Management Response

Management welcomes IDEV’s evaluation of the Bank’s 2014-2019 Financial Sector Development Policy and Strategy (FSDPS) with a focus on the role of the Bank in increasing access to finance and financial inclusion in Africa. Overall, Management agrees with most of the evaluation’s findings and recommendations, which are useful in developing a new Financial Sector Development Strategy for 2021-2026. This note presents Management’s responses to key issues raised by the evaluation and provides ongoing and foreseen actions in response to IDEV’s recommendations.

INTRODUCTION

The financial sector is the lifeblood of the real economy and has played an important role in Africa’s recent progress. The financial sector is vital to achieving inclusive growth and the transition to green growth, the two strategic objectives of the Strategy for 2013–2022 of the African Development Bank Group (the Bank Group). However, the absence of deep, efficient financial markets constrains economic growth: limited access to finance lowers welfare and hinders the alleviation of poverty and the emergence of a middle class.

Management recognises that the complexity and the multidimensional nature of financial sector development requires continuous refinement of strategic and operational approaches, analytical tools, financial instruments, as well as policies and procedures. Management therefore welcomes IDEV’s evaluation, which assessed: i) the relevance and the quality of design of the FSDPS; and ii) the relevance, quality of design, effectiveness, efficiency, and sustainability of the financial sector development (FSD) operations approved between 2011-2018, focusing on access to finance. The period covers both the pre and post periods of the adoption of the FSDPS in October 2014.

Management takes note of IDEV’s findings and recommendations including:

- The Financial Sector Development Policy and Strategy (FSDPS) was highly relevant to the Bank’s Ten-Year Strategy and the High 5’s, as well as to RMCs and clients;
- Financial sector operations were relevant to the FSDPS objectives, to clients and member country needs, particularly because access to long-term finance is still a challenge in Africa. However, the high priority given to access to finance in the FSDPS and partner countries was not reflected in the country strategy papers (CSPs).
- Despite increased internal capacity to deliver, there was a weak coordination of financial sector development activities across the AfDB. However, a strong partnership with other actors in the financial sector has helped AfDB to extend its capacity to support the sector, and
- 65% of the operations evaluated by IDEV were rated satisfactory in terms of design, however there is a need for more clarity in definition of expected outcomes and improved monitoring and evaluation at the end beneficiary level.

RELEVANCE AND QUALITY OF DESIGN OF THE FSDPS

Management notes with satisfaction that the FSDPS was highly relevant to the achievement of Bank’s Ten-Year Strategy (2013-2022) and the more recent High 5’s strategies and operations. It also agrees with IDEV’s comments with respect to the design of the document, including the lack of clarity on the relationship between concepts and objectives of the policy and strategy and how these were to be achieved.

These reflect the fact the FSDPS was a hybrid document combining both policy and strategy. In this context the document did not clearly show how the shorter-term strategy would contribute to meeting the long-term objectives of the policy.
IDEVs finding that the FSDPS was overly ambitious is in part, a consequence of this lack of clarity. In line with current practice, management is preparing separate Financial Sector Development Policy and Strategy documents for approval by the Board in Q4 2020.

Management agrees with IDEV on the lack of a Theory of Change (ToC) and a detailed business plan to support the FSDPS. Whilst developing a ToC was not commonplace at the time the FSDPS was prepared in 2013, the revised strategy will build on a strong ToC. A detailed business plan will also be prepared in line with current practice.

Building strong sustainable financial systems requires an integrated approach linking upstream policy and regulatory work with governments to downstream non-sovereign operations (NSO). This was the approach behind the establishment of the financial sector development department (PIFD) in 2013, which was intended to bring policy and transactional work on the sector under the one department. Since the introduction of the Development and Business Delivery Model (DBDM) in 2016, public sector operations in the financial sector have been handled by the regions and NSO transactions by PIFD and some other departments. As underscored by the evaluation, one unintended consequence of the new institutional arrangements has been a dilution of PIFDs unifying role in dealing with sovereign and non-sovereign financial sector interventions.

Management has been working to address this and field based PIFD staff now contribute to Country Strategy Papers (CSPs) and sector diagnostics, in addition supporting other sector departments in the delivery of financial sector related transactions. Management will reinforce this collaboration with PIFD participation in CSP and Regional Integration Strategy Paper (RISP) missions. Furthermore, management will be looking to increase capacity in this regard under the new strategy, and in the context of the ongoing rightsizing exercise. A number of initiatives are being piloted in terms of policy dialogue as discussed elsewhere in this document. Scaling these up will require increased policy dialogue expertise and access to technical assistance / grant funding to support policy / public sector mandates.

Management will also seek to improve coordination of financial sector interventions through the establishment of an inter-departmental financial sector group as described in the Management Action Record below.

**RELEVANCE AND QUALITY OF DESIGN OF FINANCIAL SECTOR OPERATIONS**

Management notes IDEV’s observation that the financial sector operations were found relevant to the FSDPS objectives, to clients and member country needs, particularly because access to long-term finance remains a challenge in Africa. IDEV also notes that the Bank invested in institutions that played an important role in national and regional financial sectors.

Management accepts that the rationale behind the Bank’s interventions may not have always been clear, partly due to the broad definition of objectives in the FSDPS. While there were no targets in the original strategy for different parts of the portfolio, the following trends can be observed from IDEVs’ evaluation:

- The number and the volume of the operations approved in 2015-2018 were almost twice as high as those approved in 2011-2014.
- The share of sovereign operations by number increased from 8% in 2011-2014 to 18% in 2015-2018. In value terms, the share of sovereign operations increased from 15% to 28% of financial sector approvals for the respective periods.
- Lines of Credit (LOCs) remain the main instrument used by the Bank, however, their share of approvals in value terms has decreased from 60% to 34%. This decrease was compensated for mainly by a steady increase in Trade Finance Lines of Credit (TFLOCs) from 5% to 26%.
- The number of countries which benefited from financial sector operations increased from 19 to 31, implying a significant effort to expand the access to finance in more countries including low income countries.

IDEV notes that whilst LOCs and TFLOCs were relevant to supply liquidity for on-lending to sub-borrowers, their contribution to access to finance for underserved and the financial sector development was not ascertained. These instruments are by their nature and design not intended to address the underlying constraints of access to finance. LOCs are designed to provide access to longer term liquidity than is available in RMCs whilst TFLOCs address short-term liquidity constraints. Management notes with satisfaction IDEVs’ finding that the Bank invested in institutions that played an important role in national and regional financial sectors, including Afreximbank, and sub-regional and national development banks like Nigeria Development Bank, Namibia Development Bank, East Africa

Addressing the longer-term barriers to access to finance requires technical assistance and policy work, to improve regulatory frameworks and build institutional capacity in RMCs funded mainly through grant facilities. PIFD's ability to provide technical assistance is severely constrained by a lack of such funding. The establishment of the Capital Markets Development Trust Fund (CMDTF), which provides technical assistance to strengthen capital markets enabling environment and institutions, disseminate knowledge, and promote regional capital markets development and integration programmes is a step in this direction.

CMDTF is currently in its pilot phase and is focused on West Africa. Based on the results of this phase, management expects to expand its operations to other regions. The Africa Digital Finance Initiative (ADFI) is a blended finance facility which will intervene across four key pillars, namely; infrastructure, policy and regulation, products and innovation and capacity building with gender as a cross cutting theme. The facility, though managed under the Financial Sector Department, will support both private and public sector entities and work with all departments in the Bank.

The bank has also worked with partners to address these issues including through the Africa Long Term Finance Initiative (LTF) which is funded by GIZ and FSD Africa through Making Finance Work for Africa. The LTF aims to enhance market transparency through the development of an LTF Database and Scoreboard that aims to improve the availability of public data on LTF markets in Africa and developing country reform programmes based on country diagnostics. With regards to regional integration PIFD has supported the integration of regional financial markets since the evaluation including: (i) the African Exchanges Linkage Project (AELP) a joint initiative by the Bank and African Securities Exchanges Association (ASEA) to facilitate cross-border trading and settlement of securities across participating bourses in Africa, and (ii) the Project of Support to the Development of the Regional Financial Market (PADMAFIR) which supports the West African Monetary Union (WAMU) in the modernization of the regulatory frameworks to improve governance and the deepening of the regional financial market.

These initiatives have however been limited in scope due to a lack of adequate grant funding. The need to identify funding for more ESW work will be discussed in detail in the new strategy.

**EFFECTIVENESS, EFFICIENCY AND SUSTAINABILITY OF FINANCIAL SECTOR OPERATIONS**

Management notes with satisfaction that 65% of the operations evaluated by IDEV were rated satisfactory in terms of design. This covers a broad range of PIFD interventions including policy-based operations, operations extended to financial intermediaries - development banks, commercial banks) and those under the SME programme.

Areas for improvement include better definition of outcomes and intended results for end beneficiaries. This links to the overall issue of how to monitor and evaluate the impact of financial sector operations, particularly lines of credit and trade finance raised by the evaluation. Management accepts the need to improve monitoring and evaluation and is making efforts in this direction as discussed below. Managements' view, as expressed earlier is that LOCS and TFLOCs are not designed to address the underlying issues of financial sector development on the continent. However, they are important tools for providing long term finance, which is lacking in RMCs, and addressing critical short-term liquidity constraints as underscored in the evaluation.

The Bank currently applies a “pipeline” approach, to monitoring and evaluation whereby client financial institutions (FIs) submit an indicative list of projects to be financed under its lines of credit. The Bank is able to influence sectors of focus during due diligence / appraisal and includes this in the results management framework. This allows for verification during supervision. The pipeline approach has number of drawbacks including the fact that the list pf projects can only be indicative at the time of approval. More importantly, the fungibility of funds at the FI level means that it is not feasible to monitor and measure the impacts of specific projects financed by AfDB.

Management supports IDEV’s recommendation to move to a portfolio approach, where the AfDB would focus on priority areas at the portfolio level of the FIs. Under this approach, it would be possible to obtain a baseline of what the FI is currently providing in terms of funding to the target groups with a goal to increase it. This also requires defining clear targets (e.g. number and volume of funding towards underserved groups) as well as setting up a suitable monitoring system. With the portfolio approach it would be possible to use a representative sample to measure the
results at the end beneficiaries: revenue, jobs, etc. The portfolio approach would also help measure sustainability of impacts since changes in portfolio composition at the FI could be measured beyond the life of Bank facilities. This fits with Management plans to increase capital support of select banks through Tier 2 capital (especially post-COVID 19 recovery period), especially when they are strategically committed to developing SME financing as a business.

Management is working to develop a digital development outcome tracking tool that can be hosted within the African Development Bank and open to the FIs and their SME clients for them to provide on a regular basis their data as funds are being deployed. The tool will allow data inflows from SMEs – to FI/Intermediaries – and from FI/Intermediaries to the Bank, and would capture for each project, development outcomes including job creation, support of key business sectors, financial inclusion of target groups, loan tenors, and changes in SMEs’ revenues and assets. The tool will be tested on SME Programme operations in the first instance and eventually rolled to cover all financial sector operations. Management will also seek to identify grant funding to support FIs to adopt the portfolio approach, including through increased digitalization of M&E and reporting frameworks. Bank staff from PIFD and other divisions, notably ECMR will also require training in this new methodology.

With respect to the effectiveness of the operations, management notes that 76% were rated satisfactory. The evaluation highlights the critical role and additionality of financial sector operations in providing resources otherwise unavailable to clients.

The picture with respect to the efficiency of operations is more mixed, with just over 50% of the sample rated as satisfactory. The rating is due to time overruns in the approval of seven out of thirteen LOCs evaluated, and the perception amongst clients that the Bank’s approval processes long compared to other international financial institutions. Whilst IDEV rates the Partial Risk Guarantee (PRG) operation for currency risk hedging in Cameroun as “complex and inefficient”, management notes that the report concludes that the operation itself was set up efficiently. Management is of the view that the despite these weaknesses, such operations are an important part of the Bank’s support to our RMCs.

In this specific case, Cameroun would not have been able to access financial hedging instruments from the international commercial banks without a guarantee from a AAA rated institution like the Bank. The product is, structurally ‘complex’ and this was also a ‘first’ for both the Bank and Cameroun. The cost of launching new products is usually steep, time and cost wise. This however should not stop the Bank from being innovative and embracing new financial products and structures, to continue to be relevant. Notwithstanding this, such products require lengthy discussions and costly negotiations.

Management notes IDEV’s conclusion that it is uncertain whether the Bank’s clients will continue to serve underserved market segments beyond the term of AfDB’s facilities. Its view is that this reflects the short-term nature of the instruments used and the weak monitoring and evaluation systems as discussed earlier.

IDEV also highlights that policy-based operations received “a marginal part of resources” despite their strong role in strengthening financial sector development. Management accepts this assessment, which is due to factors discussed earlier including the unintended consequences of the split between public sector and non-sovereign operations and resource constraints (human and financial) within PIFD. As discussed earlier, management will seek to address this in the new strategy.

CONCLUSION
The valuable lessons and recommendations in the IDEV’s evaluation report will inform and enrich the development of the new Strategy and beyond.

They will also help in shaping the Bank’s analytical, strategic, and operational engagement in the financial sector.

IDEV’s recommendations are broadly in line with Management’s thinking, which gives confidence that the Bank is moving in the right direction.
## MANAGEMENT ACTION RECORD

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<th>RECOMMENDATION</th>
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| **Recommendation 1** – Clarify AfDB’s role in financial sector development | **AGREED** – Management generally agrees with IDEV’s recommendation and will address them as part of the process of preparing the new FSD strategy. With the respect to articulating how specific operations will contribute to FSD, management’s view is that some NSO interventions are designed to address liquidity constraints and provide longer term financing than is available in RMCs, without necessarily impacting the FSD agenda. 

**Actions:**
- PIFD will work with SNSP and relevant units to submit a separate revised strategy and policy documents and a business plan. The strategy will include a strengthened Theory of Change and be supported by a business plan. [PIFD, SNSP Q2 2021]
- The new strategy and business plan will lay-out the additional HR resources required and will be discussed in the context of the rightsizing exercise. In the interim, PIFD will strengthen collaboration with country offices and regional directorates and participate in CSP and RISP missions. PIFD will also contribute to participate in Country Program Performance Reviews, Country Diagnostic Notes, etc. [PIFD, Q2 2021] |
| **Recommended 2** – Position the AfDB as a key player in financial sector development. Priority areas of action include: | **AGREED** – Management accepts IDEV’s recommendation, which speaks to the need for additional resources to support policy and analytical financial sector work, and increased coordination both internally and with other development partners. 

**Actions:**
- PIFD will increase number of joint programmes/initiatives and gradually scale up facilities like the Capital Markets Development Trust Fund, and Africa Digital Finance Inclusion Facility and other technical assistance vehicles to support policy work in RMCs [PIFD Q4 2023];
- PIVP, RDVP and ECVP to discuss and agree Terms of Reference for a bank wide FSD Coordination Group. (PIVP, Q1 2021)
- PIFD will host two regional financial sector events a year in partnership with other DFIs/partners [PIFD Q2 2021]; |

- Prepare a business plan to be approved by the Senior Management detailing realistic actions to be undertaken in the short, medium and longer term, by type of country.
- Conduct sector diagnostics that identify barriers to access to finance at country and regional levels. Financial sector experts should work closely with in-country and regional economists, not only when carrying out country diagnostics but also when preparing country and regional notes and strategy papers. CSPs and RISPs should lay out the development objectives for the financial sector and outline a plan to achieve them. Likewise, PARs should articulate how supporting specific operations, institutions and the use of instruments will contribute to advancing FSD in the country.

- Step up AfDB’s engagement in policy and regulatory dialogue aimed at strengthening the financial sector environment.
- Formalize the coordination of the departments involved in the financial sector activities and institute a Bank’s wide system of information on the financial sector activities to facilitate evaluation and decision making. Also, improve the skills mix to include non-transactional staff to cover engagement in RMCs on reforms and diagnostics.
**Recommendation 3 - Improve benefits for the intended target groups. Priority areas of action include:**

- Better define and measure the project development outcomes and the benefits for target groups. A robust results framework and functioning monitoring and evaluation system focusing on results and aligned with the corporate results measurement framework is critical. It should be an integral part of the financial sector strategy.

- Include a clear definition of what constitutes an SME in PARs and CSPs. Definitions used by operations are often not clarified in the PARs, making it difficult to assess the contribution of the AfDB to SMEs. The AfDB should identify and target firms that require its support and for which it has a comparative advantage in supporting. If the AfDB uses the definitions of Regional Member Country (RMC) governments, partner financial institutions or other IFIs, it should define a methodology for measuring and aggregating impacts at the portfolio level. The strategic review of the AfDB’s SME support operations (Genesis Analytics 2018) provides a detailed analysis, together with suggestions on how to tackle the challenge of defining SMEs. The Africa SME Program’s working definition and practice of verifying if applied definitions can be considered an SME target group in a specific context is a step in the right direction.

- Further increasing the capacity of the AfDB’s 2013 Regional Africa SME Program could be a good step.
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<td>Move from a pipeline approach to a portfolio approach, focusing on increasing</td>
<td>PIFD will seek specialist resources (including through Trust Funds) to support the</td>
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<td>the relevant target portfolio. The AfDB should improve its focus on intended</td>
<td>portfolio approach with FIs on SME financing, including to: (i) support FIs to</td>
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<td>target beneficiaries. Instead of determining a list of projects (pipeline</td>
<td>deepen their internal capacity to scale-up lending to SMEs; (ii) develop financial</td>
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<td>approach) for guiding the on-lending to the intended target groups, the AfDB</td>
<td>infrastructure to support increased lending to SMEs such as credit bureaus, collateral</td>
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<td>should define targets at the portfolio level (portfolio approach). Combined with</td>
<td>registries and SME credit insurance; and, (iii) innovate through other mechanisms</td>
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<td>tighter and strengthened M&amp;E capacity of partners, portfolio-level targets</td>
<td>for SME financing such as leasing, SME shared service platforms, and factoring</td>
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<td>(e.g., the number, volume and the percentage of SME loans in the overall lending</td>
<td>solutions for SMEs in corporate value chains [PIFD, Q2 2022].</td>
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<td>portfolio) might lead to better results. However, at the strategic level,</td>
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<td>there needs to be a reflection on how to reconcile objectives such as</td>
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<td>maximizing the financial inclusion of the underserved and job creation.</td>
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<td>Along the same lines, clearer strategic objectives for on-lending to</td>
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<td>companies in fragile states could help increase the AfDB’s impact in some of</td>
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<td>the countries that are most in need. Once a portfolio approach is adopted,</td>
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<td>it would be possible to use a representative sample to measure the results</td>
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<td>at the end-beneficiaries: jobs, sales, etc. Digital platforms could be used</td>
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<td>and AfDB should be willing to support FIs in adopting the portfolio approach</td>
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<td>and to help them increase their level of digitization.</td>
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- Use of a more deliberate approach to narrow the gender gap in access to finance. So far, women are mentioned alongside other population groups as intended end-beneficiaries of FSD operations. However, the PARs tend to lack specific considerations of how operations help reduce the gender gap in access to finance. There is broad evidence that women face multiple regulatory, cultural, social and economic barriers that hinder their access to formal financial services, and their participation in the economy more broadly (Morsy 2020). These barriers cannot be addressed through targeted lending only but require a gender-transformative approach to financial inclusion. Aligned with other efforts in the Bank, such as the Affirmative Finance Action for Women in Africa (AFAWA) approved in April 2020, the AfDB should reflect on how it can advance women’s financial and economic inclusion through its different instruments, and how it can become more gender sensitive as an institution. This will require developing a credible results chain on how an operation is likely to address the barriers. It also implies obtaining more gender-disaggregated data on access to finance for women, with a baseline, targets and effective monitoring.