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Private Sector Development: A Revised Strategic Framework

Asian Development Bank

ABBREVIATIONS

ADB	–	Asian Development Bank
BPMSD	–	Budget, Personnel, and Management Systems Department
COSO	–	Central Operations Services Office
CSP	–	country and strategy program
CTL	–	Controller's Department
DaMF	–	design and monitoring framework
DMC	–	developing member country
IEI	–	Innovation and Efficiency Initiative
MRM	–	Management Review Meeting
MTS	–	medium term strategy
OCO	–	Office of Cofinancing Operations
OED	–	Operations Evaluation Department
OGC	–	Office of the General Counsel
PPP	–	public-private partnership
PSD	–	private sector development
PSO	–	private sector operations
PSOD	–	Private Sector Operations Department
RD	–	regional department
RMU	–	Risk Management Unit
RSDD	–	Regional and Sustainable Development Department
SPD	–	Strategy and Policy Department
TD	–	Treasury Department

NOTE

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

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PRIVATE SECTOR DEVELOPMENT: A REVISED STRATEGIC FRAMEWORK

I. INTRODUCTION

1. A vibrant private sector is a critical component of economic growth and sustainable development. Thriving businesses create jobs. Jobs provide incomes. Steady incomes reduce poverty and create opportunities for new generations. This cycle is at the core of the impressive transformation of many Asian economies in recent decades. It is helping transform others today.

2. The cycle works best, and growth increases most rapidly, when the public sector understands, values, and facilitates private sector activity; when economies establish a sound policy and regulatory environment complemented by the service and physical infrastructure required to enable business to function efficiently; and when investors recognize in a market the certainty, predictability, and confidence needed to make substantial and long-term commitments.

3. The primary goal of the Asian Development Bank (ADB) is to help its developing member countries (DMCs) promote economic growth, improve standards of living, and tackle poverty. Support for private sector development (PSD), defined as activities by governments, companies, individuals, ADB, or others to build a vibrant and competitive private sector in DMCs, is a key tool in this effort.

4. PSD has been an institutional priority at ADB since 1999.¹ ADB's operations in this area have been guided by a PSD strategy adopted in 2000 and a strategic directions paper for private sector operations (PSO) adopted in 2001.²

5. In recent years, the ground has shifted. With the rise of globalization and international economic integration, there is now a growing appetite for PSD in many ADB members. To effectively support this development ADB must renew its strategic framework and business model, sharpen its market orientation, and be more responsive to its clients' needs.

6. This report explains how ADB will make this happen. The report, developed by a task force of ADB staff reporting to the Vice-President for Knowledge Management and Sustainable Development, examines the role of PSD in broader economic development and ADB's role in PSD; it reviews ADB's experience with PSD, proposes a revised PSD strategic framework and outlines the specific actions required to make the framework effective. The report benefited from stakeholder feedback gained through internal and external consultations involving DMC governments, private sector groups, other development institutions, and ADB's Board of Directors, Management, and staff.³

7. Successful implementation of the framework will help ADB deliver market-oriented finance and knowledge products and services to help DMCs attract, keep, and replicate more

¹ ADB. 1999. *The Poverty Reduction Strategy*. Manila. ADB. 2001. *Moving the Poverty Reduction Agenda Forward in Asia and the Pacific: The Long-Term Strategic Framework of the ADB (2001-2015)*. Manila.

² ADB. 2000. *Private Sector Development Strategy*. Manila. ADB. 2001. *Private Sector Operations: Strategic Directions and Review*. Manila. In common ADB usage, PSO denotes direct lending or equity to a private entity, without a sovereign guarantee.

³ Feedback from DMC governments was sought through ongoing consultations, including for the innovation and efficiency initiative (IEI) and the partnership framework for middle income countries. This is a much narrower concept than PSD.

private sector investment. It may also improve ADB's drive for greater selectivity and focus on quality when considering individual PSD operations. It may enhance the effectiveness of ADB operations through more strategic and sequenced interventions driven by roadmaps supported by rigorous diagnostic analysis. It should improve ADB's capacity to deliver PSD activities that demonstrate clear development impacts. Over time, it might change ADB's portfolio structure and risk profile, and diversify its client base while ensuring the institution's AAA credit rating.

8. A central challenge facing ADB is how to transform itself from an institution focused broadly on public sector lending into a more agile bank that can meet its overall objective of poverty reduction; and how to achieve this while combining the full range of lending and non-lending products, the skills, and the strengths and opportunities offered by both the private and public sectors.

9. Successful implementation requires an ADB-wide commitment to PSD. To ensure that commitment, PSD may need to be established as a core business theme under the second medium term strategy (MTS II). This report can be an input to the MTS II process.

II. PRIVATE SECTOR DEVELOPMENT AND ADB

A. Why engage in PSD?

10. **PSD and development.** The private sector has been, and will remain, the engine of growth in the Asia and Pacific region. The private sector creates jobs, integrates new technologies, improves productivity, and raises incomes. It drives efficient and cost effective delivery of services in key sectors and industries. Through the payment of taxes it enables governments to invest in public goods and services, including basic social services like health care and education. Much of Asia's significant success in reducing poverty in recent decades is a result of strong economic growth stimulated by private sector investments.

11. Private sector investments historically have been an important source of development finance. But the investment needs of the region are great and the private sector cannot meet them alone. A closer partnership between the public and private sectors—and a sensible division of roles between them—is essential to support sustainable development, reduce poverty, promote equity, and ultimately achieve greater prosperity. This makes the removal of impediments to private investment and the development of a dynamic private sector a high priority for ADB's DMCs.

12. **PSD and ADB.** As an institution committed to reducing poverty, ADB has long focused on the role of the private sector in development. It has worked with DMCs to promote private sector activity and build economies that meet the primary requirements of private sector investors: certainty, predictability, and confidence. ADB has focused on three mutually-supportive areas. It helps DMC governments promote an enabling environment for the development of the private sector. It invests in public goods and services to improve efficiency and attract domestic and foreign investments. And it directly finances, and shares and mitigates risk for, private sector transactions.

13. ADB is uniquely placed to offer integrated PSD solutions across these three areas. It has special relationships with DMC governments, market knowledge, financial expertise, a range of products to provide finance and share/mitigate risks, and experience working with a broad spectrum of partners.

B. Looking Back

1. Strategies

14. During the last five years, ADB's PSD operations have been guided by the 2000 PSD strategy. The strategy articulated ADB's commitment to PSD and reinforced ADB's operational focus on PSD. It had three thrusts:

- creating enabling conditions;
- generating business opportunities; and
- catalyzing private sector investment.

15. These thrusts were anchored in four main areas: governance, financial intermediation, public-private partnership, and regional and subregional cooperation. The strategy stressed the need for a country-specific approach to PSD defined through the country and strategy program (CSP) process.

16. To create synergy within ADB and offer integrated solutions to DMCs, the strategy also called for closer collaboration among ADB's regional departments (RDs) and its Private Sector Operations Department (PSOD), and the creation of a supportive corporate culture. As a guiding principle, the strategy urged RDs to "think private sector" and urged PSOD to "think development impact."

17. ADB defined its approach to the third thrust (catalyzing private sector investment) in its strategic directions for PSO in 2001 (footnote 2). Stressing the importance of greater development impact and the need to increase and diversify the flow of capital into DMCs, the paper directed ADB to:

- focus on its existing strengths in infrastructure and capital markets,
- extend its country and sector reach and pursue projects in new areas on a pilot basis,
- make wider use of innovative financial instruments, and
- build strategic alliances with other institutions.

18. To better tailor this approach to the varying needs and conditions of DMCs, the paper called for close integration of PSO into CSPs

2. Performance

19. A detailed assessment of the implementation of the 2000 PSD strategy is the subject of a separate review.⁴ This paper briefly highlights a number of operational achievements, challenges and lessons for future PSD activities.

20. An analysis of ADB operations in recent years confirms PSD as an important theme. About 28% of total loan approvals by RDs during 2000-2005 were PSD related, amounting to about \$7.3 billion. These PSD operations included lending and nonlending transactions that directly supported the creation of an enabling environment for business through policy and institutional reforms, financial market development and improved access to finance for the

⁴ ADB's Regional and Sustainable Development Department is preparing a paper on the review of implementation of the PSD strategy.

private sector, and promotion of private sector participation in the development and upgrading of infrastructure. ADB approved loans of about \$0.8 billion directly to the private sector, processed by PSOD without sovereign guarantee, and nearly \$0.4 billion of equity investments. ADB approved co-financing from private sources in the form of guarantees and the complementary finance scheme in an amount totaling \$1.7 billion. Of this amount, about \$0.5 billion was extended without sovereign counter-guarantees. Table 1 provides an overview of sovereign and non-sovereign financing approvals.

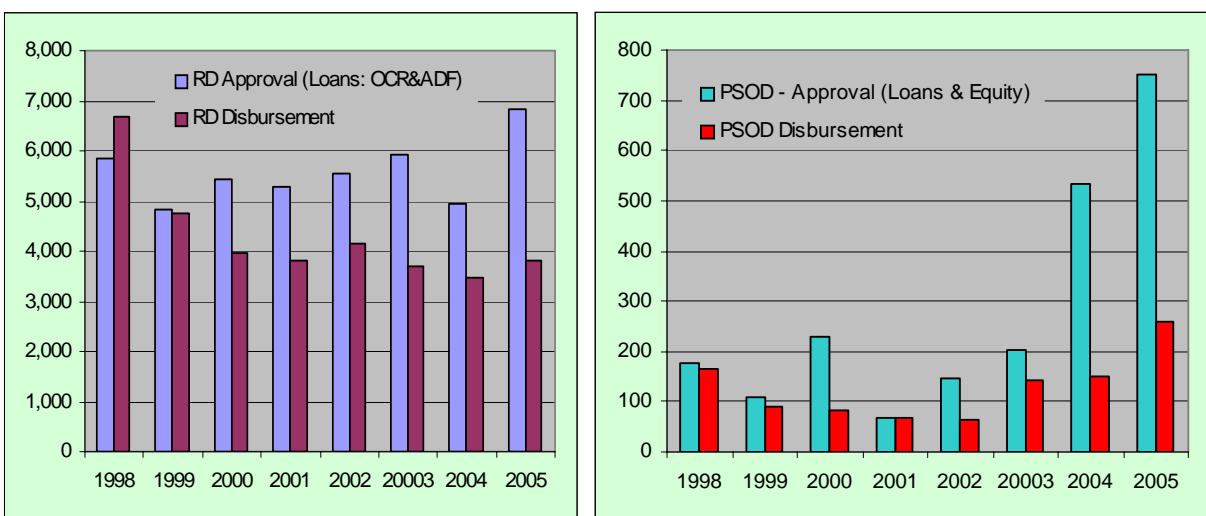
Table 1: PSD Support by ADB (2000-2005, Approvals, \$ billion)

	Sovereign (RDs)	Non-Sovereign (PSOD)	Total
Lending	7.3	0.8	8.1
Equity Investments	0.0	0.4	0.4
Grants (TA)	0.1	0.0	0.1
Cofinancing – Guarantees & CFS	1.2	0.5	1.7
Total	8.6	1.7	10.3

Source: Controller's Department

21. Total lending operations by RDs (including Ordinary Capital Resources and Asian Development Fund) in recent years have been stagnant, with disbursements hovering at about 70% of new approvals. Annual PSOD lending and investment approvals began to rise after a dip at the beginning of this decade. Annual disbursements stand at about 50% of new approvals. At end 2004, 35% of total approved PSOD loans were not yet effective (compared to 9% for RDs). The bulk of disbursements for both the RDs and PSOD are from approvals made in previous financial years, although a small share is also related to approvals made within the same year.

Figure 1: Annual Approval and Disbursement Trends for RDs and PSOD (1998-2005, \$ million)



Source: Controller's Department

- Notes:
1. Disbursements were higher than approvals for RDs in 1998, and nearly as high as approvals in 1999, due to high loan approvals made in 1997 on account of the East Asia financial crisis.
 2. RD figures refer to total approvals and disbursements.

22. Cofinancing from third parties plays an important role in ADB's PSD activities.⁵ About \$1.7 billion of cofinancing was approved during 2000-2005 (Table 1).⁶ The majority of this—\$1.2 billion—benefited from sovereign counter-guarantees. ADB's overall catalytic ratio is low compared to that of other international financing institutions.

23. In some countries, ADB was able to adopt a more proactive approach to PSD than in others. The focus was sharpest in countries with strong government ownership and commitment to PSD, and where PSD was identified as a key priority in CSPs or Regional CSPs. Some transactions capitalized on synergies between ADB's public and private sector operations. This was possible where a strong team spirit existed among RD and PSOD staff, and their skills were complementary.

3. Issues

24. Despite its PSD efforts in 2000-2005, ADB was unable to fully meet the growing and diversifying needs for PSD in DMCs. This is the result of several factors.

25. **Weak leadership.** Strong and visible leadership is essential for a successful reorientation of ADB and its operations toward PSD. This leadership role was assigned to a Presidential commission on PSD in 2000. However, the commission was abolished after two meetings and its mandate delegated in 2001 to a PSD steering committee headed by Vice-Presidents. A year later, this committee was replaced by a staff-level PSD committee. The continuous downgrading of the key leadership and oversight function indicated to staff that PSD was not a high priority at ADB.

26. **ADB's readiness overestimated.** Limited understanding of and exposure to the private sector at both the Management and staff level hampered organizational "buy-in" for the PSD strategy. The strategy and the changes it required may have been overly ambitious for an organization that had been focused since its establishment on public sector activities.

27. **Strategic limitations: lack of targets and incomplete framework.** The strategy itself had a number of inherent flaws. These include:

- *Lack of performance indicators and targets.* This diffused the strategic clarity and direction on PSD, and constrained ADB's ability to align the organization with the strategy. This was compounded by inconsistent reporting of ADB achievements in various documents, including double counting of operations, mixing ADB risk with cofinancing operations, etc.
- *Incomplete operational framework.* The strategy's operational framework deemphasized the role of public sector goods and services in creating enabling conditions for private sector investments. Staff was often confused about the difference between the first and second thrusts, especially since the second was often the end result of the first.

⁵ Cofinancing involves public and private sources. Definitions among multilateral lending institutions vary widely. A detailed analysis will be presented in a review of ADB's Cofinancing Strategy in early 2006.

⁶ This refers to cofinancing for which ADB provides some form of partial credit guarantee, political risk guarantee, or is the lender of record under the complementary financing scheme.

- *Confused operational priorities.* The operational priorities mixed two themes (governance and regional cooperation) with one modality (public-private partnerships [PPPs]) and one intervention type (financial sector intermediation). There was no focus on “sectors” as the main operational platform.

28. **Weak implementation.** Implementation of the PSD strategy suffered from inadequate planning and execution of the envisaged organizational changes. Key weaknesses included:

- *Lack of screening and monitoring mechanisms.* The strategy was not accompanied by a screening mechanism to check the PSD content of transactions. It also lacked an implementation plan or effective monitoring mechanisms. This impeded ADB’s ability to identify PSD opportunities, measure progress, act on emerging issues, and effectively manage implementation.
- *Inadequate attention to CSP quality.* CSPs have not been fully established as the key strategic platform for all ADB operations based on sound diagnoses of issues in DMCs. ADB did not fully institutionalize a strategic approach to PSD at the country level. Very few CSPs identified key PSD activities within the context of priority sector roadmaps.
- *Policies and business processes not conducive to PSD.* ADB policies and business processes remain public-sector oriented and do not encourage market-oriented operations or solutions. The current business processes and practices do not provide consistent “entry points” for screening project concepts against PSD content, estimated development impact, adherence to sound banking principles, and fostering of teamwork.
- *Weak skills base and staff incentives.* ADB has not aligned its skills base with the strategy. Furthermore, no staff incentive mechanism was developed to encourage prioritization of PSD and proactive teamwork.
- *Inadequate attention to project performance management.* A persistent gap among approvals, effectivity, and disbursements highlights a continued focus on approvals rather than results.

29. **Lack of clear accountabilities to respond to new challenges.** Responsibilities and accountabilities for specific PSD outputs—e.g., sovereign and non-sovereign operations with public and private borrowers—are becoming increasingly blurred. A lack of clear accountability for client management has at times resulted in inconsistent and conflicting communication between ADB and its sovereign clients.

30. **Limited teamwork.** Collaboration among RDs, PSOD, and other departments/offices, remains *ad hoc*. Indeed, friction among RDs, PSOD, and other departments/offices has increased in recent years due in part to an increasing overlap in areas of responsibility and the absence of clear institutional mandates to respond to new challenges, in particular for PPPs and cofinancing. Limited teamwork hampered ADB’s ability to systematically offer DMCs integrated and comprehensive PSD solutions. This happened despite ADB having public and private operations under one roof.

C. Looking Forward: Challenges and Opportunities

31. To capitalize on growing business opportunities and strengthen its relevance in the region, ADB needs to reinforce its PSD approach to increase its responsiveness to clients and

market orientation, while focusing more sharply on development impact and maintaining its creditworthiness. Success will depend on how ADB responds to current weaknesses and builds on its strengths in defining its PSD role. To make this change effectively ADB needs to:

- **Clarify the role of PSD in ADB’s corporate strategy.** MTS II will clarify the role of PSD vis-à-vis other priorities.
- **Make its PSD framework concrete.** The PSD framework should define specific results areas, performance indicators, and targets. The framework needs to clearly recognize the role of public goods and services in promoting PSD, and the part played by the private sector.
- **Improve its PSD implementation framework.** ADB should realign its key organizational elements—CSPs, policies and business processes, staff skills and incentives, accountabilities, etc.—to propel its PSD agenda.
- **Establish an effective change management system.** ADB needs to be more market-oriented. The process required to achieve this shift needs to be well managed to ensure timely and coherent organizational change. A devoted change management system for PSD will be a critical element in the success of the revised strategic framework.

32. Section III develops a revised strategic framework for PSD.

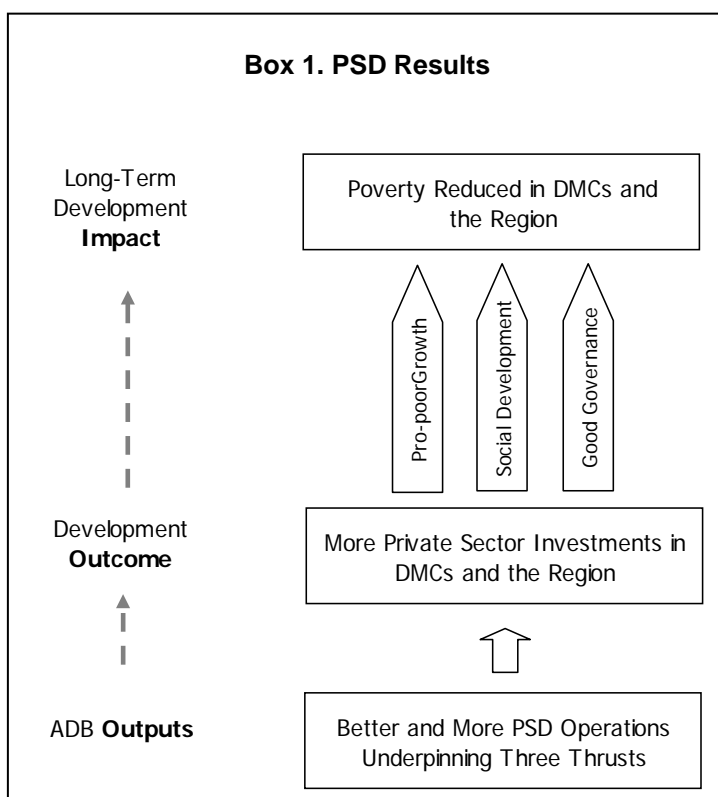
III. STRATEGIC FRAMEWORK

A. Development Outcome: Increased Private Investments in DMCs

33. Greater private sector investment and output to sustain economic growth in DMCs is the central goal of PSD. This PSD strategic framework will strengthen ADB’s ability to help DMCs achieve this goal and build more efficient economies. ADB will tailor its approach to individual country conditions through its CSPs.⁷ ADB-backed PSD operations should focus on the needs of DMCs. Box 1 explains the desired results of the framework.

B. Thrusts, Approach, Context

34. **Thrusts and Outputs.** Three thrust areas will shape all of ADB’s efforts to mobilize development finance for PSD in DMCs (Box 2 on framework). ADB will improve the quality and expand the size of its



⁷ ADB will continue to pay special attention to small and fragile economies.

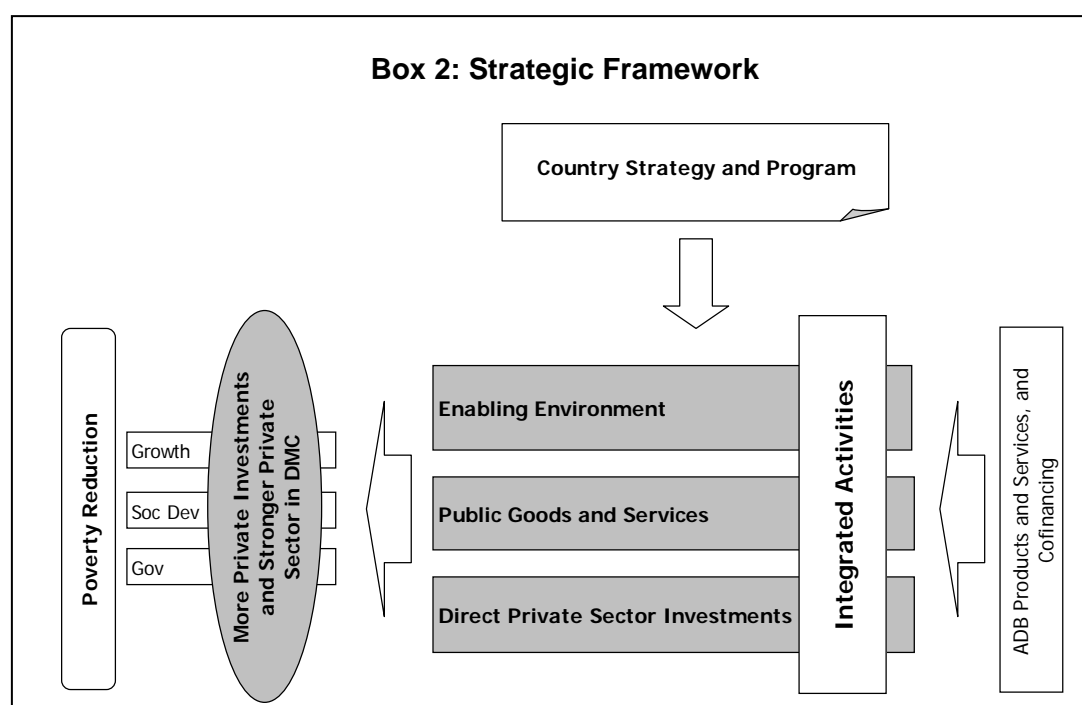
operations—ADB *outputs*—in the thrust areas and capitalize on synergies among the areas to maximize its contribution to specific PSD *outcomes* in DMCs. The three thrust areas are:

1. Establish an Enabling Policy and Institutional Environment

ADB will improve and expand its support for policy reforms and institutional development designed to create an enabling environment for private sector development. This includes assistance for the development and implementation of policy, regulatory, and legal reforms in areas related to public resource and fiscal management, financial and capital market sector development, trade and investment, good governance, the incorporation of the private sector in key productive areas and public goods/services (through privatization programs and other modalities), and related capacity development. ADB actions will be supported by technical assistance, policy dialogue, policy-based lending, sector loans, and other investment and noninvestment assistance.

2. Promote Public Sector Goods and Services

ADB will work on the development of efficient and cost-effective public goods and services. These are essential to attract and sustain private investment and develop the private sector over time. ADB will seek more efficient and innovative market-oriented approaches to finance these activities. ADB-supported transactions are expected to include PPP structures incorporating private operators in both investment and ownership. ADB may also provide support for tangible market transformations, particularly in “frontier” countries and sectors. ADB assistance is expected to be channeled primarily through project and sector loans, multitranche facilities, cofinancing, and equity investments. Public sector transactions can be structured with and without sovereign guarantees. Use of local currency financing will be prioritized for projects with a majority of their revenues in local currency.



This thrust represents a modification to the 2000 PSD strategy, and recognizes the financing of public goods and services as a separate and important area providing a real contribution to PSD.

3. **Make Direct Private Sector Investments**

ADB will focus its direct private sector investments on “market-developing” transactions that promote a larger and sustained flow of private capital into specific sectors and countries. ADB should prioritize transactions that directly or indirectly enhance poverty reduction. These transactions should have at least one of the following features:

- (i) a strong demonstration effect (i.e., those that test markets and create confidence),
- (ii) innovative and pioneering (i.e., those in frontier countries, sectors, and financing structures), and
- (iii) replicable to the extent possible by others in-country, and in relevant cases by ADB elsewhere.

ADB will aim at diversifying PSO by engaging in a range of sectors, countries, and regions with a variety of client types. Support under this thrust can be provided through debt and equity financing, guarantees, cofinancing, and other risk-sharing and risk mitigation arrangements for private sector entities.

35. **Integrated approach.** Actions in these three thrust areas will have the greatest development impact when they work together. ADB will try to maximize its PSD work and its unique public-private mandate and structure by offering integrated, comprehensive solutions across the three thrust areas (Box 3).

Box 3: PSD Thrusts—ADB in Action

Opening the Door to Investment

Clear and consistent rules and regulations are critical to investors. The *first thrust* of ADB's revised PSD framework focuses on helping DMCs establish a policy and institutional environment that will inspire trust and reduce the cost of doing business for private investors. Since 2002, ADB has funded a series of technical assistance projects in the People's Republic of China (PRC) to develop the legal and regulatory foundations of the financial sector. This work, which supported the drafting and adoption of laws governing the central bank, commercial banks, banking supervision, and the supervisory practices for foreign banks in PRC, helped the country meet its World Trade Organization accession requirements and open its financial sector to international financial institutions. These were key steps to improving the access of Chinese private enterprises to funding from international financial institutions.

Making Investments Pay

To attract investment, a sound legal and policy environment must be backed by key public goods and services. The *second thrust* of ADB's revised PSD framework aims to help countries develop the soft and hard infrastructure—the people, the roads, the ports, etc.—that makes efficient business possible. ADB is promoting private sector development in India's transport sector through the \$400-million National Highway Sector Project, which took effect in 2005. The project, which aims to improve the overall efficiency of the Indian economy through the provision of efficiently connected national highway systems, supports the government's National Highways Development Program which notes that private sector participation is a key element in the sustainability of India's highway development. The project will help the National Highways Authority of India build the capacity required to design and manage public-private partnerships and operations and maintenance concessions. The most heavily used section of the project road, the 73-kilometer Orai-Barah stretch in Uttar Pradesh state, will be developed under a build-operate-transfer scheme.

Expanding Investment Opportunities

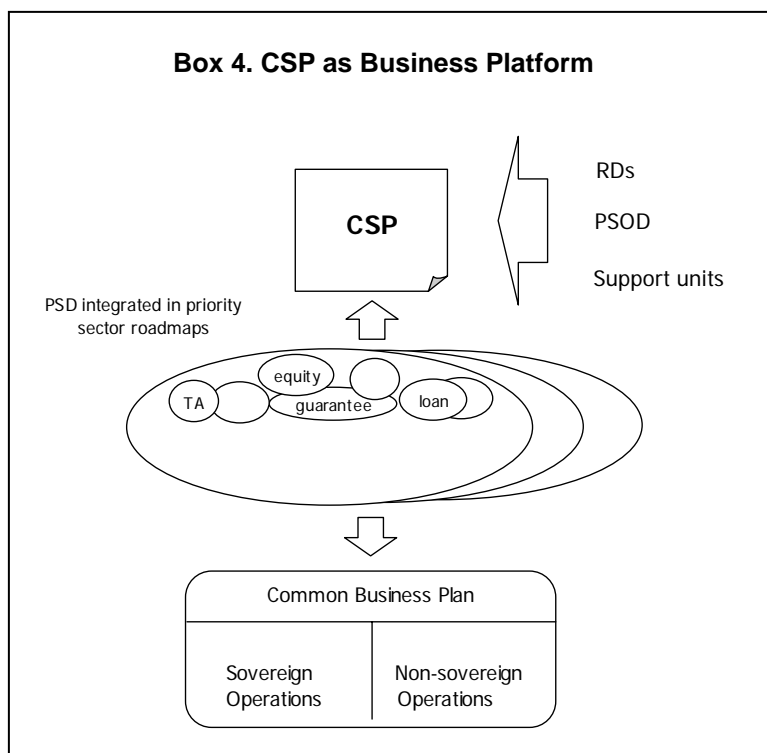
The *third thrust* of ADB's new PSD framework seeks to make innovative and pioneering private sector investments with a strong demonstration effect that other investors can replicate. An example is ADB's investment in AES Meghnaghat Limited in Bangladesh. The deal, which created the first power-generating plant in the country to be financed by the private sector, took effect in 2000 and included a \$50 million loan, a \$70 million guarantee, and a \$20 million complementary financing scheme loan. The project involves the construction and operation of a 450-megawatt power station that will provide power to domestic consumers as well as to agriculture and industry. It is the first build-own-operate power project in the country and features the lowest power tariff in the world. ADB helped catalyze commercial funding through its first use of a political risk guarantee.

Integrated Action

Actions in the three thrust areas will have the greatest development impact when they are integrated and complementary. The potential offered by integration is clear in the Nam Theun 2 Hydroelectric Project in Lao People's Democratic Republic. Under the project the Nam Theun 2 Power Company Limited (NTPC) is building a 1,070 MW hydroelectric power plant on the Nam Theun River under a 25-year concession agreement. Up to 995 MW of electricity generated by the project will be sold to the Electricity Generating Authority of Thailand. ADB supported the project, which took effect in 2005, through \$20 million public and \$50 million private sector loans, and a \$50 million guarantee.

ADB's assistance for this regional cooperation initiative reinforces all three PSD thrusts. It supports Lao PDR's reform initiatives with a direct impact on the security of private sector stakeholders' capital investment. It mobilizes a huge amount of capital resources (\$1.5 billion) in a small economy (\$2.3 billion) to develop an infrastructure project with significant private sector participation. And ADB's direct investment in the project helped mobilize commercial financing from other private sector investors through the reduction of perceived investment risks.

36. **CSP platform.** Each DMC's CSP will clearly define ADB's PSD role in the country.⁸ Within the envelope of the three thrusts, that role will be different in each country depending on needs and dedication to PSD. Each CSP will include roadmaps for priority sectors and these roadmaps will determine the appropriate menu of lending and nonlending interventions, their sequencing, PSD instruments and support. The roadmaps should form the basis for the development of business plans covering sovereign and non-sovereign operations (Box 4). It is generally easier to plan ahead for sovereign operations than for non-sovereign operations. While the latter may inevitably be more opportunistic, private sector investment proposals should be pursued to the extent possible within agreed country strategies and roadmaps.



37. **Mobilizing funds.** ADB recognizes that working alone it will have only a modest impact on PSD. Greater cofinancing is critical to ADB's ability to magnify its development effectiveness. Cofinancing levels should be increased and become a key performance indicator under the new framework.

C. Ensuring Quality: Prioritization of Individual Transactions

38. ADB will work on the prioritization of its PSD operations to ensure the quality of specific outputs (para. 34) and their contribution to desired PSD outcomes in DMCs. Investment decisions are expected to be based on the following criteria:

- **Development impact.** A project demonstrates strong and plausible linkages between its outputs and specific sector outcomes envisaged in CSP roadmaps; and is economically, environmentally, and socially sustainable. A project involves PSD activities or is designed to remove specific PSD constraints to attract directly and indirectly other investors, and promote a sustained flow of private capital into specific sectors and countries. The section below explains how ADB should demonstrate development impact (paras. 39-41).
- **PSD content.** Project concepts will be screened early in the process. An early decision in the form of ADB involvement can (i) protect ADB against potential reputational risk (including market perception); (ii) avoid wastage of resources; and (iii) provide project teams early guidance on alternative structures to explore.

⁸ If PSD activities are planned at the subregional level, regional cooperation strategies and programs (RCSPs) will provide the context.

- **CSP as platform.** A project supports PSD activities and outputs envisaged in priority sector roadmaps in a CSP (para. 36).
- **Diversification.** ADB interventions should lead to greater diversification of its overall portfolio among countries, regions, sectors, client types, and transaction structures.
- **Sound banking principles.** A project should be financially viable, creditworthy, and should not impinge negatively on ADB's AAA credit rating or a DMC's country rating.

39. **Demonstrating development impact.** ADB's ultimate performance indicator is its contribution to development outcomes at the country and regional levels. ADB transactions should be designed to achieve specific sector outcomes to support the development impact sought under DMC CSPs or specific regional initiatives. This includes all types of PSD interventions—both sovereign and non-sovereign operations—with both public and private sector borrowers.

40. ADB should work on outlining the desired development impact of individual PSD transactions at the CSP and project levels. CSPs should focus on establishing the linkages between sector-specific and ultimate development outcomes at the country level. Projects should demonstrate reasonable cause-and-effect relationships between project activities and outputs, and between project outputs and specific sector outcomes. Targeted sector outcomes ought to be consistent with the CSP. Box 5 illustrates the steps.

41. The CSP results framework and design and

Box 5. Demonstrating Development Impact—Steps

A. To be demonstrated in CSP results framework:

- *PSD as a key CSP priority.* Inadequate PSD is a major constraint to promoting the three pillars of poverty reduction—growth, social development, and good governance—in the country.
- *PSD outputs linked to sector development outcomes.* PSD activities and outputs are integrated in priority sector roadmaps in support of specific sector outcomes.

B. To be demonstrated in a design and monitoring framework:

- *Consistency between project outcomes and CSP.* A project is designed to deliver a specific outcome that is consistent with a priority sector outcome in CSP.
- *Plausible cause-and-effect relationships between project activities and results.* Project design clearly demonstrates how project activities would deliver the envisaged project outputs, how these outputs would lead to a specific sector outcome, and what risks and assumptions need to be managed.

For example, where “improved access to water” is an agreed sector outcome at the CSP level, ADB may design a project with private sector participation to deliver a more efficient and cost-effective water utility system. Prior to the investment project, ADB may also provide technical assistance to help reform the country's water tariff regime and other regulatory frameworks governing the sector.

- *Sustainability.* In addition to meeting sound banking principles, a project demonstrates that it is economically viable, ensures environmental and social sustainability, and adheres to good governance principles. Furthermore, a project is designed to promote directly or indirectly a sustained flow of private sector investments from others by removing common PSD constraints.

monitoring framework (DaMF) is expected to guide monitoring and evaluation of progress toward specific development outcomes.⁹

D. Output Indicators and Targets

42. **Quality.** ADB outputs under the revised PSD framework have two dimensions—quality and quantity. Improvements in quality at various stages of the project cycle—at entry, during implementation, and post-completion—are expected to be monitored through existing and new planned mechanisms. These include:

- retrospective review of similar projects to learn from experiences (quality at entry),¹⁰
- project implementation performance reviews (quality during implementation), and
- post-evaluation of projects (quality at completion).

43. ADB should bring about continuous improvements in these indicators during the implementation period of the new framework.

44. **Quantity.** In addition to quality, the revised framework aims to expand PSD operations (para. 34) and cofinancing. It is important to translate this quantity-related dimension into specific indicators. To sharpen results-orientation within ADB, it would be better to use loan signing, effectivity, and disbursements as indicators, rather than loan approvals. Possible indicators and targets are:

Indicator 1: Proportion of non-sovereign operations in portfolio

Target: ___ proportion in portfolio, up from the current ___

Indicator 2: Proportion of sovereign operations with PSD content

Target: ___ proportion in portfolio, up from the current ___

Indicator 3: Cofinancing ratio

Target: A ratio of ___, up from the current ratio of 0.5

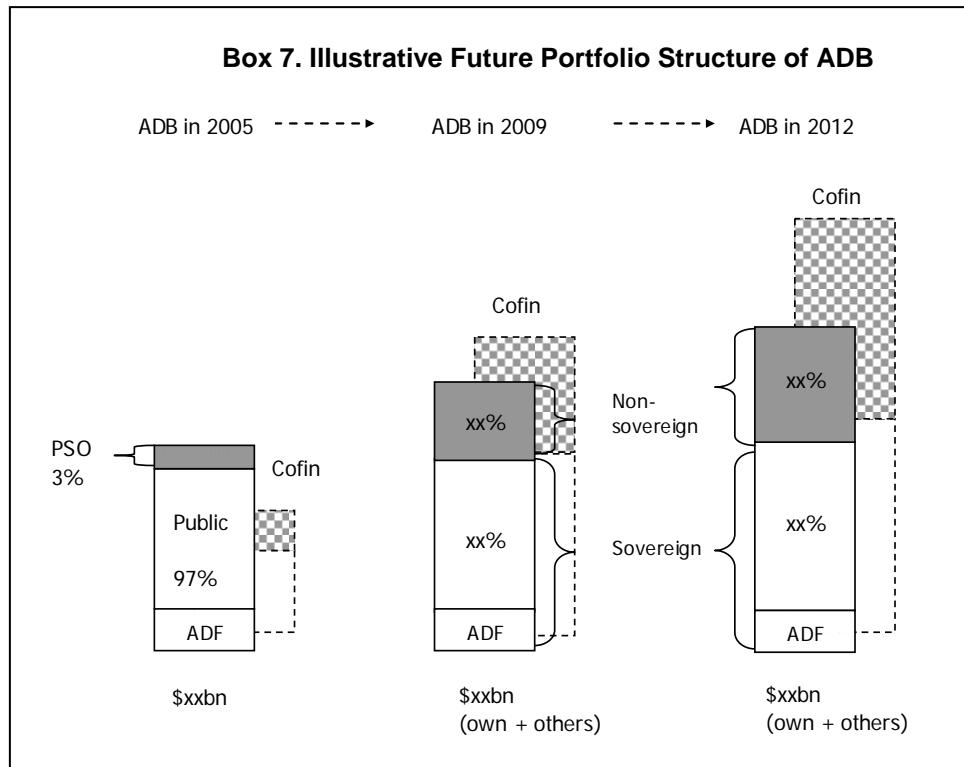
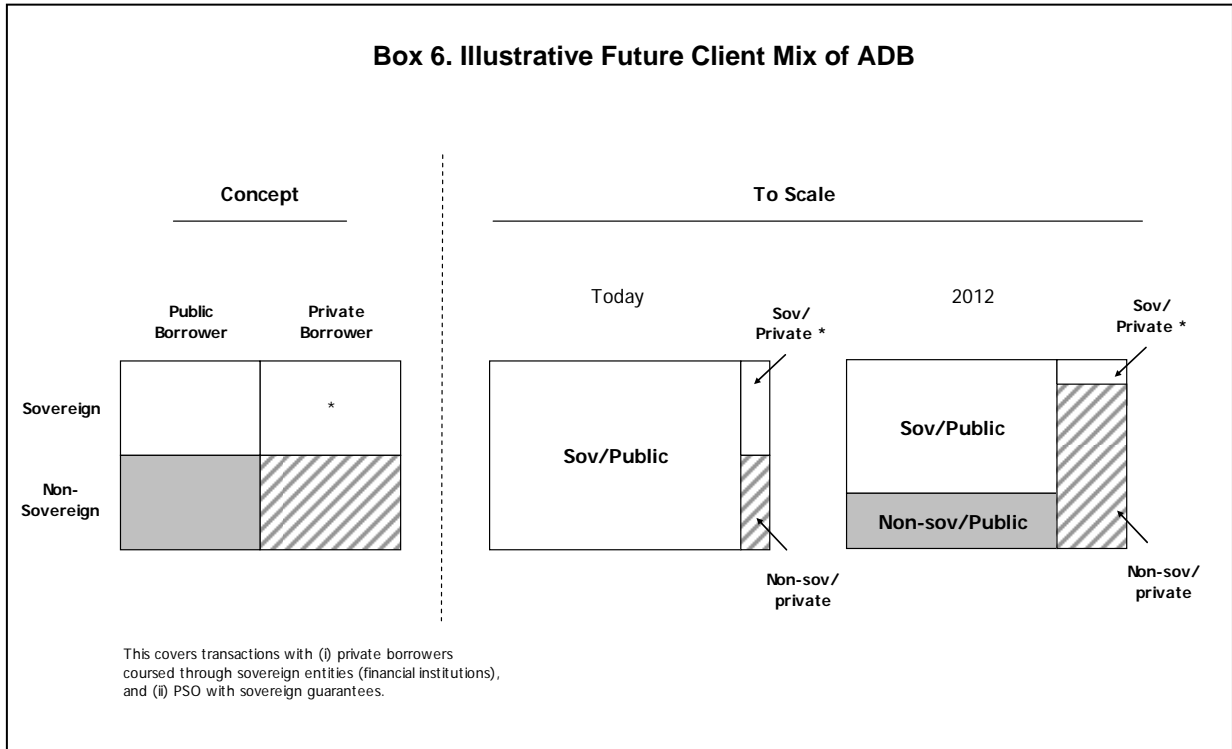
E. Transforming ADB

45. The demands of DMCs are changing (para. 5) and the revised PSD framework aims to respond to their new needs. DMCs may not only be demanding more PSD operations but also more non-sovereign finance. Successful implementation of the revised PSD framework should enable ADB to respond better to DMC demands and expand its PSD operations. As a result, ADB's portfolio might change. Box 6 illustrates a possible scenario. This is not meant to preempt final MTS II proposals. Further, the actual level of non-sovereign finance ADB is able to provide will depend on its balance sheet capacity and other financial considerations, including risk management and credit rating caps to maintain a AAA rating. The level will also be influenced by specific MTS II directions, as well as by demand considerations. ADB's client base is expected to become more diverse, especially if its business increases with regional and

⁹ For more information on DaMF see: <http://bphr/mlptoolkit/knowledge.htm>

¹⁰ ADB will initiate retrospective reviews of CSPs and projects in 2006 to establish quality benchmark of their quality, monitor trends, and disseminate good practices and lessons to enhance quality.

local governments, state-owned enterprises, and private sector entities. These trends would result in a different portfolio and, over time, an increase in cofinancing (Box 7).¹¹



¹¹ This scenario would cause an accelerated depletion of ADB's lending headroom (see Quarterly Treasury Report).

IV. ACTIONS TOWARD SUCCESSFUL EXECUTION

A. Success Factors and Short-Term Actions

46. To deliver the outputs and achieve the desired PSD outcomes envisaged in the revised PSD framework, it is essential that strong and visible leadership and a well-structured plan drive its implementation. Specifically, ADB needs to ensure a series of key success factors are in place. The following section describes these success factors and outlines the set of ADB actions required during the next few years. Successful implementation will require an ADB-wide commitment. Teams with operating, support and coordinating responsibilities will be assigned clear responsibilities and accountabilities.

1. Strategic Clarity on PSD at the Corporate Level

Action 1 Establish PSD as a core business theme in MTS II
[SPD, 2006]

47. PSD is one of ADB's five thematic priorities.¹² A sharpened focus on PSD is vital for ADB to reinvigorate its business portfolio. MTS II needs to clarify a specific context and level of priority for PSD vis-à-vis other themes.

2. CSP as platform

Action 2 Change CSP processes and format
[SPD in consultation with RDs and PSOD, 2006]

48. CSPs are the strategic documents that capture the potential impact of ADB operations at the country level. CSPs should identify priority PSD operations based on sector and thematic assessments, ADB's capacity, and fit with the PSD programs of development partners. This action requires active participation and a partnership between the RDs, PSOD and other relevant departments/offices in the development of CSPs.

49. SPD is expected to finalize proposals to reform CSP processes and format, so as to make CSPs more strategic documents. These proposals are expected to focus on

- improving the quality and depth of diagnostic work on themes (including PSD) and sectors;
- introducing more systematic collaboration among departments;
- setting roadmaps for priority sectors and integrating themes into them;
- positioning roadmaps as a common platform for designing sovereign and non-sovereign interventions (Box 4); and
- separating project concept approval from the CSP process.

50. In the interim (i.e., until new CSPs are developed), each country team, comprising an RD, PSOD and other departments and offices, should define roadmaps and business plans under the existing CSP as a stand-alone exercise.

¹²The other priorities are capacity development, environmental sustainability, gender and development, and regional cooperation.

3. Best practice policies and business processes

Action 3 Adopt a systematic approach to screening and monitoring PSD transactions [SPD, RDs, PSOD, COSO, RSDD, OCO, OED, TD, CTL, 2006-2008]

51. Focus on project quality—at entry, during implementation, and after completion—is essential for ADB to ensure its development effectiveness. This effort requires a systematic screening of operations for PSD content, and thereafter the monitoring and evaluation of PSD interventions against the criteria set out in para. 38.¹³ Screening at the project concept stage is of critical importance to ensure appropriate development solutions and transaction structures are considered and designed right from at the outset. Management attention should focus on “doing the right thing” before processing starts to “do things right”.

52. ADB should establish project concept papers as the key decision document for Management. Currently, Management focuses on projects at the Management Review Meeting (MRM) stage when substantial time and resources have already been invested in preparation and where the scope for modifications to project design and structuring is limited. Earlier Management involvement at the concept stage is essential to help identify issues, consider alternative transaction structures and enhance project quality in a more cost-effective manner. In addition to identifying key issues, and the required due diligence, this earlier entry would allow Management to examine the adequacy of proposed transaction structures (including PSD content), risks, creditworthiness, funding modalities and currency, cofinancing opportunities and potential development impact. This process would also help determine the most appropriate team composition, the terms of reference for external advisors and the processing schedule.

53. Concept papers for PSD transactions—private and public—should be cleared by the operational Vice-Presidents (VPs). They may choose to delegate this authority to their directors general (DGs). Under such scenario, the VPs will thus focus their attention on the more complex transactions or projects with major policy issues. VP oversight for concept clearance and processing would depend on the nature of operations and their geographic location. The arrangement is summarized in Table 2.

Table 2: VP Oversight

Geographic Area	Types of Borrowers and VP Oversight		
	A. Sovereign	B. Non-sovereign	
		Public	Private
OG1	VPO1 (submission by RD)	VPO1 (joint submission by RD and PSOD)	VPO1 (submission by PSOD)
OG2	VPO2 (submission by RD)	VPO2 (joint submission by RD and PSOD)	VPO1/VPO2 (submission by PSOD)

54. In relation to development impact, DaMF will serve as a design, monitoring, and evaluation tool to ensure individual projects deliver specific outputs that lead to specific sector

¹³ The business processes for sovereign and non-sovereign operations are the subject of a paper started under IEI on CSP and business processes. This paper is now being finalized by SPD.

outcomes (paras. 39-41). PSOD should continue to work with OED and the Central Operations Service Office (COSO) to ensure effective introduction of DaMF or its equivalent to PSO documents.

55. RDs are expected to continue to strengthen their project performance management to ensure greater focus on results. PSOD should explore with COSO and OED ways to integrate its operations into the ADB-wide project performance management system, including the application of a project readiness filter.

Action 4 Review existing restrictions on PSO
[SPD, RMU, OGC, PSOD, TD, 2006]

56. ADB should review existing investment restrictions on non-sovereign operations with private borrowers (country, industry, group, and single project exposure limits), and propose specific changes as necessary.

Action 5 Clarify reporting of sovereign, non-sovereign and cofinancing operations in ADB's Annual Report as well as Management Reports. Develop a separate reporting line for non-sovereign operations with public borrowers
[SPD, CTL, COSO, TD, OGC, OCO, RDs and PSOD, 2006]

57. A clear reporting framework would help in establishing agreed baseline data and key performance indicators, and would allow transparent performance tracking. Reporting should distinguish sovereign operations, non-sovereign operations with public sector borrowers which may be undertaken jointly by RDs and PSOD, and non-sovereign private sector operations, as well as consistent treatment of cofinancing in all reporting categories.

4. Clear accountabilities and teamwork

Action 6 Clarify accountabilities for all activities within the business cycle and define business processes for enforcement
[SPD, RDs, PSOD, RSDD, OCO, COSO, CTL, RMU, 2006]

58. Defining accountability for the quality and timeliness of specific outputs is essential to enhanced organizational performance. Only once accountability is clear will effective teamwork and collaboration on PSD within ADB be possible.

59. While all staff are responsible for implementing the PSD framework, various departments and offices should be accountable for the quality of certain outputs. DGs of RDs should remain accountable for preparing quality CSPs and their successful implementation. They will need to ensure the involvement of PSOD and support teams in defining ADB's strategic framework for each country, including the approach to PSD. RDs and PSOD should jointly formulate a common business plan to execute CSPs in line with the priorities identified in sector roadmaps. Support departments should define their own work taking into account these priorities and business plans.

60. Accountability for processing and implementing sovereign and non-sovereign lending and investment operations should be defined as follows:

- **Non-sovereign operations with private borrowers**—PSOD will be responsible.

- **Non-sovereign operations with public borrowers**—All transactions will be processed and implemented by a team comprising RD and PSOD staff, unless DG/RD and DG/PSOD specifically agree otherwise. Coverage will include SOEs, municipalities, and public goods and services projects involving public and private initiatives. The team leader and composition will be endorsed by Management at the concept clearance stage.
- **Sovereign operations**—RDs will be responsible.

61. Teamwork will be expected under all types of operations. RDs and PSOD will be jointly responsible for promoting teamwork and information sharing to ensure quality, synergy, and complementarity across operations.

Action 7 Clarify accountabilities of other departments/offices in relation to PSD activities
[SPD, all support units/departments, 2006]

62. All support departments/offices are expected to align their work plans and motivate staff to contribute to greater PSD orientation. RSDD should support RDs with sector and thematic work, and best practice on project structures. RMU should be accountable for ensuring the creditworthiness of individual transactions and of ADB's overall portfolio. OCO should work with RD/PSOD to increase cofinancing for both sovereign and non-sovereign transactions. TD should assist teams working on capital markets and local currency lending (see also para. 71). COSO should support teams with consulting services and procurement matters.

5. Role of Cofinancing

Action 8 Prepare a strategy paper on co-financing
[OCO, RDs and PSOD, 2006]

63. ADB is mandated to cooperate with others on the mobilization of public and private capital for development activities.¹⁴ Responding to this mandate, ADB pursues cofinancing operations—raising and directing official and private financial flows to its DMCs—to leverage ADB's financial resources.

64. The rapid economic growth in the region calls on ADB to raise its profile as a financial catalyst and risk intermediary rather than being only a direct lender. The rising liquidity in the region reinforces this call. ADB's stand-alone funding and impact is limited. ADB's value-added will be measured, in part, by its success in reducing investment risks for others and its ability to attract domestic and international funding into development activities. Third-party fund raising is essential to ensure ADB's relevance. This co-financing role needs to be among the top priorities of ADB's corporate strategy. ADB should update its policy on credit enhancement and risk mitigation instruments under a new Credit Enhancement and Guarantee Policy, and prepare a revised Cofinancing Strategy.

¹⁴ *Agreement Establishing the Asian Development Bank, (Articles 2 [i] and [v]).*

6. Market-oriented products and services

Action 9 Implement ongoing initiatives under IEI and explore the need for business lines and financial instruments
[IEI, RSDD, RDs, PSOD, support units and departments, 2006-2008]

65. Based on market trends, ADB should continue to assess and update its operational modalities and instruments as needed to best serve the PSD needs of DMCs.

66. ADB should continue to implement selected IEI proposals, including the pilot testing of new financial instruments and modalities.¹⁵ It should assess the need for new products and services and explore initiatives in new areas, several with potential PSD content, such as the carbon credits market, energy efficiency, clean air, water, wastewater, waste management, transport (including urban transport), municipal finance, capital markets, and small and medium enterprises and microfinance.

7. Capable and motivated staff

Action 10 Develop and begin implementing a skills development program
[BPMSD, RDs, PSOD and SPD, 2006]

67. ADB does not possess the right skills mix to support its transition to a more market-oriented and client-responsive institution. ADB needs a stronger skills base and leadership, especially in the areas of institutional analysis, policy reform, technical and sector knowledge, and project and structured finance.

68. BPMSD, in coordination with SPD, RDs, PSOD, and others (including the Communities of Practice and other departments/offices), should develop an integrated skills development program based on a skills inventory exercise and defined competency requirements. The program may consist of an enhanced recruitment campaign, reallocation of existing skills, and intensive staff orientation and training on PSD knowledge and other skills.

Action 11 Create a new incentive system for staff on PSD
[BPMSD, RDs, PSOD, SPD, CTL and COSO, 2006]

69. To ensure collaboration and greater productivity, ADB staff must not only have the right skills but also be motivated and willing to prioritize their time and resources to promote PSD. This will require strong leadership from Management and actions that demonstrate the importance of PSD. In addition, performance assessment and reward mechanisms need to consistently recognize staff contributions to PSD work, including teamwork and cofinancing.

70. ADB should adopt a system whereby both RD and PSOD teams are each given full credit for joint transactions (although single booking by ADB in external reporting), including cofinancing. This system should be reflected in the PDP process.

¹⁵ These cover consultancy and procurement, safeguards, CSP and business processes, cost-sharing and eligibility, and local-currency loan product.

8. Risk management capability

Action 12 Establish clear policies and procedures for independent risk assessment and management, and resource RMU
[SPD, RMU, OCO, OGC, TD, CTL, 2006]

71. Execution of the revised PSD framework will change ADB's risk profile. ADB should continue building its capacity to assess and manage risk—at the project and overall portfolio levels—and ensure adherence to sound banking principles. Staff instructions on credit risk policy and procedures should be issued as soon as possible, and integrated into a new section of ADB's Operating Manual. TD should carry out stress tests on ADB's *pro forma* financial statements to work out the appropriate level of risks (and timing) that can be taken as a result of more non-sovereign finance. OCO should work with RDs, PSOD, RMU and OCG on new guidelines for the underwriting and documentation of guarantee operations, as well as exploring new areas such as risk sharing partnerships, syndications, sell-downs and reinsurance.

9. Client and Relationship management

Action 13 Adopt a more systematic approach to managing client relationships
[Operational VPs, 2006-2008]

72. ADB must maintain credible and professional relationships with its clients. This requires consistent and coherent communications based on sound internal coordination and collaboration, and a systematic approach to managing client relationships.

73. ADB should speak with one voice in all communications with clients. Any violation of this "one-ADB, one-voice" principle should be brought to Management's attention. Integration of this principle across ADB should be driven by the integrity and common sense of individual staff. RD staff should communicate fully with their PSOD counterparts regarding emerging PSO opportunities in DMCs. PSOD staff should advise their RD counterparts (including country directors) of planned communications with DMC governments and sub-sovereign entities in relation to PSO and their outcomes in a timely manner. All relevant parties within ADB should be fully informed and involved in a dialogue with governments or sub-sovereign entities throughout the life of a project (i.e., transaction structuring, processing, implementation, and workouts). DGs of RDs and PSOD should jointly define specific procedures to ensure active information sharing on business opportunities.

B. Beyond the Short Term

74. With successful implementation of the revised PSD framework, ADB would be operating under a different business model by 2012—one that is more market-oriented, has a different portfolio structure and more diversified clientele. As this transformation proceeds, ADB will need to assess the scope for further changes, including to its products and services, skills, structure, and particularly, its risk management capacity.

75. A successful transformation of ADB's skills base will result in increased operational convergence between RDs and PSOD.

C. Implementation

76. Implementation of the revised PSD framework will require effective and timely changes. The process will be complex, time-consuming, and at times, resource intensive. ADB will need to allocate adequate resources to execute the framework and manage the required organizational changes. The latter should be done in close consultation with BPMSD. Firm commitment and strong leadership at all levels will be essential to mobilize the organization toward this goal. Experience of the last five years has demonstrated that implementation will suffer if leadership is not in place. Progress on implementation of the strategic framework will be reported through the periodic reports on ADB's Reform Agenda.

77. Management is ultimately accountable for delivering the new PSD framework. Management should steer the reorientation of ADB in line with the PSD framework and actively promote an enabling culture that nurtures teamwork and discourages territorial behavior.

V. CONCLUSION

78. The private sector drives economic growth in the Asia and Pacific region. Economic growth drives the region's development. ADB's DMCs recognize these facts and are determined to bring the concrete benefits of development—economic opportunity, education, health care, dignity—to their people.

79. The Asian Development Bank was established to foster economic growth and contribute to the economic development of DMCs.¹⁶ ADB is uniquely placed to offer integrated PSD solutions. With public and private sector expertise housed in one institution, ADB can leverage its special relationships with DMC governments and its range of financial products and services to help DMCs give investors what they need: certainty, predictability, and confidence.

80. To maximize ADB's PSD potential, ADB, too, must have certainty, predictability, and confidence in its strategic direction. The PSD framework outlined in this paper (Section III) is designed to meet this need. The actions presented in Section IV will transform ADB into a market-oriented, client-focused development bank able to help its DMCs attract the private investment essential to their future development.

¹⁶ *Agreement Establishing the Asian Development Bank, Article 1.*