

# Operations Evaluation Department

African Development Bank Group

# 2013

## Independent Evaluation of Non-Sovereign Operations, 2006-2011 **SUMMARY REPORT**



AFRICAN DEVELOPMENT BANK GROUP



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## 2013

Independent Evaluation of Non-Sovereign  
Operations, 2006-2011

## SUMMARY REPORT (Redacted)

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#### **About OPEV**

The mission of the Operations Evaluation Department is to enhance the development effectiveness of AfDB initiatives in its regional member countries through independent and instrumental evaluations and partnerships for sharing knowledge.

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# ACRONYMS

AAA	Best risk rating of long-term credit	GECL	General Counsel and Legal Services Department
ADF	African Development Fund	IDC	Industrial Development Corporation
ADOA	Additionality and Development Outcome Assessment	IFC	International Finance Corporation
AFD	Agence Française de Développement	IFI	International Financial Institution
AfDB	African Development Bank (the Bank)	IFRS	International Financial Reporting Standards
ALCO	Asset and Liability Management Committee	KPI	Key Performance Indicator
ALM	Assets and Liabilities Management	IO	Investment Officer
AsDB	Asian Development bank	LGD	Loss Given Default
ASR	Annual Supervision Report	LIBOR	London Interbank Offered Rate
bp	Basis Point	LIC	Low Income Country
BTOR	Back To Office Report	LOC	Line of Credit
COBS	[Budget Department]	MDB	Multilateral Development Bank
CRC	Credit Risk Committee	MIC	Medium Income Country
CSP	Country Strategy Paper	MSMEs	Micro, Small and Medium-Sized Enterprises
CTM	Country Team Meeting	NPL	Non-Performing Loan
DBSA	Development Bank of Southern Africa	NSO	Non-Sovereign Operation
DEG	Deutsche Investitions- und Entwicklungsgesellschaft mbH (part of the German Development Corporation)	OCS	Inventory software
DFI	Development Finance Institution	OPEV	Operations Evaluation Department
DO	Development Outcome	OPSCOM	Operations Committee
EBRD	European Bank for Reconstruction and Development	OPSM	Operations, Private Sector and Micro-finance Department
ECON	Complex of the Chief Economist	ORPC	Operations, Resources and Policies Department
EDRE	Development Research Department	ORQR	Quality Assurance and Results Department
EL	Expected Loss	OSGE	Governance, Economics and Financial Reforms Department
FAPA	Fund for African Private Sector Assistance	PACL	Performance Adjusted Country Limit
FDI	Foreign Direct Investment	PAR	Project Appraisal Report
FFCO	Financial Control Department	PCN	Project Concept Note
FFMA	Financial Management Department	PD	Probability of Default
FO	Field Officer	PPP	Public-Private Partnership
FS	Fragile State	PRR	Project Risk Rating System
GDP	Gross Domestic Product		

PSO	Private Sector Operation	SLL	Sustainable Lending Limit
PSR	Project Supervision Report	SMEs	Small and Medium-Sized Enterprises
RCUR	Risk Capital Utilization Rate	TA	Technical Assistance
RMC	Regional Member Country	UA	Units of Account
SAP	Software for managing business operations	WARR	Weighted Average Risk Rating
SCN	Summary Credit Note	XSR	Expanded Supervision Report





# Definitions

<b>Approval / Commitment / Disbursement:</b>	A Bank investment is firstly approved by the Board, following which sanction the Bank then negotiates, agrees and signs an investment agreement with the client to reach commitment. The funds are then disbursed to the client once it has met a prescribed set of conditions (conditions precedent).
<b>Client or Company:</b>	The entity implementing the project and, generally, the Bank's investment counter-party. For financial markets operations, it refers to the financial intermediary (or fund manager) as distinct from its portfolio of partially Bank-financed sub-borrowers or investee companies.
<b>Investment:</b>	The Bank's financing instrument(s) that featured in the operation: loan, guarantee, equity, risk management product, underwriting commitment, etc., singly or in combination.
<b>Investment Operation:</b>	The Bank's objectives, activities and results in making and administering its investment.
<b>Line of Credit / Credit Line:</b>	A project whereby the Bank advances a loan to a financial intermediary (such as a private sector bank), the proceeds of which are then on-lent by that bank to its own clients (sub-borrowers).
<b>Non-Performing Loan:</b>	A loan that is in default or close to being in default, usually when payments of interest and principal are past due by a prescribed number of days (typically 90) or more.
<b>Private Equity Fund:</b>	A private equity fund typically makes investments in unlisted companies funded with the capital raised from limited partners. A private equity fund is raised and managed by investment professionals of a private equity firm (the general partner or fund manager).
<b>Project:</b>	The client company's objectives, capital investments (for real sector projects) or financial investments (for financial markets projects), funding program and related business activities and results that were partially financed by the Bank's investment.
<b>Public-Private Partnership:</b>	A public service or private business venture that is funded and operated through a partnership of government and one or more private sector companies.
<b>Strategy (Private Sector):</b>	The Bank's overall vision for promoting private sector development through its non-sovereign operations, as set out in its Mid-Term Strategy 2008-2012.
<b>Strategic Objective:</b>	One of five objectives that underpin the Bank's Private Sector Strategy and which all non-sovereign operations are expected to support.
<b>Strategic Priority:</b>	Strategic priorities reflect the way in which the Bank operationalizes its strategic objectives, for example by allocating resources for the promotion of transactions in certain sectors, countries and client groups.

# Acknowledgements

This summary report was prepared by Nicholas Burke, Independent Consultant, under the overall guidance of Mohamed Manai, Manager of the Projects and Programs Evaluation Division at the Operations Evaluation Department (OPEV) of the African Development Bank. The Evaluation Team comprised Grace Kyokunda, Chief Evaluation Officer, Hadizatou Sidikou, Principal Evaluation Officer and Clément Bansé and Emmanuel Kouassi Kouadio who provided research assistance. This report is based on technical reports prepared by a team of consultants from Deloitte—USA and Republic of South Africa, on four separate streams:

- Strategic Alignment
- Portfolio Performance
- Risk Exposure
- Institutional efficiency

Deloitte's consultancy team (Brian Mc Donald, Charles Alsdorf, Mike Vincent, and Rich Simon) prepared an Inception Report following a scoping mission in May 2012, conducted the review from July through September 2012, and submitted its findings to the Bank for each of the four work streams as well as a Summary Report. Peer

reviewers, Jack Glen, IEG-WB and Alejandro Soriano (Evaluation Office, laDB) provided helpful comments for shaping and finalizing the review.

The findings, conclusions, and recommendations are based on file analysis, direct staff and subject matter interviews, details surveys, field-and phone based interviews of twenty four clients, and where possible, external benchmarking with other multilateral development banks and development finance institutions, including IFC, EBRD, AFD, IDC and DBSA. The evaluation also benefitted from discussion of draft reports with the evaluation reference group comprising major internal stakeholders (OPSM, FFMA, FFCO, EDRE, ORPC, etc.) in a series of meetings held on 13-15 November 2012.

The Inception Report as well as the technical work stream reports are available upon request from OPEV.

This Summary Report has been redacted to remove sensitive and/or confidential information and to protect the identities of the entities involved. This was done so that the evaluation can be disseminated to a wider audience.

# Executive Summary

This report reviews the performance of the Bank in relation to its private sector (non-sovereign) operations. It is based on the Bank's portfolio of 137 investments that were approved by the Board between 2006 and 2011, and which account for a total approved investment volume of UA 3.9 billion, of which UA 3.5 billion is committed.

In undertaking the study, the consultants collected data from document reviews, staff and client interviews, and field visits to a sample of projects. To interpret this data, they used methods such as trend and descriptive analysis, content and causation analysis, regulatory impact review, and portfolio segmentation by different factors such as sector and geography. Bank practices and performance metrics were also benchmarked against other Multilateral Development Banks (MDBs) and Development Finance Institutions (DFIs).

This Executive Summary Report highlights the key findings, conclusions, and recommendations from each of four underlying technical reports, which addressed the Bank's strategic alignment, portfolio performance, risk management and institutional efficiency.

## Strategic Alignment

To date, the Bank's private sector operations have been focused narrowly on investment activity rather than on broader market reforms. Most Bank support for private enterprises is via senior loans and credit lines, although the equity portfolio has grown rapidly in recent years. In comparison, the Bank has made relatively little use of other

instruments such as guarantees, trade finance facilities and technical assistance. In general, the private sector portfolio is well-aligned with the Bank's sector-level targets. Interventions in the financial sector largely comprise lines of credit to banks and regional DFIs. However, the Bank's reach to micro and small enterprises through these credit lines is not always evident. Bank support of privately-led infrastructure projects has had profound, positive effects on development, though more can be done to identify and structure projects that enhance regional trade and integration.

Recommendations arising from these findings include: clarifying the link between the Bank's priorities at the transactional level and its broader strategic objectives; strengthening the One Bank approach to break the silos and allow better synergies between the departments, deploying a broader range of instruments to address failings at macro, sector and regulatory levels, and which promote local currency and trade finance; and reviewing the strategy for financial sector support to ensure that these interventions achieve their intended reach and development goals.

## Portfolio Performance

The Bank has a strong financing role in low-income countries and has been counter-cyclical following the global economic crisis. Despite this, the Bank has not been proactive in identifying and developing viable investment projects on the ground, relying instead on sponsors to approach it with requests for funding support. From a development perspective, the Bank screens its pipeline

such that all approved projects are expected to have efficacious development outcomes and/or Bank additionality. However, the Bank has inadequate monitoring procedures to enable it to gather credible results data during supervision, so limiting its ability to judge outturn development effectiveness. The profitability of the Bank's loan portfolio is not yet evident, though there has been a recent increase in non-performing assets.

Consequently, the report recommends that the Bank: leverage its use of technical assistance and capacity building to add value to clients; strengthen its policies, procedures and staff resources for project monitoring and evaluation; review its equity portfolio to identify and address the reasons for underperformance; and introduce a performance measurement system with scorecards that balance incentives for volume growth with other priorities such as client responsiveness, profitability and development effectiveness.

## Risk Management

The May 2010 General Capital Increase has created more headroom for the Bank to expand its private sector operations going forward. This, along with the new capital allocation methodology should allow the Bank to implement its private sector strategy whilst managing its scarce resources. However, there are target growth areas within the strategy that need to be monitored closely to remain within prescribed capital and risk limits, including equity investments and exposure in low-income countries and fragile states. The Bank uses a standardized credit approval process, which is not always warranted in the case of smaller or lower-risk investments. It has recently adopted a new loan pricing framework, which brings it into

line with other commercial and multilateral banks, though evidence suggests it could be under-pricing loans relative to its peers, in particular for high-risk transactions.

In relation to its risk management, the report therefore recommends that the Bank: review the coherence of the private sector strategy and associated objectives with its risk management framework, to address possible future constraints on priority areas like equity investment and support of low-income countries and fragile states; consider delegating approval authority to levels below the Board; reinforce its procedures and systems in relation to loan collateral and address the apparent under-pricing of its loan operations for high risk projects; and establish a dedicated workout function for at-risk investments.

## Institutional Efficiency

Efficiency measures for the Bank fall short of those in other institutions. For example, the Bank's project origination processes employ more steps than other MDBs and the time taken to reach approval is significantly longer. Other MDBs employ streamlined procedures or framework agreements, combined with delegated authority, which help to expedite approval times for certain classes of investment. The Bank's complement of staff in private sector operations has grown to 80, including 39 investment officers and 13 portfolio officers. In general, these staff exhibit skills across most sectors and disciplines central to the private sector strategy. Increasingly, staff are being relocated to, or recruited in, the field as part of the Bank's decentralization roadmap. An overriding concern, however, is the repeated

failure of the Bank to budget adequately for its private sector operations.

In an effort to increase the Bank's institutional efficiency, recommendations include: proceeding with decentralization to place a critical mass of private sector staff in the field, with adequate support from the OPSM ecosystem; reviewing approval procedures with the help of client feedback to identify areas of duplication, repetition

or low value-added; developing streamlined procedures or framework agreements for approval of investments that fall below specified risk criteria; upgrading its Management Information System and introducing time-recording to track staff activities during project origination and supervision; and addressing current deficiencies in the budgeting process to ensure that budgets for private sector operations are credible and sufficient.

# African Development Bank Management Response

**Management welcomes the independent review of the Bank's Private Sector Operations (PSO) as an opportunity to learn from experience and to inform future practice. More can be done to improve the impact and effectiveness of PSO. The review's recommendations are a good entry point to further refine the key tools and processes that define the Bank's PSO framework, namely the Bank's new Private Sector Development (PSD) Policy and Strategy, as well as a new Policy and Business Plan for PSO covering the period 2013-17. All four documents will be completed in 2013.**

The Bank's overall vision for private sector development links entrepreneurship and capital investment with its broader development objectives for sustainable economic growth and poverty alleviation. This vision—outlined in the Bank's 2004 Private Sector Development (PSD) strategy, the 2008 PSD Strategy Update and Business Plan for PSO—is underpinned by five objectives:

- Improving the investment climate.
- Supporting private enterprises.
- Strengthening financial systems.
- Building competitive infrastructure.
- Promoting regional integration and trade.

While the Bank has implemented the Strategy through both sovereign and non-sovereign guaranteed transactions, this review concerns only the latter. The Bank provides support to the private sector through direct loans, credit lines, direct equity investments, participation in private equity funds and to a lesser extent through risk sharing facilities. From a single digit levels prior to 2000, non-sovereign operations have averaged 30% of the total volume of Bank approvals since then. Between 2008 and 2011, PSO approvals amounted to UA 4.8 billion, accounting for 30% of total new Bank commitments.

Key observations of the evaluation and management's responses are summarized as follows.

## Strategic Alignment

Management agrees with the finding that there has been particularly strong alignment of the PSO portfolio with three pillars in the Bank's PSD strategy, namely: supporting African enterprises, strengthening African financial markets and building African economic infrastructure. On business enabling environment pillar, an increasing number of the Bank's public sector operations address issues related to the improvement of the investment climate. The Bank's indicators in this area suggest major improvements in the business environment as a result of the Bank's assistance. There is, however, a lot more that can be done to provide the conditions for sustained private sector led growth. The Bank will continue to scale up its work in the business enabling environment.

### **Financial intermediation**

Management agrees that it is timely to review the Bank's strategy, policies and procedures for working through the financial sector. Work on a new financial sector strategy is underway. The Bank's investment thesis for working with financial intermediaries aims to utilize intermediaries as channels to reach projects and entities that are either too small for the Bank's originating and supervision capacity or whose financing needs are better addressed by private intermediaries. Other strategic objectives include building up the financial system's depth, breadth and robustness.

Effective design and monitoring of intermediated transactions is essential. Initiatives have already been taken to enhance the Bank's enforcement tools such as including development outcome indicators and reporting requirements in loan agreements. Supervision and monitoring of financial intermediaries has also been intensified and satisfactory compliance with agreed parameters is a prerequisite for each disbursement.

Nevertheless, monitoring and supervision of financial intermediation transactions needs to evolve further to align with peer best practice. This involves building into the loan agreement KPIs relative to the evolution of the intermediary's portfolio serving a specific enterprise segment, geographic or sector.

### **Sector distribution**

Management agrees that regular retrospective assessments against targets should be carried out to inform adjustments for future PSO. The exceptional performance in relative terms of the financial sector stems from the Bank's role in

providing counter-cyclical support during the financial crisis, naturally emphasizing the financial sector through programs such as the trade finance initiative. Given the macro-economic outlook and the Bank's risk constraints, financial sector operations are expected to remain the largest single sector in the Bank's PSO.

### **Instrument mix**

Diversifying the Bank's instrument mix is desirable. Now that Bank has its own trade finance program, Management expects guarantees instruments will be used for a significant share of new PSO. The Bank's Financial Products Working Group will undertake a thorough competitiveness review of the Bank's financing instruments for PSO.

## **Portfolio Performance**

### **Policy guidance and directives**

Management concurs with the needs to update the Bank's Equity Policy. Furthermore, an operational manual for private equity has been prepared and specialized software to manage the private equity portfolio is being deployed.

Management takes seriously the suggestion of underperformance of the equity portfolio. The Bank's equity portfolio may be young, more concentrated in LICs, and less profitable than entities and ventures that are purely commercially-driven. Yet, as a portfolio designed to maximize development outcomes, it still manages to achieve positive financial returns and is already realizing capital receipts from dividend payments and sales of certain underlying investments.

All funds are required to meet specified minimum reporting requirements, including quarterly

reports on financial performance and valuations of underlying investments. However, the Bank is using its influence to improve the quality of reporting so that all funds can reach the industry best standards.

### ***Training and staffing***

Enhanced oversight for private equity funds is desirable. A dedicated equity funds team has been created. Specialized training for staff has been launched and further capacity building is planned with EADI for 2013. Nevertheless, given the growth trends, Management will reassign positions to bolster the equity team and the legal team.

### ***Private equity***

Management is fully seized of the need to reconcile the Bank's operational objectives with its risk management framework for equity investments. To remain within the current risk limits, the maximum sustainable level for the Bank's equity investments is around UA 60 to 100 million per year and the pace of new equity investments has been adjusted accordingly. As part of its regular assessment and alignment with best banking practices and those of other MDBs, the Bank is reviewing its risk capital charges for equity which is currently at 100%. If lower risk charges are found to be warranted, the corollary would be an increase in headroom available under the equity limit.

Searching for viable exits and closing sales at the most opportune times is an essential part of portfolio management. Exploratory discussions have also been held with a number of secondary transactions-focused private equity funds to that effect. However, given the development focus

of the Bank's portfolio, there is limited scope for a more aggressive sales strategy for the active portfolio, particularly for equity participations in regional DFIs and SME focused funds. Regarding exit via IPO, Management recognizes the obstacles to mainstreaming this approach for most fund managers, and will target a few funds whose investment strategy is closely linked to exit via IPO to create a demonstration effect.

Management agrees with the recommendation that the Bank increases its use of alternative, equity-like, instruments.

### ***Monitoring and Evaluation***

Management agrees that there is room to improve PSO monitoring and results evaluation, particularly since the resources applied to portfolio management have increased over the past few years. Development outcomes reporting templates for the Bank's PSO clients have evolved since the mainstreaming of the ADOA framework in 2009. Results-reporting is expected to progressively increase as a larger share of the portfolio includes ADOA templates and project implementation progresses.

### ***Client Reporting***

The forthcoming evaluation of the ADOA framework provides a good opportunity to refine the reporting template, mainstream reporting requirements in project legal agreements, align the ex-post evaluation system, and further educate clients on data collection methods.

### ***Performance Management***

Management agrees that more balanced metrics should be used to inform the departmental and



individual performance objectives as well as indicators across departments participating in the PSO business process. The new PSO business plan will define portfolio quality metrics following a balanced scorecard approach.

## Risk Management

The rapid growth in non-sovereign lending has also over recent years led to concerns being raised by the rating agencies.

Equally important, is the context in which the Bank's capital resources were provided and the risk appetite statement approved by the Board in 2011.

In providing the Bank with a 200% capital increase, many shareholders indicated that the Bank should manage resources in such a way that a return to shareholders for further capital should be kept as remote as possible. In addition, the risk appetite statement provides for the allocation of risk capital as follows: 10% for non-core risks (treasury and operational risks), 45% for sovereign operations and 45% for non-sovereign operations. This allocation to non-sovereign operations, which was much larger than the position that prevailed before the GCI, was intended to reflect the shareholders' desire to ensure that the Bank remained relevant to all RMCs, including LICs. A high risk limit of 10% of the capital allocated to the non-sovereign operations, i.e. 4.5% of total Bank risk capital, was approved to enable the Bank to continue operations in higher risk countries in a manageable way.

Furthermore, the capital allocated to equity investments was increased from 10% to 15% in 2008 by the Board of Governors. Overall, the

Bank's risk appetite provides that up to 19.5% (15%+4.5%) of risk capital can be allocated to riskier operations.

### *Strategy and risk management framework*

Management agrees there is a need to ensure that the development of private sector operations remains coherent from a risk perspective to maintain the financial strength and AAA rating of the Bank and to avoid a return to shareholders for new capital. To achieve this balance, Management proposes to explore options to review the volume targets for private sector operations. At the same time, Management will continue to examine options to further refine risk management based on an Economic Capital framework as well as other possibilities for sharing the risk with other partners or through new financial instruments.

Management acknowledges that there is a real tension between the current operational objectives for the Bank's PSO (volume, geographic, sector and instrument distribution targets) and the Bank's new risk management framework.

In more than half of Africa's low income countries the Bank's sustainable lending limit is UA 10 million or less. Given the size of most infrastructure and industrial projects, the risk limits are far too low to enable the Bank to undertake even a single PSO in these countries. Moreover, the Bank is quickly reaching the ceiling<sup>1</sup> for high risk exposures that also implies the need to curtail PSO in most low income countries. It also affects the Bank's ability

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<sup>1</sup> In terms of risk capital utilized, 16% of high risk operations under the 10% ceiling are in MICs, 20% are regional operations covering LICs and blend country operations and, 64% are operations in LICs.

to support African entrepreneurs and sponsors that are perceived as more risky than counterparts with a global presence and track record.

### ***Business process***

Management agrees that in line with the practices of other MDBs the Bank should consider establishing delegated authority for programmes where the risk exposures are relatively small and the transaction costs are high. There are also other potential efficiency gains from streamlining of the roles and responsibilities of staff across the Bank's credit approval process.

### ***Pricing***

Management agrees that there is a need for further comparative analysis of pricing with sister institutions. To this effect, the Bank is currently part of a consortium of several MDBs aiming at sharing data on various risk parameters including pricing. Management remains vigilant to ensure that pricing covers the expected losses at portfolio level.

### ***Collateral value monitoring and enabling environment***

Management agrees that there is room for further improvement in the systems and procedures for managing collateral and other forms of security. New guidelines for collateral management are now operational. To further enhance the Bank's comfort on the value of its security, a comprehensive independent review is under way.

Management agrees that the Bank should play a more active role in terms of financial sector governance. While actions in this direction are

ongoing<sup>2</sup>, the new PSD Policy and Strategy place strong emphasis on the Bank's contribution to the establishment of an enabling environment for SME lending.

## **Institutional Efficiency**

### ***Decentralization***

Management agrees that for efficient decentralization of PSO, a critical mass of investment officers, portfolio managers and core operational support functions such as credit officers, legal officers, environmentalist and economists will be needed in each region. A proposal to this effect has been presented to PECOD, which will also inform the new PSO Business Plan

### ***Approval procedure***

Management agrees that in an effort to strengthen internal review, the Bank has made its approval process too long and onerous relative to the Bank's processing capacity. This places the Bank in an uncompetitive position relative to peer IFIs and limits the potential productivity of the teams processing PSO.

The Bank's new PSO Policy will propose a streamlined approval process, benchmarked with other IFIs, to ensure that each step retained in the process presents "value for money" for the Bank and its clients.

### ***Management information system (MIS)***

Management agrees that there is room to further improve the Bank's MIS for PSO. Implementation of new systems such as for the equity fund portfolio is a timely entry point to identify ways to consolidate PSO-related data into a central system.

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<sup>2</sup> For example, the Bank is already supporting the development of private sector driven financial and capital markets infrastructure such as securities clearing systems, credit registries, commodity exchanges, mortgage bonds, etc.

Management agrees that information on actual processing costs could be useful to identify areas for efficiency gains. To reap the full benefits of such processing cost information, the Bank will also develop more detailed and frequent analysis on the financial contribution of each portfolio.

### ***Budgeting process***

Management agrees that under-resourcing activities associated with appraisal, supervision, and syndication would create financial and

reputational risks for the Bank. The Bank's clients are currently billed up-front fees.

## **Conclusion**

The evaluation makes a number of insightful observations and useful recommendations for improving the Bank's PSO. On the basis on this evaluation, Management is making a commitment to implement a series of actions to enhance the performance of PSOs and other related interventions.

## MANAGEMENT ACTION RECORD

### Recommendation

### Management Response

**Recommendation 1.a:** The Bank should review its strategy, policies and procedures for financial sector investments, particularly intermediation through lines of credit:

*Review its strategy, policies and procedures for financial sector investments, particularly intermediation through lines of credit:*

**AGREED.** Management agrees that it is timely to refine the Bank's strategy, policies and procedures for working through the financial sector.

**Actions:**

- STRG will complete a new PSD Strategy by Q2 2013 that will articulate priorities for financial sector investments.
- ORPC will submit to CODE the Board Approval Procedure for Private Sector Operations as soon as the PSD Policy and Strategy are approved.
- OPSC, in conjunction with ORPC, will articulate a proposal for streamlining private sector operations review process.
- OSGE, jointly with OPSM and STRG, will complete a new Financial Sector Strategy by Q1 2014 that will propose enhanced engagement in the sector by the Bank.
- OPSM will complete a new PSO Business Plan by Q3 2013 defining the targets for PSO through financial intermediaries including equity funds.

*Develop specific investment guidelines that will allow appraisal of the benefits and trade-offs of indirect wholesaling operations against direct interventions*

**AGREED.** The Bank works through financial intermediaries (FI) to reach projects and entities that are either too small for the Bank's originating and supervision capacity or projects and entities whose financing needs are better addressed by private intermediaries.

**Actions:**

- ORPC will complete new PSO Guidelines by Q3 2013 that will articulate a framework for inventions through financial intermediaries and indicate where direct interventions might be more appropriate.

*Develop specific guidelines in supporting MSMEs in order ensure that financial intermediaries are held accountable for the deployment of Bank funds and that these funds have the best chance of reaching their intended beneficiaries (e.g. MSMEs).*

**AGREED.** Management agrees that compliance by FIs with agreed objectives should be actively and fully enforced. Management notes that supervision and monitoring of FIs has already been intensified over the past few years and satisfactory compliance with agreed parameters is a prerequisite for each subsequent disbursement.

**Actions:**

- OPSM will complete a new section of the PSO operations manual by Q3 2103. This will provide guidance and tools to strengthen origination and supervision by focusing on portfolio-level indicators that demonstrate the pace at which the FIs are scaling up their financing to target segments, regions or sectors.

*with environmental and social requirements, and Ensure that financial institutions comply*

**AGREED.** Management agrees that compliance by FIs with agreed standards should be actively and fully enforced. Management notes that experts from ONEC3 already undertake an E&S assessment of each FI which is systematically reviewed by ORQR as a prerequisite for the final E&S rating needed for project submission to the Board.

**Actions:**

- ORQR will complete the new Integrated Safeguards System by Q3 2013 that will further codify the standards for FIs

## MANAGEMENT ACTION RECORD

Recommendation	Management Response
<p><i>...adopt a more systematic approach to capacity building in client financial institutions to help them establish sound approval, credit risk management, portfolio management and supervision, audit and reporting standards.</i></p>	<p><b>AGREED.</b> Management agrees that ideally, technical assistance and capacity building should be a more systematic part of the Bank's interventions through FIs. However, scaling up would require both additional financial and delivery resources, that stretch beyond those mobilized under the FAPA trust fund.</p> <p><b>Actions:</b></p> <ul style="list-style-type: none"> <li>• OPSM will complete a new PSO Business Plan by Q3 2013 that will articulate options for expanding technical assistance support for financial institutions.</li> </ul>
<p><b>Recommendation 1. b:</b> Determine why the Bank has fallen short of its target level of support for industry and services clients</p>	
<p><i>Determine why it has fallen short of its target level of support for industry and services clients, whether this sector remains an important focus under the strategy, and hence whether it should receive a higher or lower priority going forward.</i></p>	<p><b>AGREED.</b> Management agrees that regular assessments against business plan targets should be carried out to inform adjustments for future PSOs. Management notes that although the relative share of PSO to support industries and services was lower than expected, the absolute UA volume of PSO in this sector exceeded the agreed target. The lower share was caused by the surge of PSO in the financial sector as a result of the Bank's counter-cyclical response to the global financial crisis.</p> <p><b>Actions:</b></p> <ul style="list-style-type: none"> <li>• OPSM will complete a new PSO Business Plan by Q3 2013 that will articulate new sector targets.</li> </ul>
<p><b>Recommendation 1.c:</b> The Bank should utilize a wider range of instruments at the project-level including guarantees and trade finance.</p>	
<p><i>Utilize a wider range of instruments at the project-level including guarantees and trade finance.</i></p>	<p><b>AGREED.</b> Management agrees that diversifying the Bank's instrument mix is generally desirable and should be encouraged.</p> <p><b>Actions:</b></p> <ul style="list-style-type: none"> <li>• OPSM will complete a new PSO Business Plan by Q3 2013 that will articulate options for expanding the use of guarantees (particularly through the new trade finance program).</li> </ul>

## MANAGEMENT ACTION RECORD

### Recommendation

### Management Response

**Recommendation 2.a:** The Bank should Develop policy guidance for exit strategy and deal with underperforming funds, with policy directives for re-valuation and strengthen supervision procedures.

*Develop policy guidance for exit strategy and deal with underperforming funds, with policy directives for re-valuation and strengthen supervision procedures.*

**AGREED.** Management agrees that enhanced policy guidance on exit strategies and re-valuation would be desirable. Management agrees that dealing with under-performing funds is a priority and that there is room to further strengthen the Bank's supervision procedures. Management also notes that profit maximization is not the Bank's sole priority and therefore emphasis is placed on maximizing development impact while assuring adequate financial returns.

**Actions:**

- OPSM will complete a new PSO Business Plan by Q3 2013 that will better articulate the Bank's priorities between financial returns and development outcomes.
- OPSM will complete a valuation review of the equity funds portfolio by Q2 2013.
- OPSM with CIMM and the finance complex will complete procurement of a new information system for equity funds by Q4 2013.
- OPSM will complete an update of the equity section of the PSO manual, including enhanced supervision procedures, by Q2 2013.

**Recommendation 2.b:** The Bank should provide specialized officer training, place more reporting requirements on fund managers and recruit additional investment officers and advisory board members

*Provide specialized officer training, place more detailed and frequent reporting requirements on fund managers and recruit additional experienced investment officers and fund advisory board members.*

**AGREED.** Management agrees that the team handling equity investments should be further reinforced by recruiting addition investment and legal officers and providing more specialized training to staff. Management notes that its equity funds are already required to comply with quarterly reporting. However, the Bank is actively encouraging more detailed reporting to comply with industry best standards.

**Actions:**

- Specialized training for investment officers and portfolio managers involved in private equity has been done and further capacity building is planned with EADI for 2013.
- OPSM will complete a new PSO Business Plan by Q3 2013 that will propose reinforcement of the equity team.

**Recommendation 2.c:** The Bank should be more selective in approving new equity investments

*Be more selective in approving new equity investments, increasing its underwriting restrictions and reducing the overall rate of growth of new interventions.*

**AGREED.** Management agrees with the need to be selective and carefully manage the equity portfolio within the agreed limits. Management notes that the rate of growth of new equity interventions is being scaled back to about UA 60 to 100 million per annum.

**Actions:**

- OPSM will complete a new PSO Business Plan by Q3 2013 that will define new strategic operational objectives for equity investments including exit strategies.
- FFMA is currently reviewing the risk capital requirements for equity to ensure best practices and alignment with other MDBs.

## MANAGEMENT ACTION RECORD

### Recommendation

### Management Response

**Recommendation 2.d:** The Bank should create headroom for new investments by:

- |  |  |
|--|--|
| <ul style="list-style-type: none"> <li>• <i>Search for viable exits and closing sales at the most opportune times, adopting an aggressive sales strategy for its active portfolio and devoting sufficient resources and staff towards monitoring the active portfolio;</i></li> <li>• <i>Placing greater emphasis on future exit options at the time of approval of new equity investments;</i></li> <li>• <i>Acknowledging that exits through initial public offerings (IPOs) are rarely possible, and not therefore a sufficient condition for approval;</i></li> <li>• <i>Incorporating options on sponsors wherever possible, or making use of alternative instruments such as preferred shares or other quasi-equity or mezzanine products with an assured payback schedule.</i></li> </ul> | <p><b>AGREED IN PART:</b> Management agrees with the objective of searching for viable exits and closing sales at the most opportune times. However, management believes that given the development focus of the portfolio (as opposed to a pure commercial focus), practically there is limited scope for a more aggressive sales strategy for the active portfolio. Management acknowledges that until Africa's markets develop, IPOs will be rarely possible and thus should not be the sole condition for approval. However, management also believes the Bank has a role to play to develop the IPO markets and should be prepared to take some risks. Management also agrees with the recommendation that the Bank increases its use of alternative instruments such as preferred shares or other quasi-equity or mezzanine products with an assured payback schedule.</p> <p><b>Actions:</b></p> <ul style="list-style-type: none"> <li>• OPSM will complete a new PSO Business Plan by Q3 2013 that will define new strategic operational objectives for equity and quasi-equity investments including exit strategies.</li> </ul> |
|--|--|

**Recommendation 3.a:** Introduce an appropriate monitoring and evaluation system

- |   |  |
|---|--|
| <p><i>The Bank should introduce an appropriate monitoring and evaluation system to measure and report the development effectiveness and ensure that the Bank collects sufficient, credible results data through the life of a project or technical assistance operations.</i></p> | <p><b>AGREED.</b> Management agrees that there is room to further improve the monitoring and evaluation of PSOs and the collection of credible results data. Management notes that the resources applied to PSO portfolio management have increased significantly over the past few years and results-reporting is expected to increase progressively as a larger share of the portfolio includes ADOA templates and project implementation progresses further.</p> <p><b>Actions:</b></p> <ul style="list-style-type: none"> <li>• EDRE will complete an update of the ADOA framework by Q4 2103 that reflects the outcomes of the evaluation.</li> </ul> |
|---|--|

## MANAGEMENT ACTION RECORD

### Recommendation

### Management Response

**Recommendation 3.b:** Address the apparent low level of client reporting on development results.

*Address the apparent low level of client reporting on development results by reviewing the adequacy of the reporting template, incorporating the requirement to report in project legal agreements, and working with clients to educate them on data collection methods.*

**AGREED.** Management agrees that reporting on development results can be further improved. Results-reporting is expected to increase progressively as a larger share of the portfolio includes ADOA templates and project implementation progresses further. The forthcoming evaluation of the ADOA framework provides a good opportunity to refine the reporting template, mainstream the requirement to report in project legal agreements, align the ex-post evaluation system, and work with clients to educate them on data collection methods.

**Actions:**

- EDRE will complete an update of the ADOA framework by Q4 2103 that reflects the outcomes of the evaluation.
- OPSM will include guidance for educating clients on data collection in the PSO manual by Q2 2013.

**Recommendation 3.c:** Introduce a performance measurement system based on scorecards at the departmental and individual level

*The Bank should introduce a performance measurement system based on scorecards at the departmental and individual level, which balance incentives for new approval volume*

**AGREED.** Management agrees that broader and balanced metrics should be used to inform the departmental and individual performance objectives as well as indicators across departments participating in the PSO business process.

**Actions:**

- OPSM will complete a new PSO Business Plan by Q3 2013 that will define portfolio quality metrics following a balanced scorecard approach.

**Recommendation 4.a:** Adjust the private sector strategy

*Adjust the private sector strategy in recognition of any constraints imposed by prudent portfolio risk management, to achieve a balance between core strategic objectives, strategic priorities, and risk management guidelines.*

**AGREED.** Management agrees there is a need to ensure that the development of private sector operations remains coherent from a risk perspective to maintain the financial strength and AAA rating of the Bank and to avoid a return to shareholders for new capital. To achieve this balance, Management proposes to review the volume targets for private sector operations and to focus the processing of new operations in countries where there is currently enough headroom to remain in compliance with the risk limits. At the same time, Management will continue to examine options to further refine risk management based on an Economic Capital framework as well as other possibilities for sharing the risk with other partners or through new financial instruments.

**Actions:**

- OPSM will complete a new PSO Business Plan by Q3 2013 that will define new strategic operational objectives.
- FFMA will update the Bank's capital adequacy policy, based on Economic Capital framework, by Q4 2013.
- Management will complete a proposal for a new ADF risk sharing framework by Q3 2013 that would help the Bank to prevent a sharp down-scaling of PSO in LICs.



## MANAGEMENT ACTION RECORD

### Recommendation

### Management Response

#### **Recommendation 4.b:** Closely monitor its overall capital adequacy

*Closely monitor its overall capital adequacy, the effect of downgrades of regional member countries on callable capital, and the consequent headroom for further growth in private sector operations.*

**AGREED.** Management agrees that capital adequacy, potential downgrades and the impact on headroom must continue to be closely monitored.

**Actions:**

- CRC will monitor capital adequacy and portfolio reports from FFMA on a quarterly basis.

#### **Recommendation 4.c:** Take into account explicitly the projected impact from increased exposure to LICs, fragile states and other high risk-rated priority groups

*Take into account explicitly the projected impact on portfolio risk from increased exposure to LICs, fragile states and other high risk-rated priority groups.*

**AGREED.** Management agrees that the impact of exposure to LICs should be explicitly considered. This is already included in each Summary Credit Note sent to the Board. Management agrees that new strategies need to be devised to enable the Bank to continue to support strategic priorities while remaining within prudential risk limits. For example, the Bank has already been employing a strategy of working through low risk financial intermediaries based in middle income countries to reach higher-risk end-beneficiaries in low income countries in order to manage the risk profile of the portfolio.

**Actions:**

- OPSM will complete a new PSO Business Plan by Q3 2013 that will define new strategic operational objectives.

#### **Recommendation 4.d:** Consider delegating approval authority to below the Board

- *Developing framework agreements for processing investments that fall below specified risk criteria;*
- *Clarifying the roles and responsibilities of staff for the credit approval process, and*
- *Considering introducing a position of Chief Credit Officer.*

**AGREED.** Management agrees that the Bank should consider establishing delegated authority for programs where the risk exposures are relatively small and the transaction costs are high. There are also substantial potential efficiency gains from streamlining of the roles and responsibilities of staff across the Bank's credit approval process.

**Actions:**

- ORPC will complete new PSO Guidelines by Q3 2013 that will articulate a framework for delegation of authority where appropriate and for streamlining the credit approval process, as well as clarifying the roles and responsibilities of staff for the credit approval process.
- Management will decide by Q2 2013 on whether to introduce a new position for a chief credit officer.

## MANAGEMENT ACTION RECORD

### Recommendation

### Management Response

**Recommendation 4.e:** Verify the findings of the DEG study, and FFMA reports of comparative loan pricing by the Bank and its peers, and investigate the reasons for apparent under-pricing.

*Investigate the reasons for apparent under-pricing in the category of high risk transactions and periodically review the pricing framework to ensure its alignment to the ongoing development of the Bank's risk practices and standards (Economic Capital Framework, Enterprise Risk Management etc.*

**AGREED.** Management agrees that there is a need for further comparative analysis of pricing with sister institutions. To this effect, the Bank is currently part of a consortium of several MDBs aiming at sharing data on risk parameters including pricing. Evidence suggests that in order for the Bank to finance some high risk transactions the theoretical pricing needs to be adjusted or aligned to the market or to other MDBs or financiers. Although this would entail under-pricing for certain individual transactions, Management remains vigilant to ensure that pricing covers the expected losses at portfolio level.

**Actions:**

- OPSM will verify the results of the DEG pricing survey by Q2 2013.

**Recommendation 4.f:** Reinforce the systems and procedures for monitoring the value of loan collateral

*The Bank should reinforce the systems and procedures for documenting, perfecting and monitoring the value of loan collateral, sponsor guarantees and other forms of security...*

**AGREED.** Management agrees that there is room for further improvement managing collateral and other forms of security. Guidelines for collateral management have been approved by ALCO and are operational.

**Actions:**

- OPSM will complete an independent review of the Bank's collateral by Q4 2013.
- OSGE jointly with OPSM, STRG will complete a new Financial Sector Strategy by [Q4 2013] that will articulate enhanced engagement by the Bank.
- OPSM will complete a new PSO Business Plan by Q3 2013 that will contain proposals for an enhanced Bank contribution in this area.

*... and strengthen financial systems in local markets by improving collateral protection and the enabling environment for SME lending*

**AGREED.** Management also agrees that the Bank should play a more active role in financial sector development including the enabling environment for SME lending.

**Actions:**

- STRG will complete a new PSD Strategy by Q2 2013 that will articulate priorities for financial sector investments.
- OSGE jointly with OPSM, STRG will complete a new Financial Sector Strategy by [Q4 2013] that will articulate enhanced engagement by the Bank.
- OPSM will complete a new PSO Business Plan by Q3 2013 that will contain proposals for an enhanced Bank contribution in this area.

**Recommendation 5.a:** Place a critical mass of private sector staff in the field with a mandate to identify, originate and, where appropriate, approve new investment projects.

*The Bank should proceed with its decentralization strategy to place a critical mass of private sector staff in the field with a mandate to identify, originate and, where appropriate, approve new investment projects.*

**AGREED.** Management agrees that further decentralization of PSO should ensure that there is a critical mass of expertise in field offices as well as at headquarters.

**Actions:**

- PECOD will complete its review of the initial PSO decentralization proposal by Q2 2013.
- OPSM will complete a new PSO Business Plan by Q3 2013 that will articulate a final proposal for further decentralization.

## MANAGEMENT ACTION RECORD

### Recommendation

### Management Response

**Recommendation 5.b:** Review the Bank's approval procedures to identify where processes are not adding value.

*The Bank should review its approval procedures to identify where there is duplication or repetition of activity or where certain processes are not adding value to be informed by client surveys and feedback as to the main causes of dissatisfaction.*

**AGREED.** Management agrees that the Bank's approval procedures should be comprehensively reviewed to eliminate steps that do not add sufficient value and strengthen areas where there is strong value-added. Management agrees that client surveys can provide useful insights on how to improve Bank procedures.

**Actions:**

- ORPC will complete a new PSO Guideline by Q3 2013 that will articulate a proposal for streamlining the credit approval process.
- COBS will complete a new cost accounting system by Q2 2013.

**Recommendation 5.c:** Upgrade the Bank's Management Information System and implement a time-recording system

*The Bank should upgrade its Management Information System (MIS) to provide centralized, one-stop access to all relevant project and investment documentation ...*

**AGREED.** Management agrees that there is room to further improve the Bank's MIS for PSO. Management notes that for several years now all PSO project documents have been electronically archived in a central database but links to financial and other data in other Bank systems such as SAP are weak or non-existent. The BPPS is operational but workflow functions are limited.

**Actions:**

- CIMM will complete a review of the PSO MIS by [Q2 2013].
- CIMM and ORCE will complete implementation of the BPPS by Q2 2013.

*...and implement a time-recording system to track staff activities during project origination and supervision, in order to attribute transaction costs and administrative overhead to individual investments*

**AGREED.** Management agrees that the Bank would benefit from better cost accounting information for its operations.

**Actions:**

- COBS will complete a new cost accounting system by Q3 2013.

**Recommendation 5.d:** Ensure that budgets for private sector operations are credible and sufficient

*Address current deficiencies in the budgeting process and in the skill levels of budget coordinators, to ensure that budgets for private sector operations are credible and sufficient.*

**AGREED IN PART:** Management agrees that to mitigate fiduciary risks associated with under-resourcing activities associated with appraisal, supervision, syndication and arranging fees paid for by clients budgets for private sector operations are credible and sufficient. For this purpose, a system of allocating fees earned for use against expenditure arising (in line with other IFI practices) will be introduced. However, Management has invested in the recruitment of qualified Budget Coordinators to address deficiencies.

# Chairperson's Summary— Committee on Development Effectiveness

## On the Independent Evaluation of Non-Sovereign Operations 2006 – 2011

The Committee on Development Effectiveness (CODE) discussed the Independent Evaluation of Non-Sovereign Operations, 2006 – 2011, conducted by OPEV. The report was well received by the Committee, which considered it a pivotal element in shaping the Bank's policy, strategy and business plan for the Private Sector Development Policy and Strategy governing Bank operations.

The main findings of OPEV's evaluation cover both the positive and negative aspects of the Bank's non-sovereign operations. The findings are related to the catalytic effect of the bank's operations, the risk management framework and the growth in private sector operations in LICs, the one-Bank approach, the reach to SMEs and MSMEs, and the efficiency in the approval process.

The significance of the OPEV evaluation was reflected in the Management Response document. It welcomed OPEV's evaluation and agreed with most of the recommendations made with minor reservations. Management recognised that the evaluation raised some fundamental questions requiring attention. These related to the consistency of the Bank's PSO policies, managing risks in the best interest of the Bank and improving the Bank's business processes through policy, strategy and a business plan.

CODE's deliberations focused on certain recommendations, some of which are:

- (i) Streamlining and shortening of business procedures and that the Bank needs to be in line with sister institutions and play an important role in setting standards. It was highlighted that a business process analysis and recruitment of additional staff might be needed to shorten the approval process.
- (ii) Consistency in guidelines: consolidation of some policies that are fairly old and outdated is required. Updating these policies would enable PSOs to have clear guidelines that reflect today's operating environment.
- (iii) One-Bank approach: Through the Ten-Year Strategy, inclusive growth agenda, the CSPs and decentralisation process, staff at the Headquarters and Field offices should be able to work closely in order to ensure collaboration in line with the one-Bank concept. Culture change is very important and can be achieved by interdepartmental linkage and collaboration to overcome the silos mentality.
- (iv) Portfolio performance: Decentralization could be the remedy to the lack of pro-activeness on the part of the Bank to identify and develop viable investment projects on the ground. Field Office staff needs to be sensitized to improve deal identification and origination. Alignment with the HR strategy is significant to ensure that private

sector staff are efficient and have some field experience.

- (v) Delegation of approval authority below board level for private sector operations: The committee did not reach one position regarding this issue. Some views welcomed the recommendation while others indicated that this would be a premature step especially at a time when the Private Sector Development Strategy (PSDS) is not yet approved.

CODE expressed two main concerns in relation to the recommendations of OPEV's Evaluation:

- (i) how the recommendations of the report will be translated into the three expected documents regarding the PSD (PSD Policy, PSD Strategy and

Business Plan) and (ii) the lack of an adequate monitoring mechanism that would enable the gathering of credible results data, thereby limiting the ability to judge the outcome of development effectiveness.

Management and OPEV assured the committee that the Management Action Record would be operational by the end of the year and that the new policies and strategies flagged in the Evaluation would address the three fundamental issues: streamlining policies, improving risk management in the interest of this institution, and improving the business processes.

Dr. Samy ZAGHLOUL

Executive Director Representing Egypt & Djibouti  
Chair of CODE



# The Evaluation Report

## I. Introduction, Scope and Methodology

The Bank has long recognized the essential role of the private sector as an engine of growth and prosperity. The Bank's 2008-12 Medium Term Strategy elevated private sector development to one of its four core corporate priorities. The consultations on the Sixth General Capital Increase and the Twelfth Replenishment of the African Development Fund called for a heightened, policy-based focus on private sector development. The Bank launched its private sector operations (PSOs) in 1991, to support private sector projects and entities incorporated in its RMCs. These operations – also referred to as non-sovereign operations (NSOs) – involve the Bank providing funding in the form of loans, guarantees and equity participation, or support through technical assistance (TA).

*This evaluation refers to 137 investment operations and 38 technical assistance projects approved 2006 to 2011*

This report reviews the performance of the Bank in respect of its private sector operations, by assessing its effectiveness in growing and managing the portfolio of investments, and by evaluating the development contribution of the projects it has supported. It is based on the Bank's portfolio of 137 investments that were approved by the Board between 2006 and 2011, and which account for a total approved investment volume of UA 3.9 billion, of which UA 3.5 billion is committed. Additionally, the review makes reference to 38 TA interventions approved over the same period, though these were not evaluated individually.

Following a Scoping Mission in May 2012, an Inception Report was prepared and subsequently approved by the project reference committee in June 2012. The Inception Report determined the scope of the review, which was defined by a set of evaluation questions and involved the preparation of technical reports on four separate work-streams. This Summary Report highlights the key findings, conclusions and recommendations from each of these technical reports, which addressed:

- Strategy Alignment
- Portfolio Performance
- Risk Management
- Institutional Efficiency

The following documents were referenced in conducting this evaluation: With regards to the Bank's strategy, the 2004 PSO Strategy, 2007 Update and Business Plan for PSO, and 2010 Mid-Term Review. With regards to operational policies and procedures, PSO policy documents guiding risk management, pricing, and Sustainable Lending Limits. With regards to individual operations, Project Supervision Reports (PSRs) and Annual Supervision Reports (ASRs) prepared by the Operations, Private Sector and Microfinance Department (OPSM), OCS and SAP

*The scope of the evaluation was agreed in the June 2012 Inception Report, and is framed around a set of evaluative questions for four separate work-streams*

*Data was collected from document reviews, staff and client interviews, and field visits to a sample of projects*

data, Summary Credit Notes (SCNs), Additionality and Development Outcome Assessments (ADOA), and Expanded Supervision Reports (XSRs). With regards to portfolio performance, Key Performance Indicators (KPIs), listings of the Bank's financial products, and Consolidated Project Status Reports.

Interviews were conducted with department managers and Investment Officers (IOs) from OPSM1 through OPSM5, Board members, the Bank President, and Bank officers from different support departments and support functions. Externally, field- and phone-based interviews with twenty-four clients were conducted. Detailed questionnaires, site visits and direct meetings with client management to gather relevant data were

also carried out. To interpret data, methods used included trend and descriptive analysis, content and causation analysis, regulatory impact review, and portfolio segmentation by different factors such as sector and geography.

Where possible, the evaluation looks at the strategies, priorities and portfolios of other Multilateral Development Banks (MDBs) and Development Finance Institutions (DFIs), including the IFC, EBRD, AFD, IDC and DBSA. These findings were used to benchmark the business processes, staff capacity and performance of the Bank against these key peer institutions.

*Bank practices and performance metrics were benchmarked against peer institutions*





## II. Strategic Alignment

The Bank's overall vision for private sector development links entrepreneurship and capital investment with its broader development objectives to promote sustainable economic growth and poverty alleviation. This vision is articulated in the Bank's private sector strategy and underpinned by five clear objectives. The Bank pursues these objectives through its diagnostic work, its enabling programs to improve the business climate, and its financing transactions at the project level. OPSM takes primary responsibility for the third activity. The five objectives of the Bank's 2004 PSO strategy are:

- i) **Improving the investment climate** by assisting governments to reform their legal and regulatory frameworks, strengthening corporate governance, promoting fiscal responsibility, increasing transparency and accountability, consolidating property rights, mitigating risks for domestic and foreign investors, and supporting commercial law reform.
- ii) **Supporting private enterprises** especially micro, small and medium-sized businesses (MSMEs) through support of financial intermediaries across countries of varying economic levels.
- iii) **Strengthening financial systems** by providing low-cost, long-term financing through partnerships with local banks and other MDIs; promoting the growth of non-bank financial institutions; and strengthening local capital markets through equity investing and local currency finance.

- iv) **Building competitive infrastructure** by facilitating public-private partnerships (PPPs) through increased financing availability and targeted technical assistance.
- v) **Promoting regional integration and trade** improving regional integration and coordination, increasing trade financing resources, advocating greater usage of local suppliers.

### To what extent are the Bank's private sector operations aligned with its five strategic objectives?

**Improving the investment climate:** The Bank pursues this objective at a micro level by specific project interventions, and at a macro level through coordinated activity among the



*Private sector operations have been focused narrowly on investment activity rather than broader market reforms*

different functional areas of the Bank. In terms of investments, OPSM has grown its approvals since 2006 to a current level of UA 3.9 billion, representing a compound annual growth of 34 per cent. Non-sovereign commitments now account for roughly 30 per cent of total Bank commitments. In certain projects, the Bank has achieved micro-level improvements in reporting transparency and corporate governance. However, the Bank does not impose a universal set of requirements on its clients for financial reporting and transparency standards (including Board composition and disclosures). Thus the Bank has missed a valuable opportunity to strengthen corporate governance which would also contribute to improving the investment climate.

At a macro level, the Bank is promoting greater collaboration between OPSM and core departments throughout the Bank, including the Complex of the Chief Economist (ECON) and the Governance, Economics and Financial Reforms Department (OSGE), to ensure that both sovereign and non-sovereign interventions align to country-specific development strategies. However, feedback

from private sector clients suggests that the Bank's influence on policy-makers for beneficial legal and regulatory reform at the country and sector level has been limited. More opportunities exist to address systemic weaknesses in country investment climates. For example, with its country teams, local knowledge and contacts within host government agencies, the Bank is well-placed to intervene at a macro level to address barriers to private sector investment.

**Supporting private enterprises:** The Bank supports private enterprises through direct loans, credit lines, direct equity investments, participation in private equity funds and to a lesser extent through guarantee facilities. One-third of the Bank's project appraisal reports referred to support for private enterprises as evidence of alignment to the Bank's private sector strategy. More specifically, the strategy highlights support to MSMEs, given their potentially large impact on sustainable economic development and job creation, and sets a goal of 10 per cent portfolio concentration in MSMEs through direct loans and intermediation. According to Board approval documents, the active portfolio includes 30 approved loan and equity projects that target

*The Bank supports private enterprises through direct lending, equity investment and intermediation...*



## Box 1: The ABC Bank

An example of this practice is the ABC Bank II SME facility that was approved and disbursed in 2008. AfDB intended that the facility would reach up to 30 SME borrowers, whereas ABC Bank lent the funds to only 3 enterprises. The tenor and purpose of all three loans differed from the intentions outlined by AfDB in project appraisal reports. Most notably, 2 of the 3 recipients had employment and revenue levels well above the SME definitions set by other DFI's, and had not provided updated information to AfDB (through ABC Bank) in over a year.

SMEs and microfinance institutions (excluding grant projects), accounting for 22 per cent of the active private sector portfolio.

*...but actual reach to micro and small enterprises is less evident in credit lines*

Whether or not the Bank's credit lines have reached, or will reach, MSME clients in practice is unclear. Firstly, unlike its peer MDBs, the Bank does not have a policy guideline that clearly

defines a micro, small or medium-sized enterprise. Instead, the current approach is to leave it to client financial institutions to apply their own criteria. Secondly, the Bank does not hold client financial institutions accountable for on-lending funds to target borrowers. This lack of definition and oversight allows financial intermediaries to on-lend funds based on their own internal criteria or portfolio objectives, which may or may not align with Bank priorities. This high degree of disbursement flexibility for client institutions compromises the development goals intended during the origination process and articulated in approval documents. Thus, Bank support to MSMEs is by accident rather than design.

**Strengthening financial systems:** The Bank has built relationships with commercial banks, regional development banks, and other financing institutions by providing lines of credit, direct equity investments and senior term loans. These interventions now comprise 50 per cent of the active portfolio, which is higher than the Bank's targeted concentration for financial institutions of 40 per cent. This growth has been achieved in part through repeat projects with existing clients, which are usually appraised and processed more quickly than for new clients. According to Bank



*The Bank's interventions in the financial sector largely comprise lines of credit to banks and regional DFIs*

staff, interventions with DFIs allow the Bank to reach clients in LICs and fragile states indirectly whilst limiting the Bank's own risk exposure, which is to the DFI rather than to the sub-borrowers. While this strategy has its merits, there have been cases where DFIs had invested in private clients that may have been better supported through direct intervention.

*There has been less support of non-bank financial institutions, equity markets and local currency finance*

The strategy also identifies the insurance and leasing industries as sectors where the Bank could assist in strengthening local financial systems. However, there are currently only three direct investments in these sectors, plus two recently approved investments in health care funds that target the private health insurance sector. Non-bank financial sectors have considerable growth potential across Africa, and can contribute to the broadening and deepening of financial markets. Financial sector development also requires targeted assistance in areas like financial regulation, security registration, foreclosure laws, listing requirements, and minority shareholder rights. Moreover, whilst the vast majority of Bank lending has been in hard currencies, many clients, particularly micro and small enterprises, have limited ability to bear the resulting exchange-rate risk, leaving them exposed to frequent and severe local currency devaluations. An increased supply of long-term funding denominated in domestic currency is therefore critical for many borrowers in the region.

**Building competitive infrastructure:** The bank has targeted infrastructure projects through public-private partnerships and dedicated equity

infrastructure funds. At the end of 2011, this amounted to 39 interventions accounting for 37 per cent of total funds committed, close to the target concentration of 40 per cent.

The Bank's achievements in backing integrated infrastructure projects include its four related projects in Senegal and its energy sector intervention through the ABX Hydropower project, all of which are examples of catalytic transactions that align closely with the Bank's core objectives and multiple strategic priorities. However, while infrastructure interventions are a core objective for PSO, the review found that the Bank can take additional measures to increase its pipeline of potential projects and streamline its internal approval steps. Infrastructure projects needed longer approval lead times for arranging of complex, multi-layered financing structures and fulfillment of conditions precedents that can cause unpredictable delays.

**Promoting regional integration and trade:**

Infrastructure projects make strong contributions to regional trade and development, through facilitation of new investment in ports, roads, railways, energy projects and communication systems. The Bank participates in the Infrastructure Consortium for Africa, which is an avenue for addressing policy and technical barriers to regional infrastructure development and for coordinating the activities of private sector companies and financiers. Besides its investments in infrastructure, the Bank's pursuit of this objective is limited to a guarantee under the

*Bank support of privately-led infrastructure projects has had profound, positive effects on development*

*More could be done to identify and structure projects to enhance regional trade and integration*

IFC's Global Trade Liquidity Program (GTLP), and lines of credit with a DFI and a commercial bank, the latter of which remains unsigned. Moreover, as with other credit lines advanced by the Bank, there was insufficient monitoring data to demonstrate that these facilities had actually delivered regional trade and integration benefits in line with their stated aim.

## To what extent have private sector interventions been made in priority areas?

*Generally, the private sector portfolio is well-aligned with the Bank's sector priorities...*

OPSM has defined a number of priority areas for financing transactions and has allocated resources (staffing and budget) accordingly. These transactional priorities cover certain sectors, countries and project types. For example, sector priorities and associated concentration targets include infrastructure projects (40 per cent), financial institutions including equity funds (30 per cent) and industry / service sectors (30 per cent). The Bank's performance against these targets is summarized in Figure 1, and shows that in volume terms infrastructure investments are well-aligned with the target concentration level, though the portfolio is overly weighted towards financial institutions and under-weight in industry / services. It is important to note that target concentrations in priority sectors sum to 100 per cent and so, by definition, exceeding the target concentration level in one sector will be detrimental to another priority area. It also inhibits the Bank from promoting investments in other (non-priority) sectors that may nevertheless have a strong fit with the Bank's strategic objectives.

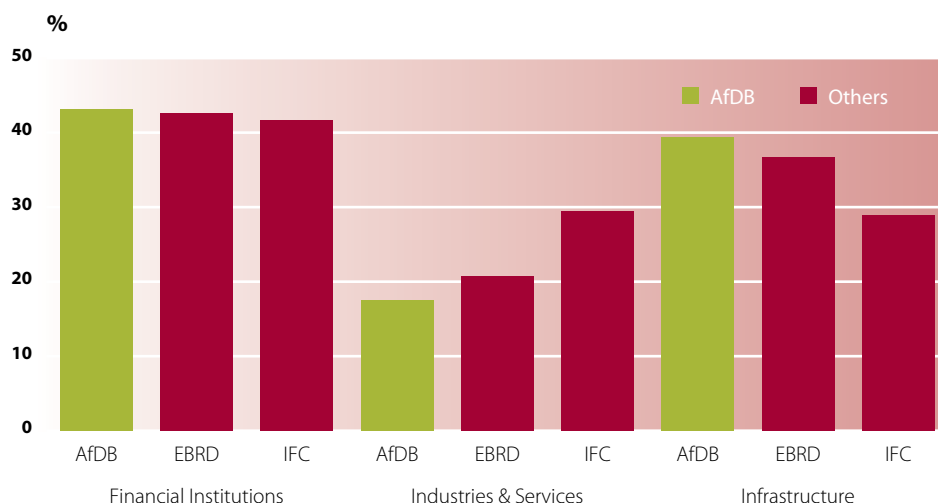
The Bank's transactional priorities are referenced consistently in appraisal reports, ADOA ratings, summary credit notes, and Board presentations to justify new interventions. Yet the five core strategic objectives (reviewed in the section above) receive less attention during origination. Consequently, the growth of the private sector portfolio has been driven much more by transactional priorities than by project-level alignment with overriding strategic objectives. Moreover, the link between these priority groups and the strategic objectives is not documented. Therefore, whilst the fact that virtually all investments are found to be aligned with one or more priority areas is ostensibly a positive finding, it raises the question as to whether there is too broad an interpretation of the strategy when it comes to screening pipeline projects for their strategic fit. It is also apparent that different departments assign higher importance to certain priority groups than to others, although no ranking order has been mandated or communicated by OPSM or the Board.

*...but the link between transactional priorities and strategic objectives is not clear*

On a volume basis, the Bank's concentration of investments in financial institutions is comparable to its MDB peers. However, both IFC and EBRD have reduced the share of their portfolios with financial institutions over the past two years in favour of direct interventions in real sector clients. Given this trend, and the current lack of assurance that the Bank is actually reaching the intended end-beneficiaries (paragraph 2.5), the Bank's

*Further growth in financial sector exposure should be reviewed in light of emerging development results*

**Figure 1: A peer group comparison of sector concentrations**



Bank concentration is calculated from Net Amount Signed of projects approved in 2006-11. Benchmark group concentrations are taken from publicly-available sources. Grants are excluded.

development thesis for intermediation projects needs to be properly tested before further growth in financial sector investments is justified.

**Credit risk and prudent exposure limits could constrain pursuit of the strategic focus on LICs and fragile states**

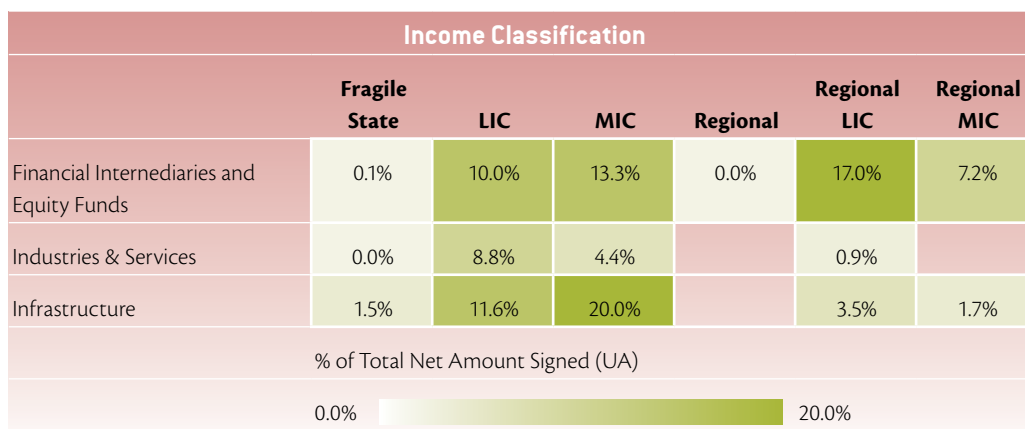
The Bank targets private enterprises in LICs and fragile states as a priority geographic focus, with an objective of maintaining 40 per cent of its portfolio in this country group. Figure 2 shows that the current private sector portfolio exceeds this target, reflecting the high priority placed on LICs during the past two years. About half of committed volume in LICs is in financial sector projects and 28 per cent is in infrastructure. Further growth in LICs is likely to increase the weighted average risk rating (WARR) of the private sector portfolio, because the average risk rating for LICs and fragile state interventions of 4.52 is nearly a full point higher

than the rating for projects in middle-income countries (MICs). At some point, therefore, the Bank will reach its own regional and country risk exposure limits, placing a constraint on further growth of the portfolio in this priority area (see paragraph 4.15).

The Bank sets overall targets for the growth of its private sector operations, defined in terms of a 400 per cent increase in the active portfolio and a 430 per cent increase in new project originations. However, it is not clear how this rapid portfolio growth aligns with the five core strategic objectives. The Bank emphasizes portfolio quality over growth *per se*, though it does not define quality as a metric. In the context of a development

**Policies, processes and incentives need to strike a balance between volume growth, portfolio risk and development effectiveness**

**Figure 2: Portfolio concentration by sector and country income group**



Bank portfolio concentration calculated by Net Amount Signed of projects approved in 2006-11.

institution, measures of quality typically refer to development outcomes, additionality, and achievement of sector- and country-based targets, client financial viability, and portfolio profitability. Delivery against these quality criteria can then be reinforced by an appropriate incentive structure and reported in performance scorecards at the departmental and individual level.

### How has the Bank deployed its instruments to support the private sector?

The Bank has at its disposal a variety of investment instruments within the broad categories of loans (term loans, lines of credit, trade finance, synthetic local currency loans, syndicated loans), and equity (common equity, equity funds, subordinated debt, preferred equity and convertibles). It can also provide credit and partial risk guarantees, and risk management products for clients. Finally, it also

provides non-investment services in the form of technical assistance.

Figure 3 shows instrument concentrations within the Bank's committed private sector portfolio at the end of 2011. Loan commitments are primarily term loans and lines of credit and represented

83 per cent of the portfolio, with senior loans accounting for roughly half. Equity interventions through direct equity or fund investments have grown to 17 per cent of the portfolio. The Bank has approved 22 direct equity or quasi-equity investments in the past five years, with 19 of these investments in banks and other financial institutions. Also, the Bank's direct equity investments in microfinance institutions and DFIs have helped these organizations raise additional risk capital from other investors. The Bank has a further 26

*Most Bank support is via senior loans and credit lines, although the equity portfolio has grown rapidly in recent years*

investments in private equity funds. These funds have investment that mainly target companies in MICs. While they therefore support private sector development by providing important long-term risk capital for medium-sized enterprises, they are not generally aligned with the Bank's priorities to support projects in LICs and fragile states.

**The Bank has made relatively little use of other instruments such as guarantees, trade finance facilities and technical assistance** Compared to other MDBs, the Bank has not actively promoted guarantee or trade finance instruments. For example, guarantee facilities account for 10 per cent of commitments at IFC, EBRD and AsDB, yet only 0.1 per cent at the Bank. This minimal level of guarantee activity by the Bank could have hindered development of regional financial markets and forced potential clients to approach other MDBs for these facilities. Technical assistance projects now include 24 initiatives, most commonly tied to investments in financial intermediaries for capacity-building purposes. Other MDBs are using technical assistance in a more systematic way. For example, EBRD requires that all commercial bank participants in its Trade Facilitation Program purchase technical assistance in the form of capacity-building. World Bank Group technical assistance is provided on certain projects, notably

## BOX 2: XYZ Airlines

The Bank provided a mezzanine loan to XYZ Airlines in 2011 to finance the purchase of five 777 aircrafts in infrastructure sector (Air Transportation). The mezzanine financing provided to XYZ Airlines was a key component of their financing package and was not available from commercial investors.

infrastructure interventions, to help improve their commercial viability and their wider development effects. Both institutions report improved outcomes as a result of the technical assistance.

## How appropriate are the Bank's policies for private sector operations?

The 1991 Policy and 1994 Update form the primary framework governing prevailing private sector policies in the Bank. This framework remains relevant, but there is scope to update the core policies in recognition of how both the portfolio and market conditions have evolved. For example, certain Bank policies limit the responsiveness of private sector operations to client needs. These include the requirement for

*There is scope to bring the policy framework in line with current priorities and market practices*





**Figure 3: Portfolio concentration by sector and instrument**

	Instrument					
	Equity/ Quasi- Equity Subtotal	Guarantee Subtotal	Loan			
			Line of Credit	Other	Senior Loan	Subtotal
Financial Intermediaries and Equity Funds	13.4%	0.1%	27.6%	6.6%		34.0%
Industries & Services	1.4%			0.6%	12.1%	12.7%
Infrastructure	2.0%				36.3%	36.3%
% of Total Net Amount Signed (UA)						
	0.1%				36.3%	

Bank portfolio concentration calculated by Net Amount Signed of projects approved in 2006-11.

Board approval of all new investments, waivers and modifications, and until recently a six-month cancellation period on project legal agreements.<sup>1</sup> Other MDBs have amended their procedures to improve the timeliness of transaction origination and their responsiveness to clients. IFC and EBRD have 18-month and 24-month cancellation periods on project agreements respectively, in acknowledgment of the longer closing periods often required for infrastructure and industrial projects. Both these institutions also use a Board notification process on smaller originations, rather than requiring full Board approval. Approvals and waivers are made at the division management or credit committee level, with accountability delegated to operational departments for effective decision-making on

new investments or amendments to existing projects.

The Bank is developing specific policies and procedures for direct equity and equity fund investments, the present guidance dating back to 1994 and pertaining mainly to direct investments. The current policies lack guidelines and risk parameters for fund selection, for example regarding sector and geographic concentration levels, targeted investment stage (early vs. later stage), and targeted investment sizes. Without such guidance, there is a risk that the Bank's participation in repeated funds with the same fund manager, such as with KPE<sup>2</sup>, may crowd out private investors. The Bank also lacks effective

*The Bank is in the process of developing policies and procedures for its equity investments*

1 In October 2012, the Bank adopted new Guidelines on Cancellation of Approved Private Sector Operations, which extend the cancellation period from 180 days to 365 days from the date of approval.

2 The Bank has invested in three equity funds directly managed by KPE.

### Box 3: Equity Funds Selectivity

The equity funds interviewed did not set specific geographic targets and more often invested in private companies in MIC's, reflecting the more established capital markets, financial institutions and consumer economies in countries such as Z and X. For example, KPE has the largest number of its investment funds committed in wealthier African markets. Many equity funds do not have geographic priorities for LIC's and Fragile States and may continue to invest more actively in MIC's, where they have more clearly defined exit strategies, better developed legal systems, and opportunities to attract co-investors. The Bank may consider the importance of policies around specific targets for geographic and sector concentrations on equity fund investments that reflect its own goals for direct intervention.

portfolio management tools as well as policy guidance on holding and exit strategies, all of which are essential for maximizing the profit contribution of equity investments. In some cases, equity fund investments entail advisory board participation by Bank staff, though there is no

Bank policy in this regard. Other MDBs have extensive policies for operations involving equity funds, which cover areas such as: formal training on advisory board participation; required qualifications of advisory board members; terms of participation;

***The Bank does not have adequate policies and procedures to address jeopardy projects, which greatly increases its risk of financial loss***

expected oversight role; and limitations on personal and institutional liability.

In its 2010 Mid-Term Update, the Bank outlined its intention to establish a dedicated workout team to address non-performing loans and investments. However, there is no comprehensive policy to support these operations, and Bank resources currently consist of a single workout officer. While the number of problem projects in the portfolio has remained low, the Bank would not be in a better position to respond effectively to a sudden increase in their number, for example as a result of a systemic economic shock, contagion effect or conflict situation. Also, in cases where the Bank is leading a loan syndicate, it owes a duty of care towards syndicate partners requiring it to react quickly to deteriorating situations to avert default or maximize recovery. The Bank's capacity in this area is much weaker than in other commercial and development institutions. IFC has a comprehensive manual for its workout policy and procedures, and a dedicated team hired from private commercial banks, which aggressively pursues recovery of capital on deteriorating projects. While the principal objective is to mitigate the risk of financial loss, work out activities based on a clear and comprehensive policy and procedures can also have a strong, positive development effect to the extent that they demonstrate how project documentation, security, guarantee and legal recourse mechanisms are upheld by the country's judicial system and applied in a predictable and effective manner.

### Conclusions

To date, the Bank's private sector operations have been focused narrowly on investment activity

rather than broader market reforms. Most Bank support for private enterprises is via senior loans and credit lines, although the equity portfolio has grown rapidly in recent years. In comparison, it has made relatively little use of other instruments such as guarantees, trade finance facilities and technical assistance. The link between the Bank's priorities at the transactional level and its broader strategic objectives could be clearer.

Generally, the private sector portfolio is well-aligned with the Bank's sector-level targets. Interventions in the financial sector largely comprise lines of credit to banks and regional DFIs, whereas there has been less support of non-bank financial institutions, equity markets and local currency finance. Moreover, the Bank's reach to micro and small enterprises through credit

lines is not evident. Bank support of privately-led infrastructure projects has had profound, positive effects on development, though more could be done to identify and structure projects to enhance regional trade and integration.

The Bank's policies, processes and incentives need to strike a balance between volume growth, portfolio risk and development effectiveness. For example, credit risk and prudent exposure limits could constrain future investment activity in LICs and fragile states. Growth and selectivity in the equity portfolio has not been steered by a considered policy framework, though this is now being addressed. Finally, the Bank lacks adequate policies and procedures to manage projects in jeopardy, which greatly increases its risk of financial loss.

### III. Portfolio Performance

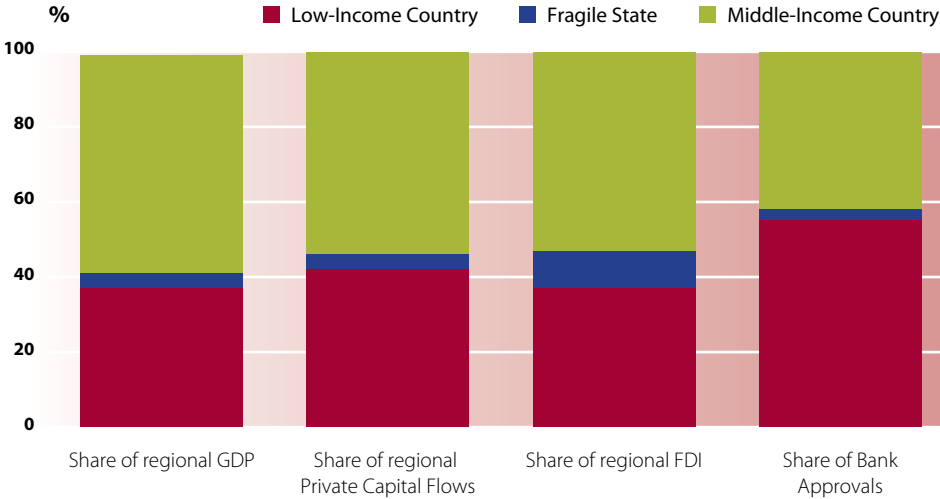
#### What have been the catalytic and demonstration effects of the Bank?

**Bank investments helped catalyse UA 20 billion of co-investment at the project level...** Between 2006 and 2011, the Bank signed into commitment UA 3.5 billion of investments, of which it has since disbursed UA 2.2 billion. This represents roughly 3.5 per cent of private capital flows in the region. In practice it is difficult to attribute wider investment activity in regional member countries to the Bank’s operations. Nevertheless, at the project level the Bank’s funding accounted for an average of 15 per cent of project costs, and hence its

presence in these transactions will have helped the sponsors to raise the balance of funding required of approximately UA 20 billion. Also, as shown in Figure 4, the Bank’s investments are markedly more concentrated in LICs, compared to regional foreign direct investment (FDI) and private capital flows. In other words, the Bank has been relatively more active in this priority group of countries than investors generally in the African region. Accordingly, the Bank is less concentrated in MICs, which are able to attract a greater proportion of private investment without requiring the catalytic effect of the Bank.

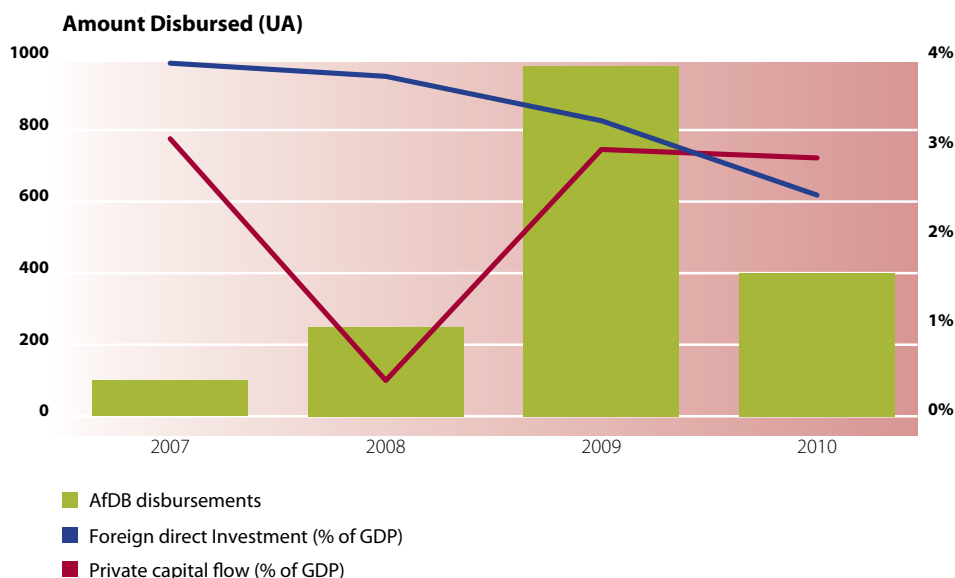
*...and the Bank has a relatively strong financing role in low-income countries*

**Figure 4: Concentration of Bank approvals, compared to regional GDP, FDI and private capital flows**



The figure shows the concentration of Bank approvals from 2006-2011 in RMCs classified by income group. Concentration of GDP indicates the relative absorptive capacity of these country groups, whilst concentration of FDI and private capital flows indicates the relative level of investment support they receive. The 10 per cent share of regional FDI in fragile states is likely a result of large inward investment in extractive and mining projects in some of these countries, though confirmation of this is beyond the scope of this evaluation.

## Figure 5: Bank disbursements following the global economic crisis



The trend in Bank disbursements in the period during and after the global economic crisis is compared with trends in foreign direct investment and private capital flows.

***The Bank has provided useful counter-cyclical support following the global economic crisis***

The effects of the 2008 financial crisis can be seen clearly in Figure 5. In 2008, there was a sharp reduction in private capital flow as a percentage of regional GDP, and a gradual decline in FDI thereafter. FDI and private capital flow relative to GDP has yet to return to pre-crisis levels. In contrast, there has been a rising trend in Bank disbursements over the period, with a substantial response to funding needs in 2009, which was achieved through the emergency liquidity fund (ELF), the trade finance initiative (TFI) and participation in the Global Trade Liquidity Program (GTLF) led by IFC.

The Bank has the potential for strong catalytic and demonstration effects by making

proactive efforts on the ground to identify projects, and by working with sponsors to develop these into viable investment opportunities. However, the vast majority of projects (95 per cent of the investment portfolio) result from clients approaching the Bank with requests for funding support, as confirmed by feedback from both investment staff and clients themselves. The Bank has not, therefore, used its convening power to promote projects on the ground. Other MDBs report that their own origination efforts tend to result in proposals that are relevant and of high quality at entry, and so more likely to lead to viable investment opportunities. For example, IFC is very proactive in project origination and

***The Bank has not been proactive in identifying and developing viable investment projects on the ground***

deploys investment officers in the field with a clear mandate to scout their allocated countries for new business.

## How successful have the Bank's private sector operations been in contributing to development?

*The Bank's ADOA system provides an ex-ante estimate of project development results...*

The Bank introduced its system for Additionality and Development Outcome Assessment for PSOs in September 2008, and revised the framework in 2009.

Since then, it has applied the ADOA system to 83 pipeline projects that have been subsequently approved and therefore feature in the 2006-2011 cohorts. The ADOA system is designed to provide an ex-ante estimate of a project's likely development outcome, measured across the following eight categories and informed by a set of core indicators: household benefits; infrastructure effects; effects on government; macroeconomic resilience; environmental effects; gender and social effects; private sector development and demonstration effects; and business success. The system also measures the Bank's additionality in terms of its contribution to political risk mitigation; financial risk mitigation; and improved development outcomes.

ADOA notes are issued five times during the origination and approval stages of a project. At each stage, ADOA ratings are verified by the Bank's Complex of the Chief Economist (ECON). The system provides some input into the screening and design of projects as they progress through to the Board. Consequently, projects that are

found wanting in development and/or additionality dimensions will either be dropped from the pipeline or redesigned to meet minimum quality-at-entry standards. It follows that, of the projects with ADOA ratings in the 2006-2011 cohort, 95 per cent are expected to achieve *good* or better development outcomes and 94 per cent are expected to have *positive* or *strongly positive* Bank additionality; all are expected to be positive in one or both of these dimensions.

Tracking achievement of expected development results requires relevant and credible data to be collected during project supervision. The Bank incorporates information covenants in legal documentation to obligate clients to collate and report such data, and provides templates and guidance to assist them in this task. However, only 15 per cent of clients complete such templates, and the Bank's own monitoring of development results during project implementation is patchy. Moreover, where clients do report data on development indicators, it tends to be that which is most easily accessible and readily available, such as total employee numbers and taxes paid, without clear attribution to the project supported by the Bank. At present, therefore, the predictive reliability of the ADOA system has not been tested, partly because there are few projects of sufficient maturity to judge actual outcomes and partly because of these data limitations.

Once investment operations have reached early operating maturity, they are subject to independent ex-post evaluation. This typically occurs five years after approval, by which time the project has been fully implemented and its development results evident from several years of

**The Bank's ex-post evaluation system has been upgraded to comply with the latest Good Practice Standards**

operational performance. The Bank's Expanded Supervision Reporting (XSR) system is aligned with the Good Practice Standards for Private Sector Evaluation, as endorsed by the MDB members of the Evaluation Cooperation Group. As such, it is designed to provide an objective and independently verified assessment of outturn project development results, profit contribution and associated Bank work quality.

Only a few of the projects in the 2006-2011 approvals population have been evaluated through the XSR system, and so information on the portfolio's overall development success is limited. However, these in-depth assessments illustrate the wide variety of contributions that individual projects can make. They include:

- **Economic benefits from infrastructure improvements:** The Dakar Toll Road was the first highway constructed in West Africa to European standards. It carries about 23,000 vehicles per day, bringing visitors and tourists to the area, and has accomplished the goals

of reducing travel time and increasing traffic flow.

- **Private sector development through linkage effects:** During construction of the ABX hydropower project, millions of dollars were paid to local contractors and thousands of temporary jobs were created. The Gabsi Agriculture project supports 2,000 local farmers and growers through its purchases and assistance programs.
- **Catalyzing investment through positive demonstration effects:** PKE has established a reputation on the back of the success of its private equity funds in the region. PKE III is the third-generation fund, which aims to make investments of USD 25-100 million in African companies.
- **Positive social effects through community development programs:** The ABX hydropower project promotes community development by providing training, education, access to healthcare and an improved water supply. It also assists local small businesses involved in agriculture and fisheries.



*... the Bank has inadequate monitoring procedures to enable it to gather credible results data during supervision*

*The Bank could use technical assistance in pursuit of greater development effectiveness*

Figure 6 shows the Bank's overall volume of technical assistance (not just that targeted at private sector operations) in 2011, compared to other MDBs. It indicates that other MDBs such as the AsDB, EBRD and the World Bank Group, use technical assistance to a much greater extent. The Bank's deployment of technical assistance for PSOs comprises 38 initiatives, most commonly tied to investments in financial intermediaries for capacity-building purposes.<sup>3</sup> At the project level, there are opportunities for the Bank to make more use of TA in areas like project design and feasibility studies, market intelligence and corporate governance reform. At the macro level, it can be used in partnership with other Bank practitioners for addressing regulatory, legislative and trade barriers to private sector development. For example, IFC deploys its technical assistance resources across four business lines: access to finance; investment climate; public-private partnerships; and sustainable business advisory services.

## How profitable is the Bank's private sector portfolio?

The disbursement profile of the 137 investments in the private sector portfolio is shown in Figure 7. Given that the portfolio is relatively young, two-thirds of investments have yet to reach full disbursement with some recently-approved investments not yet even signed into commitments.

Within this portfolio, there are 82 operations involving debt-type instruments, of which 29 are fully disbursed and five fully repaid. Based on ex-ante expectations, the rate of return ranges from 2.7 per cent (average for lines of credit) to 5.1 per cent (average for senior loans). However, a high proportion (63 per cent by volume) of Bank loans are still in their grace period, and the capacity of the borrower to meet installments of capital as well as interest is yet to be tested. Consequently, the gross profit contribution of the loan portfolio is not yet evident, as it will

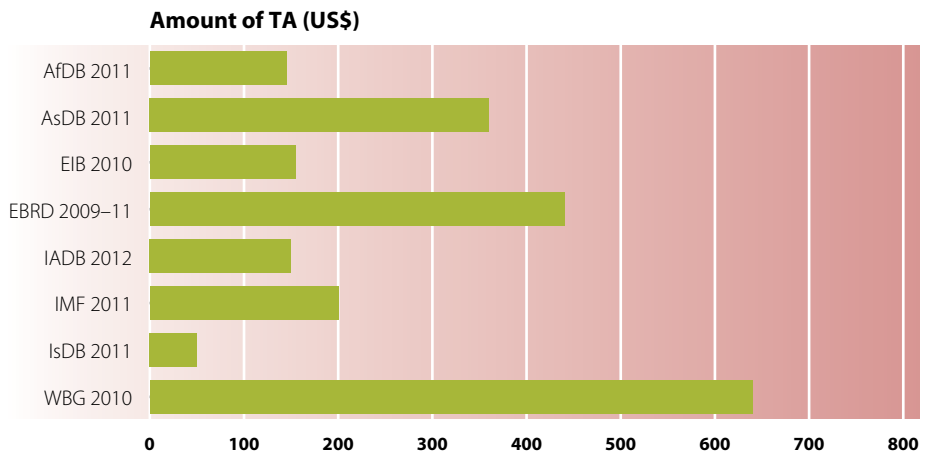
*The loan portfolio is relatively young and its profit contribution not yet evident...*

*Private sector projects supported by the Bank have made a wide range of contributions to development*



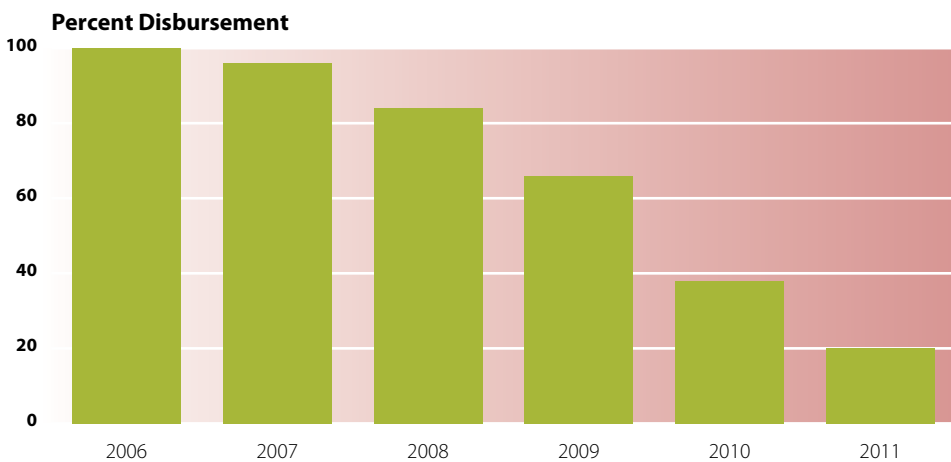


**Figure 6: MDB volumes of technical assistance**



Source: Evaluation Cooperation Group Technical Assistance working group submissions and MDB annual reports.

**Figure 7: Disbursement profile of investments approved from 2006-2011**



Projects approved in 2006-2011, excluding grants and guarantees. Disbursements are shown as a proportion of net amount signed.

*...although there has been a recent increase in non-performing assets*

ultimately be affected in part or in full by any losses from loans that are written-off. In that regard, 22 per cent of loans are currently on the Bank's watch list, meaning that the Bank perceives some risk to its recouping in full the interest and capital due in respect of these loans (see Figure 8).<sup>4</sup> Non-performing loans (NPLs) within the private sector portfolio have increased significantly to UA 42.7 million as of December 2011. Over half

the current level of NPLs is due to the recent classification of one loan<sup>5</sup> as non-performing.

Financial profitability and performance information is not available for much of the Bank's equity investment portfolio, especially for direct equity investments. For example, the Bank's October 2012 Equity Portfolio report

*The Bank has yet to realize any capital gains from its equity portfolio, which is currently yielding negative returns overall*

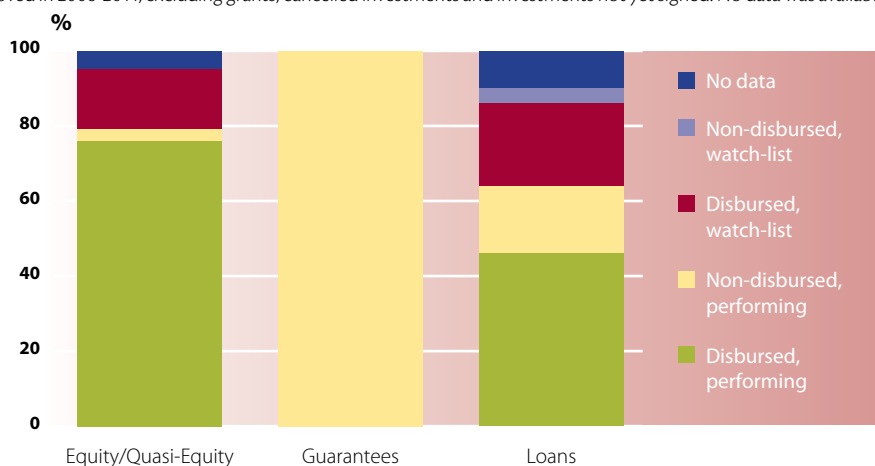
contains information on only 62 per cent of the total net signed equity portfolio of UA 591 million, and pertains only to investments in equity funds. These investments are either still in the fund-raising or investment stages. As yet, none have reached their divestment period, hence the Bank has yet to realize any capital receipts from

4 Projects are placed on the watch list for reasons including: non-payment of principal or interest when due; significant decline in collateral value; borrower reports a loss either in half or full-year results and there is evidence that the loss was not due to extraordinary circumstances; default in financial covenants; financial difficulty of the borrower; poor information disclosure; poor corporate governance or issues relating to the competence of management; major management changes, especially of key decision-makers, without evidence of an acceptable succession plan; negative market trends or government directives; legal suits or threats of bankruptcy by other creditors; or deterioration in the economic environment in general or in the industry that the company operates in.

5 Telecom project in Libya

## Figure 8: Current portfolio performance status for committed investments

Investments approved in 2006-2011, excluding grants, cancelled investments and investments not yet signed. No data was available



for 10 per cent of loans and 5 per cent of equity investments. Guarantees do not involve disbursements, but once committed the Bank is at risk.

sales. The net effect of deducting management fees means many of these funds are therefore currently yielding negative cumulative returns: the range being from -48.5 per cent to +62.5 per cent, and the overall aggregate return -1.8 per cent. The investment profitability of the PSO equity investment is consistent with the “J-curve” notion<sup>6</sup> where the returns are expected to be negative during the fund raising phase due to management fees which are drawn from committed capital and investment phase due to the continuation of drawing down of capital, the length of time needed to realize gains, and the write-off of under-performing investments<sup>7</sup>.

In addition to the information gaps highlighted above in respect of the gross profit contribution of loan and equity investments, the Bank also lacks information systems that allow it to estimate the net profitability of individual investments, i.e., after deducting transaction costs and

an apportionment of Bank overhead. Projects that involve lengthy and time-consuming approval stages, or that subsequently perform poorly requiring close Bank oversight, waiver processing or intervention, will have significant transaction and supervision costs that erode or nullify returns from the associated investment. Small-sized loans, in particular, could result in net losses for the Bank even if they perform as expected, because current approval processes are equally involved regardless of investment size. Data on transaction costs could therefore provide valuable input into pricing and fee structures to ensure all projects have the possibility to deliver a positive net profit contribution.

## Conclusions

Bank investments helped catalyse UA 20 billion of co-investment at the project level. In particular, it has a strong financing role in low-income countries, having been more active in this priority group of countries than investors generally in the African region. It has also fulfilled a counter-cyclical role following the global economic crisis. Despite this, the Bank has not been proactive in identifying and developing viable investment projects on the ground, relying instead on sponsors to approach the Bank with requests for funding support.

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6 Understanding the J-Curve: A Primer on Interim Performance of Private Equity Investments by Daniel Murphy, Goldman Sachs Asset Management Strategic Research, December 2006.

7 The equity funds’ management fees range from 2.0% to 2.5% for AfDB investments. To benchmark to Bank’s investments with industry, David T. Robinson and Berk A. Sensoy, “Do Private Equity Fund Managers Earn their Fees? Compensation, Ownership, and Cash Flow Performance,” white paper, March 14, 2012 cited management fees in the range of 1.5% to 2.5%



*The Bank does not have adequate systems in place to calculate net profit contribution for individual investments*

The Bank's ADOA system provides an ex-ante estimate of project development results, on the basis of which, all approved projects are expected to have efficacious development outcomes and/or Bank additionality. However, the Bank has inadequate monitoring procedures to enable it to gather credible results data during supervision, so limiting its ability to judge outturn development effectiveness. To help improve the quality of ex-post evaluation, the Bank has upgraded its methodology to comply with the latest Good Practice Standards.

In terms of profitability, the Bank's loan portfolio is still relatively young and its profit contribution not yet evident. There has, however, been a recent increase in non-performing assets. Finally, the

Bank does not have adequate systems in place to calculate net profit contribution for individual operations, and cannot therefore determine the relative profitability of large vs. small investments or the effect of resource-intensive projects.

AfDB's policies lack specific guidelines on exit strategies, which poses a risk and capital cost to the Bank. Different funds may require different hold periods (infrastructure funds often require commitments of 10-15 years, whereas general purpose funds may be set at 8-10 years). Fund-of-fund investors often look to create additionality by selling down an investment in a successful equity fund after several years. AfDB's policies should address the issues related to exit strategies to provide guidance for investment officers

## IV. Management of Risk

### What frameworks and processes does the Bank use to manage portfolio risk?

*The Bank has adopted best practices from both peer MDBs and commercial banks for its risk management framework*

The Bank is exposed to financial risks through both its banking and treasury activities, most markedly in terms of credit, market and liquidity risk. The Bank has undertaken frequent review, evaluation and adjustment of

its risk models, procedures, and policies in order to maintain an appropriate risk management framework for private sector operations (see Figure 9 below). Currently, the Bank's portfolio risk is managed by two separate units: the Financial Management Department (FFMA), which is responsible for the identification, measurement, monitoring and mitigation of all risks incurred by the Bank; and OPSM 5, which

is responsible for portfolio management. This is consistent with best practices in commercial banks and MDBs.

The Bank's risk appetite statement considers priorities such as support to LICs and fragile states, and maintaining the AAA rating of the Bank. Following concerns expressed by external stakeholders over the rate of growth of private sector investments and associated consumption of risk capital, the Bank appointed McKinsey in 2010 to review and adjust its risk appetite statement. The new statement better aligns the allocation of risk capital with the business strategy and better communicates prudential exposure limits across the institution. Updated risk management practices are embodied in written guidelines, which are reviewed and updated periodically. These include the *Credit Risk Management Guidelines for Non-Sovereign Operations*, and the *Asset and Liability Management Guidelines* for identification

**Figure 9: Evolution of the Bank's risk management policies and procedures**

2008	2010	2011
New exposure limits	Revised credit risk guidelines	New risk appetite statement
	Revised asset and liability management guidelines	New capital adequacy framework
	Increase of the Bank's capital resources	New non-sovereign pricing framework
		Creation of credit risk committee

and management of market (including interest rate and currency risk), liquidity and operational risks.

**The Bank has remained within defined exposure limits for the private sector portfolio overall, and for single clients and sectors...**

The Bank's exposure management framework, designed to ensure a well-diversified portfolio, is based on three categories of prudential limits: strategic, operational, and business level, as described in Pillar II of the *Capital Adequacy and Exposure*

*Management Framework Policy 2011*. The limits in each category are percentage limits of the total risk capital.<sup>8</sup> Other MDBs observe similar prudential limits with regards to their private sector operations. During the review period, the Bank was in full compliance with its non-sovereign risk capital limit, with the single obligor limit, and with the single sector limit.

**...but exceeds some country limits under the new exposure framework.**

Prior to the introduction in 2011 of the Performance Adjusted Country Limits (PACL) formula developed by FFMA, there were no breaches of country exposure limits. The PACL formula takes into account a country's risk rating, GDP and population. Consequently, some country-level exposures that were formerly compliant are now in excess of the PACL limit. Under the *Capital Adequacy and Exposure Management Policy 2011* public and private sector allocations are aggregated, such that AfDB countries among this list remain in compliance with their global limits. However,

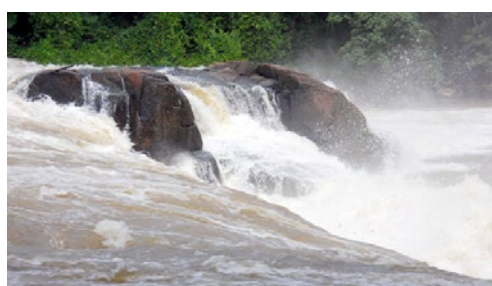
this is not the case for the African Development Fund (ADF) countries, which remain in breach. In time, loan repayments will reduce risk capital utilization to compliant levels; meanwhile, private sector lending in these countries will need to slow or cease.

The two largest country-level exposures for the Bank are in X and Z, which together account for 21 per cent of private sector risk capital, this share having fallen over the last three years. However, the true level of exposure to country-level risk also includes corresponding exposure under regional projects. This could be significant, though is not reported in country-level exposure data.

## How does the Bank assess and price investment risk?

The Bank has a standardized process for credit approval, which is the same for all projects regardless of the investment amount. FFMA is responsible for issuing credit risk ratings at the transaction level. However, the Bank's guidelines do not make clear which officer or group (below Board level) is directly responsible for making credit-based decisions as part of the approval process. There is, for example, no Chief Risk Officer or Chief Credit Officer, as is common to commercial banks and some MDBs. Moreover,

**The Bank uses a standardized credit approval process, which is not always warranted.**



<sup>8</sup> Total risk capital for lending operations is calculated after providing 10 per cent of risk capital for treasury and operational risks. Risk capital consists of paid-in capital and reserves (including loan loss reserves).

there is no delegation of authority permitted within the Bank's guidelines, meaning that all projects, regardless of size, complexity, risk, and borrower history require approval by the Board. This arrangement is inefficient and at odds with other institutions, who typically refer only large, complex or high-risk operations for full Board review, smaller and lower-risk operations being approved below Board level.

The internal risk-rating model has been updated to make it more granular and aligned to industry best practices, with 22 grades between 1+ and 10 for the lowest- to highest-risk investments respectively. Regulatory requirements for commercial banks typically specify that at least seven grades should be used for non-defaulting borrowers and that the rating scale should be defined such as to differentiate sufficiently between all borrowers. The Bank's risk-rating model complies with these requirements. For new investments, normally only obligors rated 5 or better are considered. There is scope, however, for the Bank to approve projects with higher risk ratings (above 5) if these are in fragile states or LICs, or otherwise exhibit high additionality or prospective development outcome quality. For active investments, credit risk ratings are reviewed twice a year for those larger than UA 50 million and once annually for all others.

The weighted average risk rating (WARR) of the active private sector portfolio for the period from 2006 to 2011 has remained within the target band of 3 to 4.50. The WARR on new approvals has increased from 2.86 in 2010 to 3.44 in 2011, partly because of the change in the Bank's risk rating methodology and partly due to increased

interventions in LICs and fragile states. As part of its risk management strategy, the Bank aims to make a small number of large, low-risk investments to balance a small number of higher risk investments.

The Bank's loan pricing methodology (summarized in Figure 10) has been updated in accordance with its *Capital Adequacy and Exposure Management Framework Policy 2011* and its *Proposal for a Revision of Loan Pricing for Non-Sovereign Operations*. This new framework reflects the real cost of funds to the Bank and takes into account all related risks (credit and concentration). In addition, it incorporates a flexible element to the margin (which can be positive or negative) to enable the Bank to maintain its competitiveness in the market by aligning its pricing to those of other lenders. However, the Bank does not include prepayment risk in its pricing formula in contrast to other MDBs such as IFC, EBRD, and AsDB, which have defined policies on prepayments. Furthermore, the Bank does not currently have a time-recording system<sup>9</sup> to track and assign transaction costs to individual investment operations, and hence cannot accurately reflect administrative charges in its loan pricing.

*The weighted average risk rating is within the target band, though has risen recently due to increased interventions in LICs and fragile states*

*The new loan pricing framework is closely aligned with those of other commercial and multilateral banks...*

*...but does not accurately capture prepayment risk or administrative costs*

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<sup>9</sup> A Time-recording system was instituted recently and was not in use for the period of the evaluation.

## Figure 10: Changes in the Bank's pricing framework for private sector loans

Parameters	Old Pricing Framework	New Pricing Framework (2011)
Base Rate	Reference rate	Reference rate + Funding margin
Spread	Credit spread	Credit spread + Tenor spread + Concentration spread
Administrative Charges	Fixed fees	Fixed fees + Total private sector cost
Flexible Margin	Not Applicable	Positive or negative
Cap	750 bps	Dynamic
Floor	0 bps	60 bps

### *Pricing and credit risk are more strongly correlated under the new framework...*

In analysis undertaken by FFMA, the lending margins for 49 private sector loans were determined using the new pricing framework and compared with their corresponding credit risk ratings (see Figure 11). Credit risk and pricing were found to be closely correlated (with a factor of 0.86), which confirms that the Bank is charging more for higher risk and that the relationship is reasonably linear. This is a marked improvement over the previous pricing framework, for which the relationship between risk and price was much weaker (with a correlation factor of just 0.50).

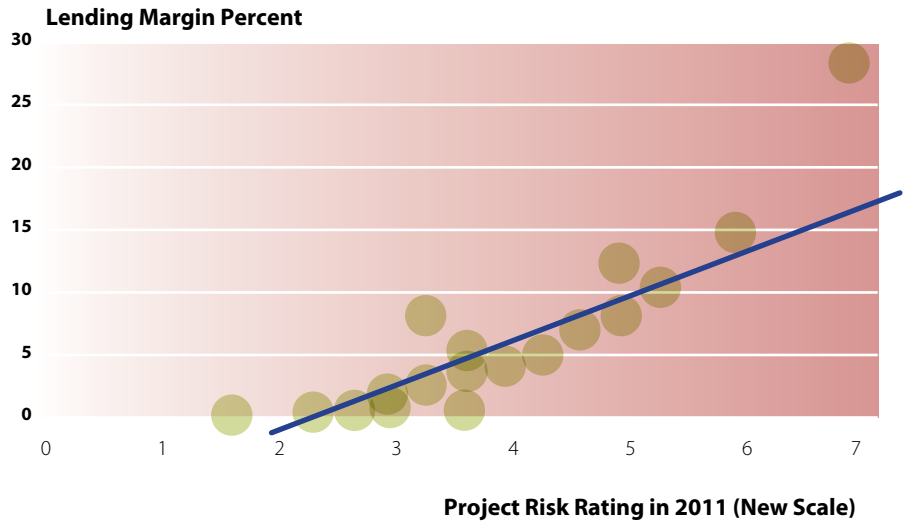
### *...but there is a risk that the Bank could be under-pricing loans relative to peer institutions*

A study comparing the pricing of five theoretical loan operations by different MBDs was recently conducted by DEG. Respondents were required to indicate the total premium

they would charge on each. The results are summarized in Figure 12, and in four of the five cases show that the Bank is pricing risk at the lower end of the range of quotes from peer institutions. This raises two concerns: firstly, the potential negative impact on the Bank's profitability; and secondly, the possibility of distorting the market and displacing private sector lenders operating on more commercial terms. This apparent under-pricing could stem from the omission of prepayment risk in the Bank's new pricing framework. Furthermore, a comparison of credit risk and loan pricing under the new framework carried out by FFMA, shows that the Bank under-prices higher risk transactions but overprices lower risk transactions. Although the pricing framework cannot ensure full recovery of the cost of risk at transaction level, it is imperative that the Bank remains able to comply with this principle at portfolio level with particular attention to high risk transactions.



**Figure 11: Comparison of credit risk and loan pricing under the new framework**



Each project is represented by a transparent circle. Darker areas indicate a higher concentration of projects. Project risk is determined in accordance with the latest risk-rating scale.

**Figure 12: Pricing of five theoretical projects by MDBs**

Project	Equivalent International Rating	Total Bank Premium	Premium Range Among MDBs
1	B+	471 bps	200-900 bps
2	BBB	148 bps	70-1000 bps
3	BBB-	148 bps	80-450 bps
4	BB	256 bps	110-600 bps
5	BB+	196 bps	110-1020 bps

## What are the implications of the Bank's risk management policies for its private sector strategy?

*The May 2010 General Capital Increase has created more headroom for the Bank's private sector operations...*

The Bank's risk capital determines the volume and type of risks that it can bear under its investment and treasury operations. The Bank's usable capital is one of the most important criteria used by

credit rating agencies in monitoring the Bank's AAA credit rating. The most recent General Capital Increase (GCI-VI), approved in May 2010 by shareholders, increases the Bank's capacity to provide investment support for private sector development. The current risk capital utilization rate of 60 per cent means there should in theory be sufficient headroom to continue private sector lending operations without breaching prudential limits before the end of 2020. However, the effect of recent downgrades of major African countries where the Bank has exposure has been to decrease the quality of callable capital and could reduce the Bank's risk-bearing capacity in the near term.

*...though growth of the Bank's equity portfolio will need to be managed carefully to remain within prescribed limits*

The Bank's investments in equity funds entail greater instrument risk in comparison to loans and credit lines. They also have a longer average life and therefore tie up the Bank's capital for a minimum of seven

years. Equity investments (both direct and via funds) had consumed 10.3 per cent of total risk capital in 2011, which is approaching the Bank's ceiling on equity investments of 15 per cent. Lack

of headroom for the remaining period to 2020 could therefore constrain further growth in the equity portfolio (stress-testing shows that the equity limit could be reached as early as 2014). For comparison, in the Asian Development Bank the maximum allocation for equity investments is fixed at 10 per cent of total risk capital, whilst IFC has no explicit limit but instead sets a target that is reviewed periodically based on sector and regional criteria.

In 2011, the Bank adjusted its capital adequacy framework to align with its strategic focus on LICs and fragile states, increasing gradually the allocated risk capital for private sector operations in these countries from 40 to 50 per cent. This decision was made based on feedback received from shareholders, external auditors, and rating agencies, and following recent changes in the regulatory requirements and International Financial Reporting Standards (IFRS). The new allocation methodology provides a more dynamic and flexible framework for managing the Bank's scarce resources.

However, overall lending activity to LICs and fragile states as a risk group could still be constrained by new PACLs and Sustainable Lending Limits (SLLs), such that further lending operations in specific countries would require Board waivers. This is because the Bank has a 10 per cent aggregate restriction on

*The new capital allocation methodology should allow the Bank to implement its strategy whilst managing its scarce resources...*

*...though other criteria could restrict portfolio growth in LICs and fragile states, and limit large investments in infrastructure projects*

## Box 4: Selective Equity Participation

Given potential constraints on equity headroom for the remainder of GCI\_VI period (2012-2020), the Bank should be more selective with regards to the equity participation projects. It should consider reviewing the entire portfolio and explore the possibility of selling part of its equity exposure (at the appropriate time) to create additional headroom.

high-risk projects (with credit risk ratings of 5- or more). As of December 2011, 19 of the 22 LICs and fragile states in the Africa region were rated 5 or higher, and so investments in these countries will count towards this 10 per cent limit. Moreover, SLLs in these countries could restrict or preclude important, large infrastructure projects and make simultaneous development efforts, similar to those seen in Senegal<sup>10</sup>, difficult or impossible.

## Conclusions

To date, the Bank has managed the growth of its private sector operations within the defined exposure limits for the overall portfolio and for

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<sup>10</sup> The Bank supported four infrastructure interventions in Senegal, which helped institutionalize best practices in the management and transparency of tender processes for future Senegalese infrastructure projects.

single clients and sectors. The May 2010 General Capital Increase has created more headroom for the Bank to expand its private sector operations going forward. This, along with the new capital allocation methodology should allow the Bank to implement its strategy whilst managing its scarce resources. However, there are target growth areas within the private sector strategy that need to be monitored closely to remain within prescribed capital and risk limits, including equity investments and exposure in LICs and fragile states.

The Bank uses a standardized credit approval process, which is not always warranted in the case of smaller or lower-risk investments where delegated authority would likely prove more efficient. For loans, the Bank has adopted a new pricing framework that brings it into line with other commercial and multilateral banks, and more closely reflects the underlying credit risk. There is evidence to suggest, however, that the Bank is under-pricing loans relative to its peers, possibly because of the omission of prepayment risk from the pricing formula. Furthermore, a comparison of credit risk and loan pricing under the new framework carried out by FFMA, shows that the Bank overprices lower risk transactions and under-prices high risk transactions. The under-pricing of high-risk transactions is of concern from a risk-management perspective and requires particular attention.

## V. Institutional Efficiency

### How do the Bank's business processes and procedures compare with its peers?

*The Bank's project approval processes are cumbersome and employ more steps than other MDBs. Thus, the time taken to reach approval is significantly longer.*

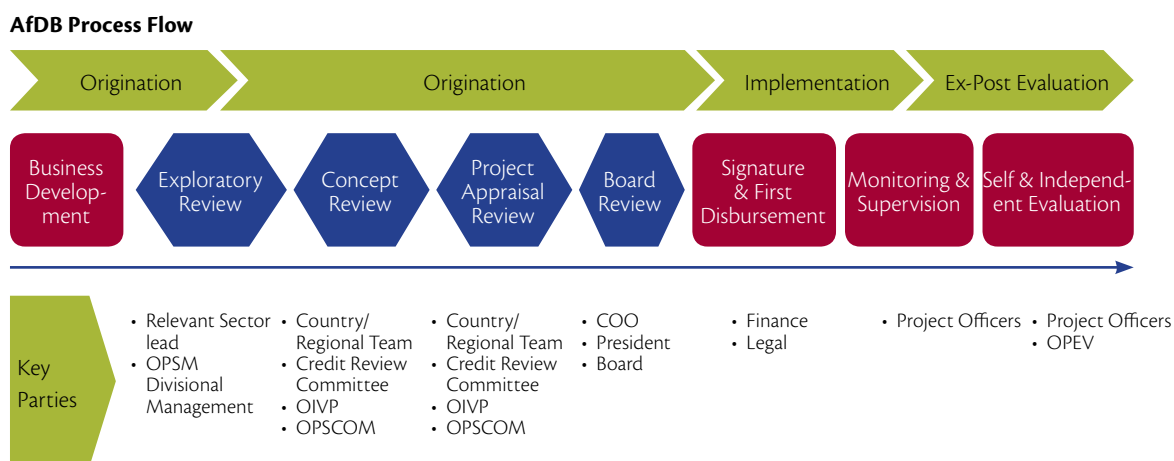
Under the Bank's operating model for private sector operations, the core business processes of origination and portfolio management are performed in OPSM and governed by OPSCOM and the Board. These business processes are supported by legal, risk, financial

control, treasury, human resources, economics, research, and country / regional teams. In Tunis, staff are organized by their functional discipline and area of expertise. There are also 16 private sector field officers (FOs) based in the Field Offices or the Regional Resource Centres, who carry out origination and portfolio management activities.

The Bank's approval processes, summarized in Figure 13 below, are similar in overall structure to those of other MDBs and DFIs. However, the Bank has at least five gating stages during Concept Review and at least five more before final approval. In contrast, peer institutions typically have three gating stages for the entire approval process. The Bank's processes are therefore more cumbersome and require IOs to spend a great deal of time preparing documentation for each stage, often repeating activities along the way.

The number of projects approved per annum has increased from eight projects in 2006 to 29 projects in 2011. However, over the same period, the time required for projects to reach Board approval has increased, reaching a high of 16 months on average in 2010, with some taking as long as 43 months (see Figure 14 below). Approval times vary depending on

**Figure 14: Bank processes involved during the project lifecycle**



sector (infrastructure projects taking slightly longer on average due to their relative size and complexity), and on instrument (equity funds and lines of credit generally taking less time than senior loans).

Other MDBs and DFIs require between four and six months on average for their projects to reach approval; any project taking 12 months is considered an outlier. In comparison, therefore, the Bank's processes are resulting in protracted approval times, which impedes its responsiveness for clients, causing them to delay their investment plans or incur additional costs from bridging loans.

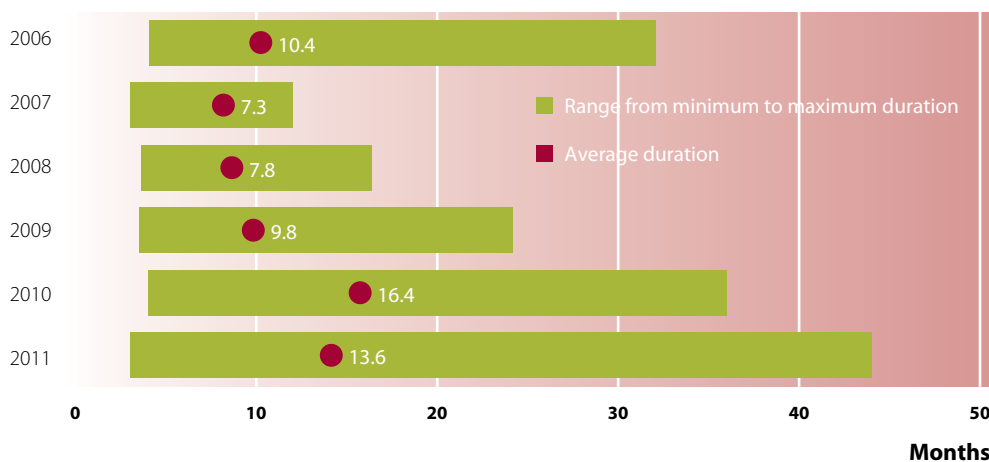
All investments, regardless of value, are approved by the Bank's Board. Other institutions use delegated approval authority to levels below the Board, which makes the approval process more efficient for certain types of investment operation. For example, IFC has decentralized both

project origination and credit decisions, with only the largest investments requiring Board approval. IFC uses a streamlined Board approval process for low-risk investments of a small enough size, which involves Board notification rather than full review. Similarly, the IDC has delegated decision-making to the credit committee for investments below UA 2 million, and to the full executive team if up to UA 20 million, with only investments above UA 20 million requiring full Board approval. In ERBD, most projects in financial institutions are processed under framework agreements, which are approved by the Board. Individual approvals of up to UA 8.5 million are then sanctioned by credit committee, typically within four to six weeks.

From the point of Board approval, Bank investments then require a further seven months on

*Other MDBs employ streamlined procedures or framework agreements, combined with delegated authority, to expedite approval times*

**Figure 15: Average time required from exploratory review to Board approval**



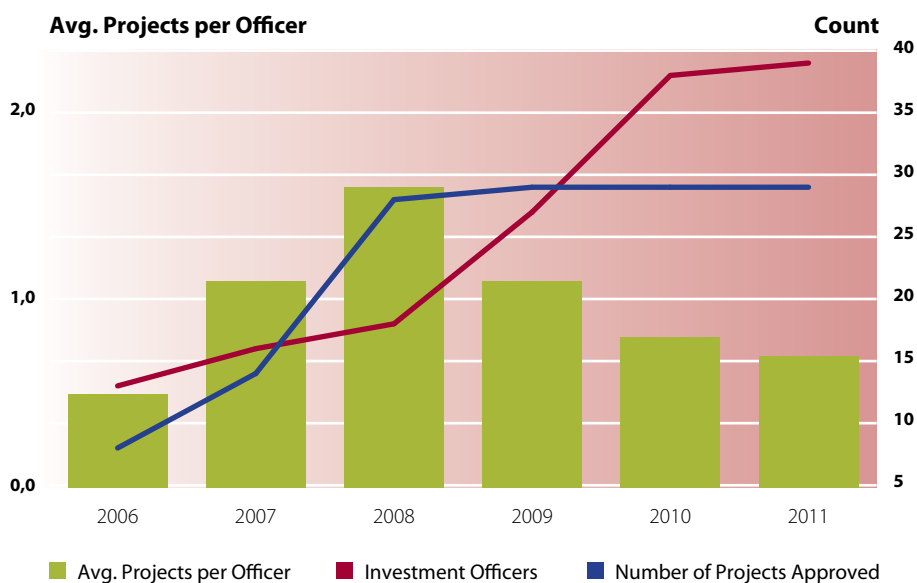
average in order to reach commitment upon signature of the investment agreement. Again, this is significantly longer than in other MDBs, where the time required is generally less than three months. In most cases, at the Bank, the delays are due to protracted legal negotiations or extended due diligence.

to four for IFC and EBRD. In practice, Bank performance has fallen short of these targets. In part, this is due to the time lag between increasing staff numbers and new projects reaching approval (exacerbated by the lengthy approval processes described above). Bank performance also falls short of its peers in respect of portfolio management efficiency, which is illustrated in Figure 17. Although the number of projects per portfolio officer has increased steadily to seven by 2011, this remains below the industry standard of ten. With growth in the Bank's complement of portfolio staff having now levelled off, this efficiency ratio can be expected to improve in future years as the active portfolio continues to grow.

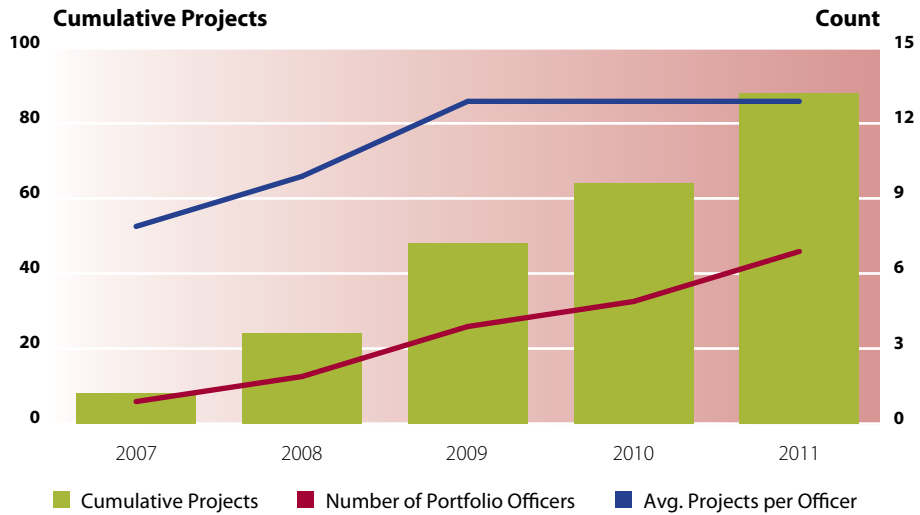
**Efficiency measures for the Bank fall short of those in other institutions**

Figure 16 shows the average number of projects approved per investment officer (IO) per annum over the review period. For this measure, the Bank originally set a target of 1.1 with the intention of increasing this over time to a level more aligned with peer institutions, which range from three

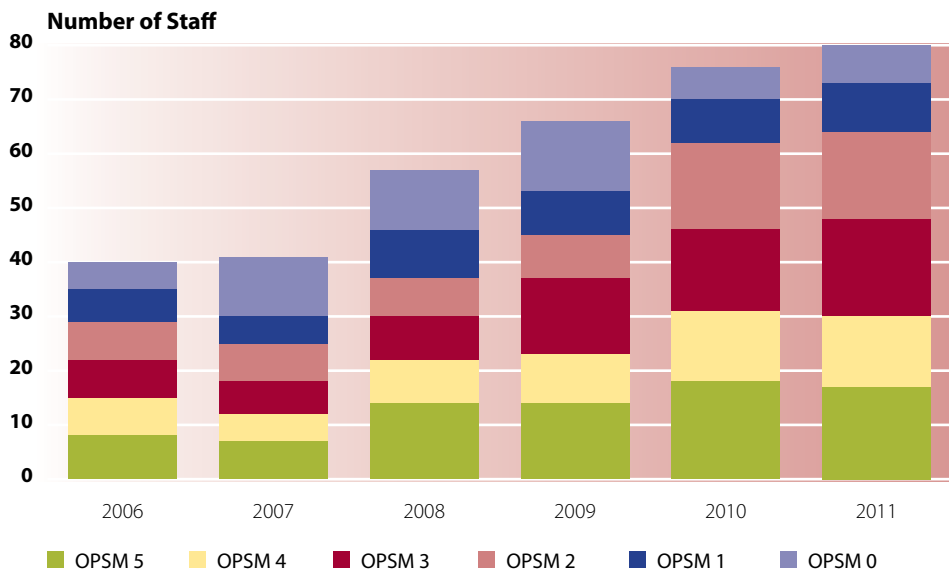
**Figure 16: Average number of projects approved per investment officer**



**Figure 17: Average number of projects per portfolio officer**



**Figure 18: Growth in OPSM staff from 2006 to 2011**



## How adequate are the Bank's resources and its institutional structure?

*Bank staff exhibit skills across most sectors and disciplines, but more staff are needed with experience in project workouts and investment recovery*

Since 2007, OPSM's budget has grown by 80 per cent to UA 7.9 million in 2011. The proportion of the annual budget expended each year ranges from 92 to 98 per cent with no incidence of overspend. On the face of it, the budgeting process

therefore appears to be accurate. However, the department usually runs out of budget to support its operations by mid-way through the year, which restricts its ability to carry out missions for appraisal or supervision, and to hire consultant support for project origination and implementation. In every year except 2008, the budget has had to be

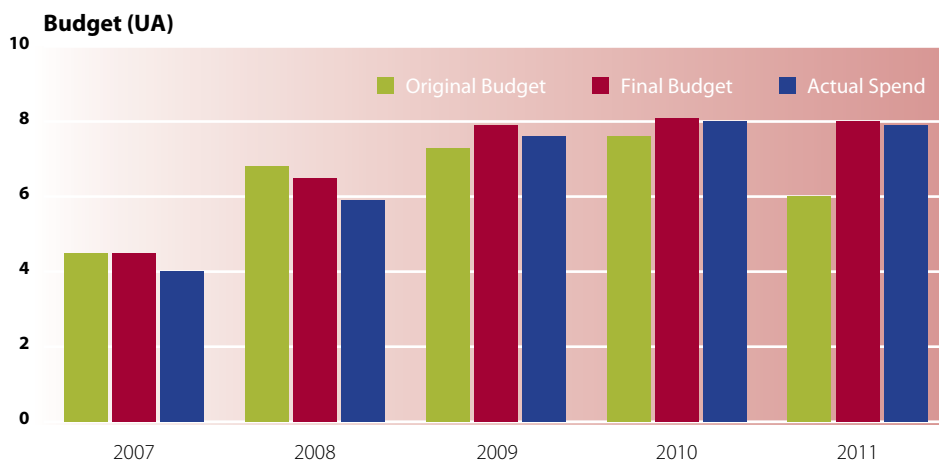
*The Bank consistently fails to budget properly and adequately for execution of its private sector strategy*

adjusted in-year and reallocated between OPSM organisational units (see Figure 19). The largest difference between original and final budgets is usually for

consultant costs, where increases over the last four years have been 100 per cent or more. The perennial inadequacy of the budget appears to stem from a lack of collaboration between OPSM and the Bank's budgeting department (COBS). COBS reported that some work plans submitted by OPSM were not credible or robust enough for the budget to be allocated, whilst OPSM reported that the reasons for budget cuts were not communicated clearly. COBS also acknowledged that some budget coordinators lacked sufficient skills and knowledge to manage the budget processes. The rate of budget utilization is one important indicator of budget adequacy which should be considered along with benchmark norms of other institutions (see Para 5.7) and the increase in OPSM portfolio over the last five years.

The decentralization roadmap aims for a 40 per cent increase in project origination by FOs by 2015. Currently, FOs hand-over eligible projects to Tunis-based IOs after exploratory review, although they still participate in the appraisal

**Figure 19: In-year amendments to the OPSM budget**





*The Bank's decentralization roadmap aims to increase its capacity to source and process more operations in the field*

process if there is a need. Also under the roadmap, more supervision responsibilities will be delegated to field staff. Implementation will therefore require more skilled and experienced staff in the field. To date, the Bank has deployed 16 FOs in Field Offices or regional

hubs based in 14 countries. International FOs are deployed in broader geographical locations that might cover more than one country, whilst local FOs tend to be focused more domestically. Most clients respond positively to FOs as they have better country knowledge and their presence in the field enhances communication and relationships with the Bank.

## Conclusions

Efficiency measures for the Bank fall short of those in other institutions. For example,

the Bank's project approval processes employ more steps than other MDBs and the time taken to reach approval is significantly longer. Other MDBs employ streamlined procedures or framework agreements, combined with delegated authority, which help to expedite approval times for certain classes of investment.

The Bank's complement of staff in private sector operations has grown to 80, including 39 investment officers and 13 portfolio officers. In general, these staff exhibit skills across most sectors and disciplines central to the private sector strategy, though more are needed with experience in project workouts and investment recovery. Increasingly, staff are being relocated to, or recruited in, the field as part of the Bank's decentralization roadmap. An overriding concern, however, is the repeated failure of the Bank to budget adequately for its private sector operations.



## VI. Overall Conclusions and Recommendations

### In what areas is the Bank performing well?

Through the selection and financing of the projects it supports, the Bank has generally achieved good alignment of its operations with the private sector strategy. Its presence as a finance partner has a signal effect on other investors and lenders, such that in addition to its own contribution of UA 3.9 billion, these projects have succeeded in mobilizing a further UA 20 billion of financial support. The Bank has originated 54 per cent of its approvals in low-income countries, evidence of its critical role in catalysing private sector investment in economies that attract only a relatively small share of regional FDI and private capital flows.

The Bank has adopted industry best practices for measuring and managing risk in its private sector portfolio. It has remained within defined exposure limits, and within a target range for the portfolio's weighted average risk rating. Under its new pricing framework, loan margins and fee structures are now more closely aligned with the underlying credit risk of transactions. The May 2010 General Capital Increase has created more headroom for the Bank to expand its investment operations in pursuit of the private sector strategy.

The Bank has increased to 80 the number of staff dedicated to private sector operations. They exhibit skills across the sectors and functional disciplines that are central to the strategy. Implementation of the decentralization roadmap will provide more resources in the field to help

the Bank originate, transact and supervise investments more efficiently and enhance client responsiveness.

### In what areas could the Bank improve its performance?

Compared to its peers, the Bank has used a relatively narrow range of instruments to support private sector development; predominantly senior loans, lines of credit and equity investments. At the project level, greater use of guarantees, local currency and trade finance, and other innovative financing products could help meet the needs of more clients. Technical assistance at the project or macro level is also under-utilized by the Bank yet could help relieve market, regulatory and policy constraints to private sector investment.

Although the Bank aims to increase its reach to micro and small enterprises by channelling its funding through financial intermediaries, there is insufficient evidence that these target groups are actually the beneficiaries of sub-loans. More generally, the Bank has inadequate systems for monitoring and reporting the development effects at the project level. In part, this is due to a lack of client knowledge or capacity to collect and provide relevant data to the Bank, but it also stems from a lack of internal focus on these areas during supervision.

The Bank has been unsuccessful in sourcing new investment opportunities on the ground, relying instead on approaches from prospective

or existing clients, or on referrals from other multilateral or commercial banks and investors. In converting pipeline projects into approved investment operations, the Bank falls well short of its peers in the time it requires and the efficiency of its processes. The Bank is also hindered by a repeated failure to budget adequately for its operational requirements.

The Bank's loan portfolio is still relatively young and its profit contribution is not yet evident. The Bank's non-performing assets show an increase and are now at 2.51%. While this is reasonable, it is important to note that more than half the portfolio is less than 2 years old and still in the grace period. Thus it is hard to determine the direction of the non-performing portfolio for the future. As a comparator, the level of non-performing assets at the IFC which holds a mature portfolio is 4.7%. There is also evidence to suggest that the Bank is overpricing or under-pricing loans relative to its peers. The under-pricing occurs in the high risk category and requires particular attention. Finally, during the period under review, the Bank has yet to realize any capital gains from its equity portfolio, which is currently yielding negative returns overall.

## Recommendations

Given the detailed findings of the four technical reports and the summary findings in this overview report, the following recommendations are made for the Bank's consideration.

### *Strategic priorities*

- 1. Bank's alignment with its strategy for private sector development. The Bank should:**

### *Financial sector operations*

- i) Review its strategy, policies and procedures for financial sector investments, particularly intermediation through lines of credit:
  - a. Develop specific investment guidelines that will allow to appraise the benefits and trade-offs of indirect wholesaling operations against direct interventions
  - b. Develop specific guidelines in supporting MSMEs in order to ensure that financial intermediaries are held accountable for the deployment of Bank funds and that these funds have the best chance of reaching their intended beneficiaries (e.g. MSMEs)

### *Bank value-added*

- c. Ensure that financial institutions comply with environmental and social requirements, and adopt a more systematic approach to capacity building in client financial institutions to help them establish sound approval, credit risk management, portfolio management and supervision, audit and reporting standards;
- ii) Determine why it has fallen short of its target level of support for industry and services clients, whether this sector remains an important focus under the strategy, and hence whether it should receive a higher or lower priority going forward.

### *Instrument mix*

- iii) Utilize a wider range of instruments including guarantees and trade finance.

### *One Bank culture*

- iv) Strengthen the One Bank approach to break silos and allow better synergies between the departments.

### *Equity performance*

## **2. Growth of Equity Portfolio**

- i) Develop policy guidance for exit strategy and deal with underperforming funds, with policy directives for re-valuation and strengthen supervision procedures.
- ii) Provide specialized officer training, place more detailed and more frequent reporting requirements on fund managers and recruit additional experienced investment officers and fund advisory board members.

### *Equity portfolio growth*

- iii) Be more selective in approving new equity investments, increase underwriting restrictions and reduce the overall rate of growth of new interventions.



- iv) Create headroom for new investments by:
  - a. Adopting an aggressive sales strategy for its active portfolio and devoting sufficient resources and staff towards monitoring the active portfolio, searching for viable exits and closing sales at the most opportune times;
  - b. Placing greater emphasis on future exit options at the time of approval of new equity investments;
  - c. Acknowledging that exits through initial public offerings (IPOs) are rarely possible, and not therefore a sufficient condition for approval;
  - d. Incorporating options on sponsors wherever possible or making use of alternative instruments such as preferred shares or other quasi-equity or mezzanine products with an assured payback schedule.

### *Monitoring and Evaluation*

## **3. Monitoring and Evaluating Results**

- i) Introduce an appropriate monitoring and evaluation system to measure and report the development effectiveness and ensure that the Bank collects sufficient, credible results data throughout the life of a project or technical assistance operations;
- ii) Address the apparent low level of client reporting on development results by reviewing the adequacy of the reporting template,

incorporating the requirement to report in project legal agreements, and working with clients to educate them on data collection methods;

#### *Performance measurement*

- iii) Introduce a highlight system based on score-cards at the departmental and individual level, which balance incentives for new approval volume

#### *Strategic, riskmanagement and capital adequacy imperatives*

#### **4. Strategic, risk-management and capital adequacy imperatives**

- i) Adjust the private sector strategy in recognition of any constraints imposed by prudent portfolio risk management, to achieve a balance between core strategic objectives, strategic priorities, and risk management guidelines.
- ii) Monitor closely the overall capital adequacy, the effect of downgrades of regional member countries on callable capital, and the consequent headroom for further growth in private sector operations.
- iii) Take into account explicitly the projected impact on portfolio risk from increased exposure to LICs, fragile states and other high risk-rated priority group.

#### *Delegated approval authority*

- iv) Consider delegating approval authority to levels below the Board by:

- a. Developing framework agreements for processing investments that fall below specified risk criteria;
- b. Clarifying the roles and responsibilities of staff for the credit approval process, and
- c. Considering introducing a position of Chief Credit Officer.

#### *High-risk operations*

#### *Loan pricing*

- v) Investigate the reasons for apparent under-pricing in the category of high risk transactions and periodically review the pricing framework to ensure its effectiveness and alignment to the ongoing development of the Bank's risk practices and standards (Economic Capital Framework, Enterprise Risk Management etc.

#### *Loan security*

- vi) Reinforce the systems and procedures for documenting, perfecting and monitoring the value of loan collateral, sponsor guarantees and other forms of security and strengthen financial systems in local markets by improving collateral protection and the enabling environment for SME lending.

#### *Workout capacity*

- vii) Develop its work out capacity by developing comprehensive and clear policies, procedures and resources required to react quickly to deteriorating credit quality in investments, intervene with clients, sponsors and co-financiers, and where necessary instigate

recovery measures to minimize financial loss for the Bank.

## **5. Institutional Efficiency**

### *Decentralization*

- i) Proceed with its decentralization strategy to place a critical mass of private sector staff in the field with a mandate to identify, originate and, where appropriate, approve new investment projects;

### *Approval times*

- ii) Review its approval procedures to identify where there is duplication or repetition of activity or where certain processes are not adding value to be informed by client surveys and feedback as to the main causes of dissatisfaction.

### *Time-recording system*

### *Management Information System*

- iii) Upgrade its Management Information System (MIS) to provide centralized, one-stop access to all relevant project and investment documentation and implement a time-recording system to track staff activities during project origination and supervision, in order to attribute transaction costs and administrative overhead to individual investments.

### *Budget processes*

- iv) Address current deficiencies in the budgeting process and in the skill levels of budget coordinators, to ensure that budgets for private sector operations are credible and sufficient





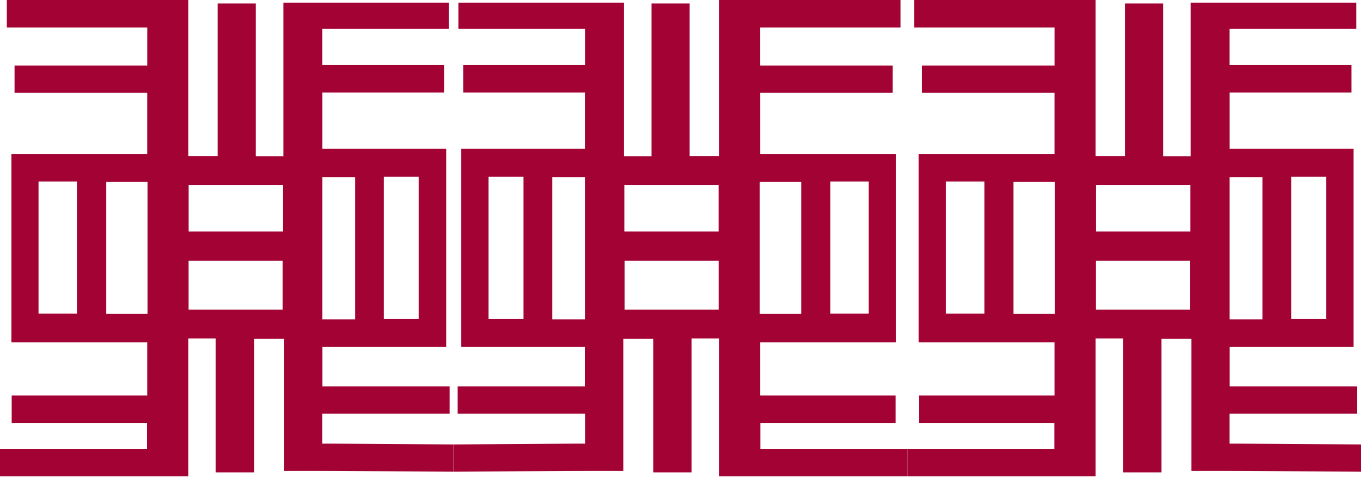




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Independent Evaluation of Non-Sovereign Operations, 2006-2011

## SUMMARY REPORT

This evaluation reviews the Bank's portfolio of 137 investment operations and 38 technical assistance projects approved by the Board between 2006 and 2011. It assesses four aspects of the portfolio: the strategic alignment of the portfolio, the performance of the portfolio, the risk management framework and risk exposures, and institutional efficiency.

The evaluation highlights such positives as the catalytic effect of the Bank's operations, the risk management framework and growth in private sector operations in LICs. It reports negatives related to the one-Bank approach, the reach to SMEs and MSMEs, and inefficiency in the approval process.

**About the AfDB:** The overarching objective of the African Development Bank Group is to spur sustainable economic development and social progress in its regional member countries (RMCs), thus contributing to poverty reduction. The Bank Group achieves this objective by mobilizing and allocating resources for investment in RMCs; and providing policy advice and technical assistance to support development efforts.

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