



1. Project Data :
OEDID: C2084
Project ID: P004809
Project Name: Second Development Bank Project
Country: Tonga
Sector: Financial Sector Development
L/C Number: C2084
Partners involved : ADB
Prepared by : Elliott Hurwitz, OEDCR
Reviewed by : John Johnson
Group Manager : Rene Vandendries (acting)
Date Posted : 08/09/1999

2. Project Objectives, Financing, Costs and Components :
Objectives : The project objectives were to: (1) implement interest rate policy reform; (2) increase production capacity in the agricultural, industrial, tourism, and service sectors (by providing funding which the GOT could on-lend to Tonga Development Bank to enable it to make sub-loans to enterprises); (3) support TDB's institutional development. **Costs and Financing :** As a cofinancier, IDA planned to contribute US\$3 million to supplement US\$5 million from ADB, which took primary responsibility for identification, appraisal, and supervision. Actual project expenditures totaled US\$6.7 million, of which US\$2.3 million was from IDA and US\$4.4 million was from ADB. IDA cancellations were US\$1.2 million. The project was signed on March 7, 1990, became effective on August 9, 1990, and closed (after 2 extensions granted by IDA) on December 31, 1995. The IDA project was closed after IDA declined a request from the government for a third extension (due to slow disbursement and TDB violation of ADB covenanted financial limits). ADB extended the project a third time until its closure in September, 1996.

3. Achievement of Relevant Objectives :
Interest rate reform : The government of Tonga removed interest rate ceilings on July 1, 1991, in accordance with their commitment under the project; **Increase production capacity :** 2,105 sub-loans were made--55 percent in services, and 32% in agriculture--which utilized around 84% of the funds available under the project, and according to ADB estimates created 521 jobs; **Support TDB institutional development :** TDB did not fulfill project expectations that it implement new internal procedures and diversify its portfolio.

4. Significant Achievements :
The government liberalized interest rates, which had previously been subject to a ceiling.

5. Significant Shortcomings :

- Despite lagging disbursements and long-held concerns regarding the financial health of TDB, the project received uniform ratings of "satisfactory" for both IP and DO from the beginning of supervision in 1990 until the project closed in 1995. These ratings do not appear to be justified.
- The subprojects supported by the credit were weak; of 110 subloans reviewed by an ADB mission, 30 were in arrears and 4 had been rescheduled; of the 47 that had been fully repaid, just 37 companies remained operational
- The weakness of the subprojects appears to have contributed to the deterioration of TDB's financial health. As of September 1995, TDB's "hard-core arrears" (12 months or longer) comprised 9.8% of its portfolio, compared with a maximum of 2.5% under ADB covenants.
- The weak subprojects appear to have resulted from a worse business environment than expected (recessions in Tonga's main trade partners--Australia, New Zealand, and Japan--and a shortfall in tourism). Despite this inauspicious environment, TDP loaned funds to companies that ADB assessed as having inadequate commitment to the projects, insufficient working capital, a poor sense of demand, and weak management.
- TDB violated its own operational policy by accepting the foreign exchange risks of a foreign currency denominated loan.

6. Ratings:	ICR	OED Review	Reason for Disagreement /Comments
Outcome:	Unsatisfactory	Unsatisfactory	
Institutional Dev .:	Not Applicable	Negligible	TDB did not diversify its portfolio, and remains overly dependent on a few, poorly-performing sectors. Collection efforts remain weak.
Sustainability:	Unlikely	Unlikely	
Bank Performance:	Deficient	Unsatisfactory	These ratings are essentially equivalent
Borrower Perf .:	Not Rated	Unsatisfactory	There were numerous covenant violations, and TDB failed to act expeditiously on recommendations for improved portfolio and operational procedures.
Quality of ICR:		Satisfactory	

7. Lessons of Broad Applicability :

- Even when IDA acts as a cofinancier, it should play an active role in project preparation and supervision to help ensure project effectiveness
- If it chooses to use a government-owned development bank as an intermediary for a FIL, IDA should have a strong justification, and should carefully monitor the operation
- Sound market analysis of potential long-term loan demand is essential in designing an effective FIL operation

8. Audit Recommended? Yes No

9. Comments on Quality of ICR :

IDA did not participate in the final supervisory mission, so the ICR is based mainly on information provided in the ADB Project Completion Report. Given that information base, the quality of the ICR is satisfactory, although it would have been useful to have information on: IDA's strategy in collaborating with ABD, and in utilizing a government-owned investment bank as an intermediary; why collaborating with TDB was continued for an extended period when the quality of its portfolio was not improving and its financial condition was deteriorating .