

Management Response to the Thematic Evaluation Study on ADB Private Sector Operations: Contributions to Inclusive & Environmentally Sustainable Growth

On 4 September 2013, the Director General, Independent Evaluation received the following responses from the Managing Director General on behalf of the Management.

I. General Comments

1. We welcome the Thematic Evaluation Study on ADB Private Sector Operations: Contributions to Inclusive and Environmentally Sustainable Growth (the Study). We thank IED for incorporating a number of comments transmitted during the interdepartmental review process. Notwithstanding, a number of major concerns and reservations remain.

Nature of Private Sector Operations

2. ADB pursues a variety of objectives for nonsovereign operations (NSO). Instruments and modalities employed do not all have to contribute evenly to all these objectives. In achieving these objectives, NSO are surely required to be more sensitive to financial returns.

3. The Study suggests that private sector operations (PSO) should directly support the poor and disadvantaged. While the poor are certainly bankable, the role of the private sector is to foster competition, in turn, raising affordability and improving quality of services so that these services could be used by low-income households to ensure choice and affordability. While all private sector projects contribute to inclusive growth (IG) either directly or indirectly, direct IG interventions can only represent a relatively modest proportion of PSO. It should be recognized that direct IG interventions are time-consuming and resource-intensive.

4. The Study suggests no evidence of a trade-off between projects being inclusive and having satisfactory investment returns. The IG projects reviewed by IED were those which were selected for their financial and economic viability. It should be recognized that a satisfactory return is a precondition for all PSO. Accordingly, it is not surprising that these are both bankable and inclusive. Our experience, as well as that of other development finance institutions (DFIs), indicates that opportunities for financially viable IG are limited. As indicated in the Study, IFC has invested \$7 billion in inclusive business between 2005 and 2012. This is equivalent to 6.2% of IFC's total commitments of \$112 billion (including B-loans and parallel financing) over the period.

5. PSOD involvement in project design could result in an inherent conflict of interest with legal implications. Accordingly, in contrast to ADB's public sector operations, PSOD is generally not involved in the project development stage. PSOD's role is to work constructively with the private sector to optimize development results, with a focus on efficiency, innovation, and private sector development. Like other DFIs, PSOD is principally a project financier and invests

a maximum of 25% of a project's total cost. PSOD influences project design through project selection and the resulting demonstration effect.

6. NSO needs to combine development objectives with considerations for economies of scale and creditworthiness. Furthermore, there is a limit to ADB's capacity to process IG transactions due to: (i) the usual, modest project size against ADB's high fixed transaction cost; (ii) constrained technical assistance and staff resources; and (iii) risk management policies and associated capital allocation. For example, the \$2 million intervention in the Simpa off-grid pay as-you-go solar power project in rural India is highly inclusive. While the project is expected to yield high development impact, to achieve the 2013 indicative planning figures target of \$1.75 billion, PSOD would have to process 875 Simpas.

Evaluation Approach

7. We have reservations on the application of the concepts of IG and environmentally sustainable growth retroactively to a sample of projects approved before the corresponding policies were in force. This reservation was communicated on the proposed evaluation approach. Whereas the sample of projects covers the period 2000 to 2012, the concept of IG was not introduced until Strategy 2020 (S2020) in 2008. We therefore question the application of IG criteria retroactively to projects approved between 2000 and 2008. Prior to 2008, the Study should have reviewed the performance of PSO against poverty reduction through contribution to economic growth which was ADB's objective for PSO. Similarly, while we agree that some elements of the 2009 Safeguard Policy Statement were already in existence prior to its introduction, we feel that selected projects should have been reviewed against the safeguard requirements enforced at the time of approval.

8. We believe that the sample of projects evaluated is small and dated, being based on extended annual review reports. Accordingly, the Study's findings do not capture recent practices in NSO, which have intensified emphasis on IG projects.

9. The Study has applied varying levels of benchmarks for different safeguard categories of projects. For category A projects, the review focused on safeguard documentation and the application of policy principles; for category B projects, on the procedural requirements; and for category FI projects on safeguard requirements. No rationale was provided for this approach. For the Study to produce credible findings, benchmarks should be clear and consistently applied across all projects reviewed.

Definition of Inclusive Growth

10. IED's definition of IG deviates substantially from ADB's own framework for inclusive economic growth and is much narrower.

11. ADB's Private Sector Development Strategy (2000) and the Long-Term Strategic Framework promote high economic growth: (i) growth creates jobs and labor is the only asset of the poor; and (ii) growth widens the tax base, increasing

potential for governments to provide basic social services to the poor. This was reaffirmed in the Private Sector Development: Revised Strategic Framework (2006). In 2008, S2020 defined IG as “***growth that focuses on creation and expansion of economic opportunities, and ensures broader access to these opportunities.***”

12. A functional definition of IG was articulated in March 2013, in the Guidelines on Inclusive Economic Growth in the Country Partnership Strategy (the Guidelines), through three pillars: ***(i) high and sustainable growth to create and expand economic opportunities, including jobs; (ii) broader access to economic opportunities, including jobs, especially for the poor and disadvantaged, to ensure that members of society can participate in and benefit from growth; and (iii) provision of adequate social protection to reduce poverty and vulnerability.*** In this regard, we have strong reservation on IED’s introducing criteria for direct inclusion, as outlined in para. 53 of the Study, which deviates from the ADB framework. The S2020 definition should have been applied in assessing 2008 to 2012 projects.

Benchmark for PSOD’s Performance in Inclusive Growth

13. One of the main findings of the study is that the share of NSO directly seeking to promote inclusion has not increased after S2020 and has remained at less than 13% of total approvals (para. 46 of the Study). Notwithstanding our reservation about IED’s criteria we believe that maintaining the 13% share should be recognized as an achievement considering that annual lending has almost tripled over the period.

14. The aforementioned Guidelines suggest that operations could contribute to *any one* or more of the three pillars of inclusive economic growth. We reiterate that NSO’s contribution to IG should be measured in the broader context of its direct as well as indirect contribution.

Financial Sector NSO

15. One of the main findings of the Study is that the impact of PSO on access to finance is unclear. To derive meaningful conclusions about PSO’s impact on financial sector development and inclusiveness, a more comprehensive analysis based on (i) a wider survey and (ii) public sector interventions within a country should have been undertaken.

16. The following critical questions should have been raised to ascertain ADB’s value addition and development impact on small-and-medium-sized enterprises (SMEs): were SMEs able to obtain (i) longer tenors than available in the market; (ii) lower interest rates; and (iii) the required amount of finance. With regards to supporting financing availability, we note that none of the SMEs in PSOD’s private equity fund portfolio had access to alternate equity funding. Moreover, SME support should not be limited to SMEs that do not have access to finance. Maintaining access to finance is in itself an important objective. We also believe that the sample used for SMEs is too small and dated.

17. In S2020, the development of the financial sector is recognized as essential to sustainable private sector-led economic growth. To promote IG, ADB seeks to create an enabling environment for microfinance, rural finance, and SMEs. This conceptual link has been recognized by research and has contributed to the establishment of the G20 forum on SMEs. In 2009, an ERD study reviewed the theoretical and empirical literature on the role of financial sector development in facilitating economic growth and supporting poverty reduction. The ERD study underpinned the support for SME interventions. The ERD study also notes there is a consensus that financial sector development: (i) has a vital role in facilitating economic growth; and (ii) contributes to poverty reduction (and a major channel of that is through economic growth). The Private Sector Capital Markets Business Plan is based on the ERD study and specifies project selection criteria, including development impact. The financial sector operations promote S2020 objectives by conducting developmentally effective transactions with its private sector clients on commercial terms.

18. Over the past two years, PSOD has also introduced a gender mainstreaming checklist for banks onlending to SMEs. This process has resulted in several ADB client banks committing to targets for women-owned or managed SMEs. In 2012, the Trade Finance Program supported \$3.9 billion of trade finance for 1,577 SMEs in 18 countries with 96% of transactions in ADF countries.

II. Comments on Recommendations

19. We note that some of the Study's recommendations have been implemented.

Recommendation 1. PSOD needs to update its internal business strategy to help operationalize inclusive and sustainable growth objectives.

20. We do not believe that there is a need to update PSOD's business strategy. However, given that the midterm review of S2020 is ongoing, we will look into this issue in the context of the evolving corporate strategic framework. We are also mindful of the suggestions in the Study on operationalizing inclusive and environmentally sustainable growth which we will review and implement, as appropriate, going forward. We are already addressing IG through selected highly demonstrative projects with inclusive elements. Furthermore, PSOD has completed a RETA on inclusive business with RSDD and is now working on operationalizing its recommendations.

21. In line with corporate priorities, within its operational constraints, PSOD has been actively seeking to enhance inclusive and environmentally sustainable growth objectives within its business strategy. In addition to ADB's core areas of intervention, infrastructure and financial sector, PSOD is diversifying its operations and widening the scope for identifying projects with IG elements. Agribusiness, education, manufacturing, and health are among these areas. Examples include Simpa off-grid pay-as-you-go solar power project in rural India, the Pune Slum Rehabilitation Project, and the microfinance risk participation program in India and Bangladesh. Frontier markets and disadvantaged areas in other DMCs are already priorities embedded in PSO with a target of 40% of NSO in A and B countries by 2015. Over the past three years PSOD has achieved an average of 37%. We anticipate that the 40% target will be achieved by 2015. In

terms of NSO in economically disadvantaged areas in middle income countries, please note that PSOD has targeted tier 2 and 3 municipalities for water supply and waste to energy projects in the PRC. In addition, financial sector projects do establish gender and regional targets whenever feasible and agreed with private sector clients. Labor standards and gender mainstreaming have been further integrated in PSOD's interventions. The lead role of ADB's PSO towards environmentally sustainable growth (i.e., clean energy, energy efficiency, and climate change) also should be duly recognized.

22. While PSOD is making concerted efforts to promote inclusive and environmentally sustainable growth, it should however be recognized that, in view of inherent constraints, such transactions can only make up a modest proportion of PSO.

23. ADB is engaged in policy dialogue to remove constraints to private sector investments in social infrastructure and finance. We agree that additional emphasis could be placed on these areas. We also agree that policy dialogue to establish a conducive environment for clean energy and energy efficiency operations could be enhanced. It is our quest to expand the ADB's footprint in clean energy. In some countries, public sector investment is the only option to initiate investment in new sectors. To attract private sector investment, a robust regulatory framework should be in place.

Recommendation 2. PSOD and ADB need to (i) improve their analysis of project contributions to inclusive growth and related transmission channels, and (ii) strengthen their capacity for technical and economic feasibility assessments of clean energy projects.

24. We agree that we could improve in these areas. A few procedural examples in place highlight our efforts in this regard. The sector analysis and economic analysis undertaken for each PSOD transaction identify the development challenges facing the country and the sector. While each Report and Recommendation of the President (RRP) may not repeat the theoretical underpinnings of the transmission channels and causal pathways, the 2012 PSO Development Effectiveness Report (DEfR) elucidated these for each sector. The PSO DEfR also recognizes that while it is our best aim to achieve certain objectives with particular interventions there are inherent risks and critical assumptions being made, with regards to the transmission channels. The assumptions and risks related to the achievement of objectives are captured in the DMF for each transaction.

25. PSOD undertakes comprehensive due diligence on clean energy projects, including an assessment of their technical and economic feasibility. Furthermore, external independent lenders' technical advisers are systematically engaged to review the technical viability of each project. To further strengthen the economic and financial analysis, PSOD is coordinating with ERD and RSDD, especially on the valuation of environmental costs and benefits, and the social discount rate for clean energy projects. The treatment of environmental and social safeguards is one of the major ADB contributions to its interventions.

Recommendation 3. PSOD needs to strengthen the monitoring of PSO development outcomes by (i) improving the inclusion of relevant outcome statements and indicators in project design and monitoring frameworks, and (ii) systematically collecting required monitoring reports from private sponsors and fund managers.

26. We feel that this recommendation is redundant since it is already being implemented. It should be recognized that while there is room for improvement, since 2009 substantial effort has already been made in this area. A dedicated Development Effectiveness and Safeguards Team was established to strengthen the development rationale of NSO. The DMF for each PSOD transaction contains a concise and logical outcome statement, with indicators to measure the associated development objectives.

27. PSOD also formally tracks and reports its contribution to ADB's corporate results, including those related to sector outcomes in an annual publication, the PSO DEfR. The 2012 PSO DEfR articulates how PSO contributes to ADB strategic objectives, including inclusive and environmentally sustainable growth. Since 2013, legal agreements for PSO have a clause requiring private sponsors to report on development results as articulated in the DMF.