Office of Evaluation and Oversight

Approach Paper

Evaluation of Contingent Lending at the IDB

Inter-American Development Bank

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www.iadb.org/evaluation

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ACRONYMS AND ABBREVIATIONS

CCF	Contingent Credit Facility for Natural Disaster Emergencies
CCL	Contingent Credit Line for Natural Disasters
CPE	Country Program Evaluation
DDO	Deferred Drawdown Option
DSL	Development Sustainability Credit Line
ERF	Emergency Reconstruction Facility
GDP	Gross Domestic Product
IAMC	Independent Assessment of Macroeconomic Conditions
IFI	International Financial Institution
IRF	Immediate Response Facility
PBL	Policy-Based Loan
SG	Sovereign-guaranteed

I. INTRODUCTION

1.1 **International financial institutions (IFIs) have developed various tools for assisting countries in times of crisis.** The sovereign-guaranteed (SG) instruments range from ex-post crisis resolution measures to precautionary tools that help countries prepare for crises ex-ante. Ex-post crisis resolution involves providing resources to support countries when a shock has already taken place. Emergency lending modalities generally fall under this category: countries demand an emergency loan after the shock has occurred and, therefore, approval from the IFI's Board of Executive Directors follows the crisis. Ex-ante crisis mitigation, on the other hand, is meant to guarantee the availability of funds in anticipation of an actual financing need (usually subject to certain conditions), so that resources can be swiftly accessed if the need arises. Contingent lending modalities fall under this latter approach: countries request a contingent credit line before a potential shock strikes, and thus approval from the IFI's Board of Executive Directors precedes the eventual crisis.

1.2 **Contingent lending is therefore a tool to help countries enhance their ability to manage risk and exhibits some characteristics of an insurance policy.** Insurance theory[1] states that demand is formed by consumers (governments, in this case) weighing the decision of whether or not to buy insurance by taking into account five dimensions: i) the probability of the insured event occurring, ii) the expected size of the loss should the event occur, iii) the insured amount (or expected insurance payout), iv) the insurance premium or cost, and v) the wealth (or income) in place to weather the shock. From the countries' perspective, these five decision factors are viewed not in isolation, but relative to other alternatives in preparing for crisis situations, including savings (e.g. through reserve build-up), non-IFI financing, swap or other financing arrangements, and ex-post emergency assistance. Albeit with caveats, all these factors are also relevant in the case of contingent borrowing from IFIs.

1.3 **In recent years, the IDB has created several contingent lending instruments designed to anticipate needs caused by external economic shocks or natural disasters.** As originally conceived, most of those modalities provided emergency assistance approved after the occurrence of the shock, but since the 2008-2009 global financial crisis (and, in particular, since IDB's Ninth Capital Increase in 2012) the Bank has established several contingent credit lines and facilities designed to help countries prepare ex-ante for exogenous shocks. Even though the role of lender of last resort has traditionally been assumed by other institutions, the Bank has recognized that "development banks still have a key role to play in ensuring that long-term programs are preserved so that social progress and development agendas do not get off-track" (AB-2890).

1.4 **The Board of Executive Directors has requested that OVE conduct an assessment of IDB's contingent lending instruments.** The Office of Strategic

1 Kunreuther, H. and Pauly, M. (2006), 'Insurance Decision-Making and Market Behavior', Foundations and Trends in Microeconomics, Vol. 1, No 2 (2005) 63-127. University of Pennsylvania, Philadelphia PA.

Planning and Development Effectiveness (SPD) is carrying out a study aimed at proposing alternatives to better align Bank instruments to country financing and development needs. This will include assessing how effectively the Bank provides counter-cyclical financing (GN-2837). Given OVE's recent review of the Bank's policy-based lending and its contribution to the discussion on IDB's counter-cyclical financing role, the Board of Executive Directors has requested OVE to study the recent use of contingent lending at the Bank, providing inputs to SPD's forthcoming review. This Approach Paper outlines the planned coverage of OVE's evaluation.

II. BACKGROUND

Contingent lending in the event of an external economic shock

2.1 **For the first 25 years the Bank lent almost exclusively for specific projects related to investments in infrastructure**. This was based on Bank's Charter, which states that loans made or guaranteed by the Bank shall be principally for financing specific expenditures. However, the debt crisis in the 1980s created a perception that policies and institutions were impairing individual investment projects and holding back the region's growth. Responding to this diagnosis—and to the World Bank's wider array of instruments—the Bank established fast-disbursing sector loans under the IDB-7 agreement in 1989 (renamed policy-based loans, or PBLs, in 1994). PBLs were established to provide borrowing countries with liquidity to help meet their financing needs and to support them in undertaking policy or institutional reforms. Occasionally, these PBLs were used to support reforms as part of an emergency package, and the IDB participated in several IMF-led emergency rescue operations through PBLs.

2.2 **The Asian Crisis in 1997-1998 stretched the Bank's capacity to respond to country financing needs in times of stress, which led to the creation of a new lending category: emergency loans**. The closure of capital markets in the late 1990s challenged some aspects of PBLs and led to the introduction of a temporary "Emergency" variant of policy-based lending. With the approval of the New Lending Framework (NLF) in 2002, the Governors approved the establishment of a new, now separate, Emergency Lending Category (EME). Since 2002, the Bank has therefore offered three broad lending categories: investment, policy-based, and emergency lending.

2.3 **The importance of effective emergency instruments was further highlighted by the advent of the global financial crisis in 2008**. In the late 2000s, the global financial crisis challenged IDB's capacity to provide funding with the speed and at the levels commensurate with the needs of the time. In that context, the Bank created the Liquidity Program for Growth Sustainability to provide liquidity up to US$500 million per country to regulated financial institutions facing reduced access to foreign credit lines and interbank credit. The program was created within the EME category (meaning that there would be no opportunity cost in terms of the Bank's normal lending program for investment and policy-based loans) and on a temporary basis. It expired on December 31, 2009.

2.4 **In response to IDB's Ninth Capital Increase requirements and experience during the global financial crisis, the Bank created a contingent credit line that replaced the EME category in 2012**. In 2011, Bank Management undertook an analysis of the Bank's SG instruments, and a year later the Board of Governors approved a new instrument, the Development Sustainability Credit Line (DSL). The DSL was created with the objective of protecting poverty-related programs in the event of an external economic shock (systemic or country-specific) and was structured as a contingent credit line: individual loan operations would be approved by the Board of Executive Directors prior to the onset of the shock, and a borrowing member country could draw down on the approved resources if and when the shock occurred. Specific triggers for the drawdown of resources were included in the loan proposal. Two billion US dollars were made available for the DSL each year from 2012 to 2014, and resources could be utilized for the financing of individual loan operations from 2012 through 2015.[2]

2.5 **In 2012 the Governors also authorized the use of the Deferred Drawdown Option (DDO) for policy-based operations**. The PBL DDO allows countries to obtain approval for a policy-based loan in a given year but have access to the resources in amounts, and at the time, that meets their needs most effectively. Specifically, countries can draw down resources within three years from the date of eligibility for disbursements, with an option for a one time renewal of another three years. Since borrowers can use the resources at any point in time during those six years (provided that the country complies with the disbursement policy conditions and maintains a positive macroeconomic assessment), the PBL DDO is not a traditional contingent instrument but *de facto* behaves as such. Moreover, proceeds can be used to weather any types of shocks. Importantly, the DDO and DSL differ in financial terms, eligibility and disbursement requirements, and caps, and whereas DDO lending—like PBLs in general—counts against a country's financing envelope, DSL resources do not.

Contingent lending in the event of a natural disaster

2.6 **The Bank has assisted countries that face natural hazards since its early days, but it was not until the 1990s that it introduced a specific facility for this purpose.** In the context of growing frequency of natural disasters in Latin America and the Caribbean, the Bank approved the creation of the Emergency Reconstruction Facility (ERF) in 1998, along with Operational Policy Guidelines for addressing emergency situations arising from natural disasters. The objective of the ERF was to provide financial resources to borrowing member countries to cover the cost of restoring basic services in the immediate aftermath of a disaster. Since 2002, the ERF has been revised and expanded to include non-natural hazards, such as structural collapse or explosions. As such, the Facility's name was changed to Immediate Response Facility for Emergencies caused by Natural and Unexpected Disasters (IRF). The last IRF operation was approved for Haiti in 2012; since then, the facility has not been used and remains on hold.

2 A maximum limit of $300 million, or 2% of a country's gross domestic product (GDP), whichever was less, was established per country.

2.7 **In the last decade, the Bank has approved new disaster risk management policies and developed contingent credit lines and facilities for natural disasters, which *de facto* have replaced the previous emergency instruments.** In 2007, the Bank approved the Disaster Risk Management Policy (GN-2354-5) and later the Integrated Disaster Risk Management and Finance Approach (GN-2354-7), which called for the creation of ex-ante risk financing instruments. The first financial instrument developed was the Contingent Credit Facility (CCF) for Natural Disaster Emergencies, created to provide funds to bridge fiscal gaps after a major natural hazard and to cover extraordinary expenditures that arise after its occurrence. Disbursements are determined by predefined parametric triggers based on the magnitude of the event and the affected population. The CCF was configured as an investment loan, albeit with exceptions related to procurement and disbursement rules (see GN-2502-2). To complement the CCF, the Bank established a new Contingent Credit Line for Natural Disasters (CCL) five years later. Loans under the CCL are structured as PBLs (with the Policy Matrix of the program including measures on risk analysis, prevention, mitigation, etc.), and proceeds are drawn down to cover financing needs that arise after natural disasters of less-than-catastrophic magnitudes.

Use and current status

2.8 **As of January 2016, the Bank has three available contingent credit lines and facilities—the CCF and CCL modalities to provide liquidity in case of a natural disaster, and the PBL DDO to provide liquidity in case of economic shocks.** Since the expiration of the DSL at the end of 2015, the only available contingent credit line to assist countries in the event of a financial shock is the PBL DDO (Table 2.1).[3]

Table 2.1: Contingent Lending Credit Lines and Facilities

	Investment	Policy-Based Loans	Development Sustainability Contingent Credit Line
Currently available	Contingent Credit Facility for Natural Disaster Emergencies (CCF)	Contingent Credit Line for Natural Disasters (CCL) Deferred Drawdown Option (DDO)	-
Recently expired	-	-	Development Sustainability Contingent Credit Line (DSL)

Source: OVE

2.9 **In recent years, uptake of contingent modalities has been limited, especially for those aimed at providing liquidity in cases of financial crisis (Table 3.1).** Since their establishment in 2012, only two countries have used the DSL (El Salvador and Ecuador, with proceeds disbursed only in the latter case) and two other countries have used the PBL DDO (Uruguay and Peru). Uptake of

3 As mentioned earlier, since borrowers can decide to use the PBL DDO resources at any point in time during the disbursement period, proceeds can actually be used to weather any type of shock.

the CCF has been higher, with seven countries taking advantage of the facility since its establishment in 2009. The CCL has not been used.

III. EVALUATION OBJECTIVES AND SCOPE

3.1 **The objective of the evaluation is to review Bank's recent experience with contingent lending and compare it with that of other IFIs.** The following questions will guide OVE's analysis:

- How has IDB's approach to contingent lending evolved over time?
  - What is the scope of IDB's contingent lending approach (i.e. which type of shocks can be covered with Bank's available instruments)?
  - How does it compare to that of other IFIs?
- How are IDB's contingent credit lines and facilities structured in terms of expected payout (insured amount), cost, and other relevant factors such as disbursement triggers?
  - How do they compare to the terms and conditions of contingent products in other IFIs?
- From a financial and capital adequacy perspective, what are the main considerations that arise from contingent lending?
- Which are the main design and implementation characteristics of IDB's contingent lending portfolio approved since 2009? Is there evidence on results achieved and lessons learned (including reasons for low uptake)?

3.2 **OVE will collect data from various sources.** The team will review IDB guidelines and protocols, relevant OVE evaluations, and pertinent evaluations on emergency and contingent lending instruments conducted in other IFIs. OVE will survey the contingent lending products offered by the International Monetary Fund, the World Bank, the Development Bank of Latin America, and the Asian Development Bank, and compare terms and conditions with that of the IDB. In addition, the team will review the universe of CCL, CCF, DSL, and PBL DDO operations (see Table 3.1) and compare the portfolio to that of the mentioned Multilateral Development Banks. OVE CPEs, sector and thematic evaluations, and interviews with key stakeholders will serve as inputs.

3.3 **The evaluation and any recommendations arising out of it will aim to provide input to Management's 2016 review of IDB lending instruments**.

Table 3.1: Uptake of Contingent Lending Credit Lines and Facilities, 2009-2015

	Facilities / Credit Line	Country	Operation Name	Operation Number	Year	Approved Amount (*million*)
Economic Crisis	DSL	El Salvador	Contingent Credit Line for Sustainable Development	ES-X1007	2013	$100
		Ecuador		EC-L1145	2014	$300
	PBL DDO	Uruguay	Strategic International Positioning	UR-L1076; UR-L1097; UR-L1106	2013 2014 2015	$550.7
		Peru	Improving Management for Universal Health Coverage Program	PE-L1169	2015	$300
		Peru	Results Management Program For Social Inclusion	PE-L1154	2015	$300
Natural Disasters	CCF	Dominican Republic	Contingent Loan for Natural Disaster Emergencies	DR-X1003	2009	$100
		Honduras		HO-X1016	2011	$100
		Ecuador		EC-X1008 EC-X1014	2012 2014	$300[4]
		Panama		PN-X1007	2012	$100
		Costa Rica		CR-X1010	2012	$200
		Peru		PE-X1006	2013	$300
		Nicaragua		NI-X1007	2013	$186
	CCL	-	-	-	-	-

Source: OVE based on IDB data warehouse

IV. TEAM AND TIMELINE

4.1 The report will be prepared by a team led by Agustina Schijman under the direction of Cheryl Gray (Director, OVE). Other team members will include Ulrike Haarsager, Ali Khadr, Maria Jose Hernandez, and Maya Jansson.

4.2 The draft report is expected to be ready for Management review in April 2016 and for discussion at the Board of Executive Directors in May 2016. If requested, OVE could make a preliminary presentation to the Board of the main findings of the evaluation in late March or early April 2016.

[4] In 2014, the loan was modified and the total approved amount increased from $100 to $300 million.