and evaluation; and development of plans, guidelines, and consultation procedures for optimal use of natural resources and conservation of the environment. In the industry and nonfuel mineral sector, technical assistance sought to examine the effectiveness and adequacy of government policies—and of the existing legal and regulatory framework—for developing the mineral sector. In the social infrastructure sector, technical assistance was mostly for institutional strengthening and capacity building as well as for promoting private sector participation in social sector operations.

1. Infrastructure

Two program loans and one project loan in the infrastructure sector have included policy reforms to create conditions for increased private sector

participation: (i) the \$300 million power sector restructuring program, (ii) the \$40 million electricity market transmission project, and (iii) the \$100 million road and road transport sector program. The power sector restructuring program, approved in 1998, supported the development of a wholesale restructuring plan for the sector, including the preparation of a new legal framework for competitive power markets, with the unbundling of the national power utility and preparation for privatization. The electricity market transmission project, approved in 2002, supports the establishment of the wholesale electricity spot market.¹⁴⁴ The road and road transport sector program, completed in 1992, included provisions for policy reforms in deregulation, taxation, and importation and resulted in the privatization of road maintenance operations and in the liberalization of imports. In this way both programs created business opportunities for the private sector (privatization) and improved the enabling environment for private sector development (opening up markets, clarifying regulation, and revising tax policy).

Looking forward, preparations are under way for a new power sector development program intended to take a broad view of the issues affecting the fiscal sustainability of the sector. The program, still under definition, would seek to further strengthen the legal and regulatory framework in the power sector, to establish cost-recovering tariffs, to strengthen the distribution utilities, and to facilitate implementation of EPIRA, including the privatization of the remaining NPC assets.

In addition to program loans, 40 technical assistance projects with a value totaling \$21.8 million were implemented in the infrastructure sector from 1986 to 2001. These include 17 in the energy sector and 20 in the transport sector, all generally in support of policy reforms, institutional strengthening, and capacity building. In the water supply and sanitation sector, ADB has funded 3 technical assistance projects to support increased private sector participation.

¹⁴⁴ This project also includes a loan for implementation of upgrades to the transmission system, but these have encountered major start-up delays due to land acquisition and right-of-way problems.

2. Financial Sector

In the financial sector, two program loans have been implemented since 1986, and a third is ongoing. The \$150 million capital market development program completed in 1997 supported the development of basic capital market infrastructure, while the \$75 million Nonbank Financial Sector Governance Program I completed in 2002 addressed a set of second generation challenges: (i) strengthening the governance of SEC; (ii) modernizing the governance and regulatory structure of PSE; (iii) strengthening market oversight, compliance, and enforcement; and (iv) facilitating diversification and innovation in corporate financing. Both programs laid important groundwork for strengthening capital markets as an essential instrument for sourcing funding and for diversifying risk for private investors.

In 2003, the follow-on \$150 million Nonbank Financial Sector Governance Program II (NBFG II) was approved leading to significant achievements in the functioning of capital markets, most notably the adoption of risk-based capital as a regulatory principal. The second and final tranche of the NBFG II was approved for early release in November 2004 following the government's compliance with all second tranche conditions. Overall, the NBFG II focuses on four areas of weakness that need further attention to pave the way for the recovery of the NBFS: (i) the weak and fragmented regulatory structure and policy, (ii) the supervisory and surveillance capacities of SEC, (iii) financial information and disclosure and prudential standards for NBFIs, and (iv) the excessive reliance on banks to mobilize savings.

In addition to these program loans, 22 technical assistance projects were implemented for a total value of \$8.3 million. They covered a wide range of issues including feasibility studies for the development of a corporate bond market, venture capital, leasing and mutual fund products, institutional strengthening within financial intermediaries, regulatory bodies (SEC, Insurance Commission, Deposit Insurance Corporation) and local government units, and development of modern rules and regulations to support financial sector development.

3. Overall Performance

The January 2003 country assistance program evaluation reviewed ADB's programs in the Philippines through 2001. It found that on the whole, the development impact of ADB's assistance since 1966 had been mixed. Performance audit reports rated 43% of public sector projects successful, 36% partly successful, and the remaining 21% as unsuccessful. This performance record placed the Philippines below the average of ADB's developing member countries. If only those projects/programs that were both approved and completed during 1986–2001 are considered, the evaluation sample of 14 projects reveals that four (29%) were rated generally successful, nine (64%) partly successful, and one (7%) unsuccessful.

While the overall portfolio assessment is instructive, it does not provide specific insight into the effectiveness of the strictly PSD-promoting programs of ADB. Evaluations of these programs are only available on an individual basis (through their project completion reports), and are not numerous enough to permit broad conclusions. The overall portfolio assessment does provide lessons that appear quite relevant for the design of PSD-related programs going forward, however, as detailed in section D below.

C. Private Sector Operations

During 1986–2004, the private sector operations arm of ADB implemented a total of \$282 million in loans¹⁴⁵ to 13 private sector projects with \$109 million to transport and communications; \$77 million to energy; \$52 million to agriculture, manufacturing, and other industries; and \$45 million to social infrastructure. In addition, 17 equity investments were made for a total of \$34.8 million to provide funds for industrial and mining companies, to catalyze infrastructure development by the private sector, and to support financial institutions and investment funds. The financial sector received close to 50% of the equity

¹⁴⁵ This does not include the \$200 million peso swap facility approved in January 2004.

investments; the energy sector received the next largest percentage.

In 2004, two new investment programs were approved: a \$200 million peso swap facility financed through a loan from ADB's ordinary capital resources to release long-term peso funding to support infrastructure project finance and other long-term financing needs, and a \$2 million equity investment in the LGU Guarantee Corporation, a quasi-government institution established to provide debt guarantees to LGUs for enhancing their ability to raise finance for infrastructure and other public service purposes.

On the whole, ADB's private sector interventions in 1986–2001 had a mixed record. The January 2003 Philippine evaluation report summarizes the performance of the portfolio in the following way. Three BOT power plants resulted in profitable investments and a loan to PLDT was fully repaid. However, three ongoing projects for water services, an air terminal, and a toll road encountered serious difficulties that clouded their prospects. The BOT projects played an important role in addressing the power crisis of the early 1990s. Together with public sector loans, they acted as catalysts to attract other financing and brought about a rapid resolution to the crisis. While the immediate problems were alleviated by the BOT projects, the subsequent Asian financial crisis resulted in a slowdown in power demand growth that led to overcapacity in generation.

The private sector operations portfolio also includes financial support for seven financial institutions. Of these, one was a line of equity that was never drawn due to a weakness in the design of the financial instrument and another has been fully and successfully divested. The remaining five are all currently receiving positive ratings. Two country-focused venture capital funds in the Philippines have been more successful than others that ADB has funded. In addition, ADB's public sector support through the capital market development program led to the restructuring of PSE and improved its efficiency, transparency, and accountability thus contributing to enhancing governance in the financial sector and to fostering private sector development.

In the industrial and mining sectors, ADB's private sector operations were unsuccessful. None of the six companies assisted by ADB thrived. One

was foreclosed; another prepaid its loan pending investigation of breaches of environmental protection provisions; and still another is in receivership with a view to salvaging the interests of lenders, including ADB. The other three have all been rated high risks. The failures are generally attributed to inadequate investigation of raw material sources and prices, poor assessments of market opportunities, and technical difficulties. These failures have led ADB to discontinue its private sector operations in these sectors.

D. Lessons Learned

The mixed performance of the ADB's public and private sector operations in the Philippines has yielded some important lessons (ADB 2003).

- i. Political and macroeconomic stability is a critical factor behind the success of a development assistance program. ADB projects have been more successful when they have been implemented in a stable environment.
- ii. Success requires careful project preparation. An important cause of project failures in the Philippines has been the lack of thorough preparation involving detailed analytical work and active participation of beneficiaries in design and implementation.
- iii. Project design should be relatively simple. Designs that are too complex and impose excessive demands on the organizational capabilities of the implementing agencies are likely to fail. Early loans to the Philippines were small and simple and made modest demands on the organizational capacity of executing agencies and as a result were more successful.
- iv. Sustaining development impact requires close monitoring during implementation and after project completion. The Philippine experience strongly suggests that the quality of project monitoring has an important bearing on success.
- v. The success of the assistance program depends on its ability to nurture institutional

development. Weak institutions have often been cited as a principal cause of project failures in the Philippines.

As ADB has evolved into a broad-based development institution, the role of nonlending activities in the form of knowledge products and services has increased in significance. The Philippines has been an important beneficiary of various technical assistance activities related to policy reform, institutional development, and capacity building in many sectors of the economy. Compared with 1968–1985, the number of technical assistance projects doubled and their combined value rose almost seven times during 1986–2001. Given the

increased emphasis on advisory technical assistance, the growth in this category was even more dramatic—from \$5 million in 1968–1985 to \$65 million in 1986–2001. Although it takes some time for the effects of such substantial activities to materialize, one would expect a positive impact on project performance of the more conducive policy environment and from more comprehensive project preparation. Although the proportion of unsuccessful projects was reduced significantly in the 1990s, the Philippines remains a poor performer. As the country moves to a higher stage of development, the demand for knowledge products and services is likely to increase. Lessons learned indicate that selectivity will be essential.