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Project Evaluation

Evaluation of the IDB's Non-Sovereign Operations with Sub-National Entities: 2007-2010

IDB
Inter-American Development Bank
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Office of Evaluation and Oversight
1350 New York Avenue, N.W.
Washington, D.C. 20577
www.iadb.org/evaluation

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This evaluation was led by Inder Jit Ruprah, under the general direction of Cheryl Gray. The team included Jose Ignacio Sembler, Camilo Pecha, and Patricia Sadeghi.

ABBREVIATIONS

C&D	IDB Classification of countries (now called Small & Vulnerable)
ESG	Environmental & Safeguard Unit
EBRD	European Bank for Reconstruction and Development
EIB	European Investment Bank
FI	Financial institutions
IBRD	International Bank for Reconstruction and Development
IDB	Inter-American Development Bank
IDB-9	Ninth General Increase of the Resources of the Bank
IFC	International Finance Corporation
INE	VPS Infrastructure Division
KNL	Knowledge and Learning Sector
LEG	Legal Department
MEI	Municipal and Environment Infrastructure
MIF	Multilateral Investment Fund
NSG	Non-Sovereign Guaranteed
OMJ	Opportunities for the Majority Initiative
PEC	Programming and Evaluation Committee of the Board
PPI	Private Participation in Infrastructure
PPP	Public Private Partnership
PSDS	Private Sector Development Strategy
RMG	Risk Management Office
SABESP	Companhia de Saneamento Basico do Estado de São Paulo
SCF	Structured & Corporate Finance Department
SG	Sovereign Guaranteed
SME	Small & medium enterprise
SOE	State-owned enterprise
TFFP	Trade Finance Facilitation Program
VPC	Vice Presidency for Countries
VPP	Vice Presidency for Private Sector
VPS	Vice Presidency for Sectors

EXECUTIVE SUMMARY

In 2006 the Bank's Board of Governors authorised newly eligible sectors and borrowers for non-sovereign lending. In 2009 the Policy and Evaluation Committee requested an evaluation from OVE, but only for a sub-component of the expanded mandate, namely the expansion to sub-national borrowers.

The 2006 non-sovereign loan expansion to sub-national entities was based on expectations of a large and growing market for non-sovereign sub-national loans. Concern that sub-national operations would crowd out pure private operations led to the placing of an upper limit on such lending: up to a maximum of one third of total NSG lending for the 4-year period 2007-2010. The Business Plan was less optimistic, as it assumed that sub-nationals plus national state-owned enterprises would represent at most 15% of the expected total of NSG lending of US$4 billion during this period.

The overall expansion of NSG lending to newly eligible sectors and borrowers was successful. The cumulative approvals of US$6.6 billion during 2007-2010 surpassed the expected US$4 billion specified in the Business Plan of 2007-2010, and the Bank managed to avoid a material deterioration in credit risk. Twenty-three percent of the number of projects was in the new sectors –mainly agriculture and rural development, industry, information and telecommunications.

In contrast, delivery of loans to sub-nationals was very modest, and there was never a danger of breaching the one third or 10% upper ceilings. Actual delivery was 1.8% (three projects) to enterprises partially or wholly owned by a sub-national government, or 3.6% (six projects) if PPPs, where the authorising counterpart is a public sub-national entity, are included. Such under-delivery with respect to expectations can be attributed in large part to three factors: (i) the decision to exclude sub-national governments and to treat sub-national enterprises on par with the other clients of SCF in terms of eligibility criteria; (ii) the absence of a specific institutional unit charged with this agenda; and (iii) the lack of sufficient complementary grant resources to nurture the market and to increase the competitiveness of SCF loans. The eligibility criteria essentially excluded most sub-national enterprises. The absence of a dedicated unit facilitated a crowding out of these loans given that sub-national operations are more costly to prepare.

Going forward, the Bank needs to decide between two options. One option is the *status quo*. This option places little importance for the Bank in using non-sovereign lending to improve local services through increased private investment. With the Bank at the cusp of a major increase in non-sovereign lending under IDB-9, this "no change" option has an obvious virtue.

If the Bank's considers that this is an agenda that needs to be more aggressively pursued, however, the *status quo* is not appropriate. Given that effective public service delivery is critical for poverty reduction, low gross capital formation is hindering development in the Region, and decentralisation has increasingly placed investment decisions for infrastructure services at the sub-national level, OVE believes that this market should be a concern for IDB. A comparison with peer multilaterals suggests that the Bank could do better.

OVE thus recommends that IDB management:

- To understand the potential market for sub-national lending, analyse and map eligible and excluded sub-national entities in client countries under alternative policy scenarios for both SG and NSG operations.

- Review the guidelines and practices of peer multilaterals, particularly EBRD, to determine the desirability and feasibility of emulating them, considering the characteristics of the sub-national market in the Region.

- Propose changes to existing policy and guidelines (institutional framework, costs to the borrower, and eligibility criteria) such that the Bank can better serve currently excluded sub-national enterprises through NSG lending.

Management Response to the Recommendations of the Evaluation on the Bank's Non-Sovereign Operations with Sub-national Entities: 2007-2010

Evaluation Recommendations	Management response
To understand the potential market for sub-national lending, analyse and map eligible and excluded sub-national entities in client countries under alternative policy scenarios for both SG and NSG operations.	
Review the guidelines and practices of peer multilaterals, particularly EBRD, to determine the desirability and feasibility of emulating them, considering the characteristics of the sub-national market in the Region.	
Propose changes to existing policy and guidelines (institutional framework, costs to the borrower, and eligibility criteria) such that the Bank can better serve currently excluded sub-national enterprises through NSG lending.	

I. INTRODUCTION

1.1 In 2006 the Bank's Board of Governors authorised newly eligible sectors and borrowers for non-sovereign lending. As a condition of the expansion, the Policy and Evaluation Committee of the Board (PEC) requested that Management *"organize a midterm report of the implementation of the expanded mandate for the initial four-year program (2007-2010) including both the integrated business plan and the operational guidelines*."[1] In 2009, PEC requested an evaluation from OVE but only for a sub-component of the expanded mandate namely the expansion to sub- national actors.

1.2 This report is an independent evaluation of the Bank's expanded mandate for NSG loans to sub-national entities. The evaluation is designed to provide lessons of the past four years' experience as an input to discussions on guidelines as the Bank implements IDB-9. The latter tasks the Bank as follows: "*Management, through VPP, and the Board of Executive Directors, will review the guidelines for NSG lending to public, municipal and semi-public (autonomous state) entities to facilitate public-private partnerships, foster joint ventures and avoid potential regulatory arbitration.*"(s=See paragraph 3.33).

1.3 The sources of information for this evaluation include a desk review of the relevant NSG portfolio, loan documents, visit to clients, and discussions with Bank staff. The evaluation covers the operations of the Structured Finance Department (SCF) and the Opportunities for the Majority Initiative (OMJ) of the Vice Presidency for Private Sector (VPP), which is responsible for implementing the mandate.

II. CHARACTERISTICS OF THE SUB-NATIONAL MARKET

2.1 Multilaterals face difficult challenges in supporting actors in the sub-national market through non-sovereign instrument because of key characteristics of those actors. Latin America has gone through a significant process of decentralisation. This decentralisation has been marked by: (i) an asymmetry between expenditure functions and revenue authority, leading to a financing gap; (ii) the direct election of local officials, making them more accountable for the delivery of local public services; and (iii) an increase in the share of investment decisions related to the provision of infrastructure services that are made at the sub-national level.

2.2 However, decentralisation has not been uniform in the Region. As shown in Chart 1, countries with the highest level of decentralisation, measured by expenditure to GDP ratio, are the federal countries Argentina, Brazil, and Mexico as well as non-federal countries Bolivia and Colombia. At the other extreme are Chile, Costa Rica and Paraguay, which have low levels of decentralisation and do not show any change. Heterogeneity can also be seen (see Chart 2) in terms of changes in public services provided by sub-national governments. Traditional services like refuse collection and transport have been joined more recently by water and sewerage, health, and education.

Chart 1: Expenditure at the Sub-national Level

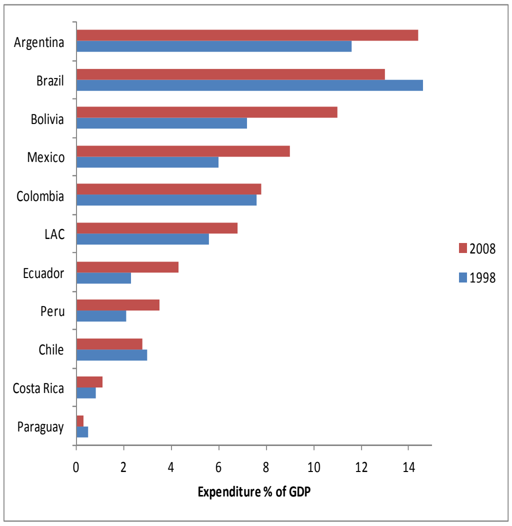
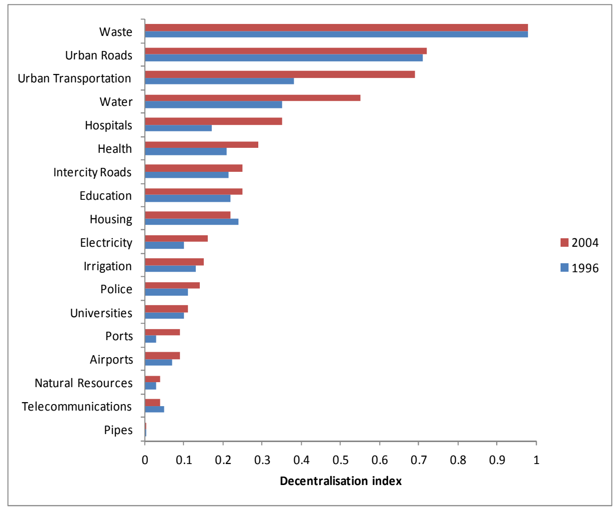


Chart 2: Decentralisation of Activities

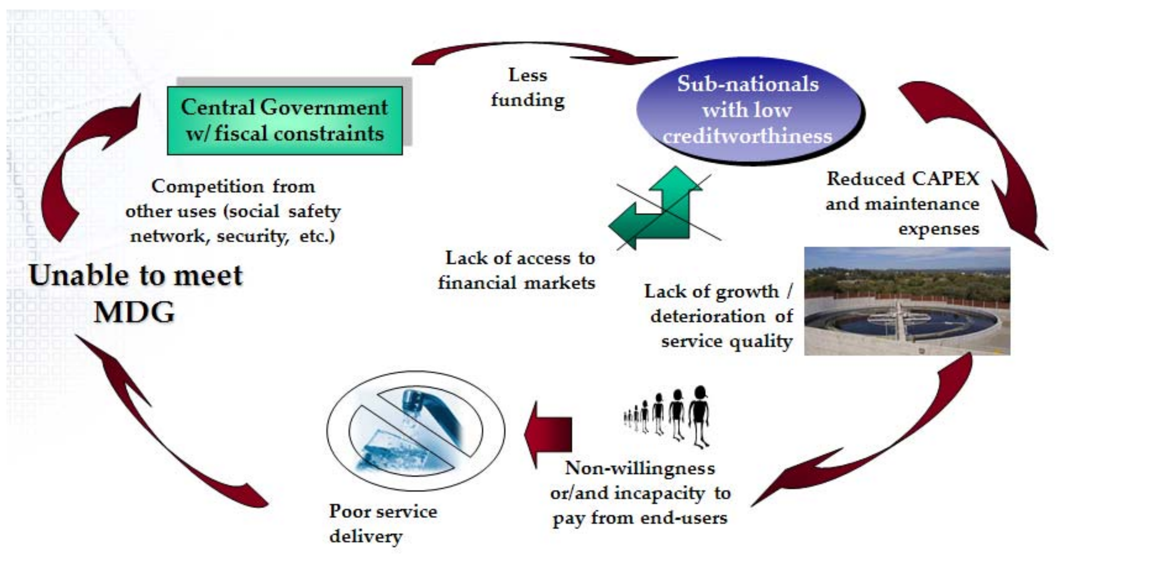


Source M. Grazzi and F. Jaramillo (2010)[2]

2.3 Nonetheless, fiscal decentralisation has resulted in lower public investment at the municipal level, and low sub-national spending on investment is associated with lower economy-wide gross capital formation (see Mello 2010[3]). Many countries that experienced macro-economic crisis and required central government public retrenchment did so through a sharp reduction in investment expenditure. Central governments' investment expenditure has never recovered, and sub-national governments have not offset that decline. In addition, there has been a sea change in the infrastructure model towards a model where the private sector is central in both the financing and the provision of infrastructure, with the role of governments limited to a regulatory one. Yet, private flows have not offset the collapse of public investment (see Fay and Morrison 2005)[4].

2.4 Box 1 illustrates the dilemmas facing sub-national governments in infrastructure provision. Governments often have unsatisfactory financial management (tax, expenditure, debt, and asset systems) and inadequate infrastructure management (tariff setting and collection, social tariff and subsidy policies, engagement of the private sector in investment planning). Service providers have inadequate corporate governance (procurement, safeguards, audited financial statements, credit ratings, public trading) and often work in inadequate regulatory frameworks (capital market regulation, bankruptcy law, contract enforcement). Under-funding from central governments has been compounded by pressures for other non-infrastructure public spending. Limited access to capital markets and the unwillingness or incapacity of end users to pay have limited private funding. The resulting shortages in capital expenditure and poor service delivery reduce the probability of achieving the Millennium Development Goals (MDGs).

Box 1: Sub-National Infrastructure Service Provision Dilemma



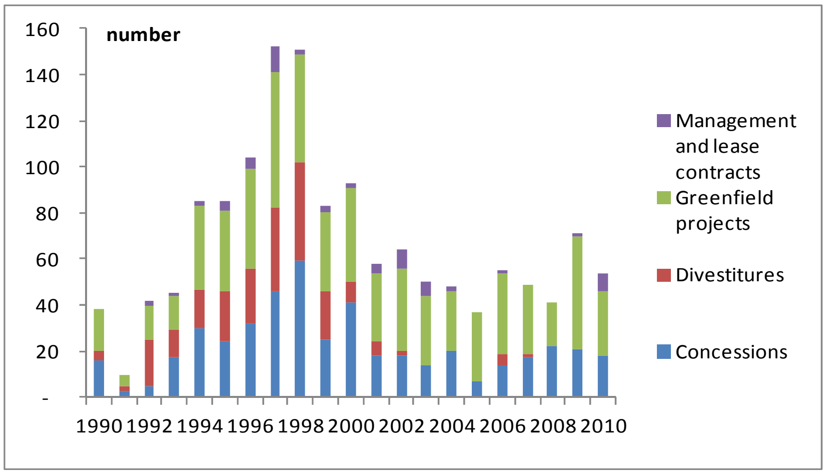
Source: modified from slide 4 of Sub National Development Program, World Bank, November 2006.

2.5 Private participation in infrastructure (PPI) has often been advanced as a solution to the dilemmas faced by sub-national governments. Private participation in infrastructure includes divestiture, concessions (both greenfield projects and concessions of existing assets) and management and lease contracts (see Chart 3). However, PPI has been uneven across countries and has occurred in certain sectors more than others. Six countries (Argentina, Brazil, Chile, Colombia, Peru and Mexico) have absorbed over 90% of the Region's PPI (see Chart 4), with most in telecommunications, energy, transport (mainly airports and ports), and water and sanitation.

2.6 This uneven country and sector distribution reflects in part the uneven pace of reform across countries and sectors. It also reflects the fact that there are two different types of services, with different feasibility of PPI. For some public services there is a high degree of certainty that end-users will be able to pay full cost recovery tariffs. They have limited fiscal risks and can be procured via the private sector with limited government support. These are typically services provided to corporate or commercial clients –such as ports, airports, and cargo railways– that are not typically under the jurisdiction of local governments. For other public services there is a high degree of uncertainty that end-users will be able to pay full cost recovery tariffs, and these have high fiscal risks and can be procured via PPPs only with strong public support. These services typically include urban transport (mass transit systems, bridges and tunnels), highways, water and sanitation, and communal services –activities that are more often than not under the jurisdiction of local governments and are often provided through non-enterprise institutional forms.

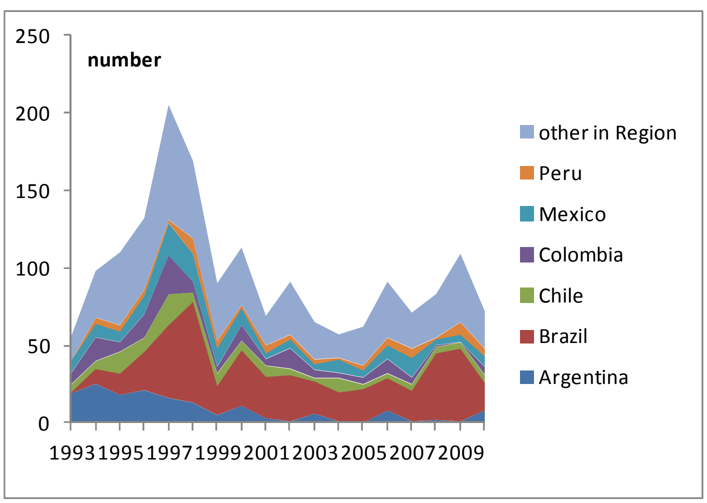
2.7 An idea of the feasibility of PPPs and the diversity of the environment for public-private partnerships at the sub-national and national level can be gauged from the infrascope index, a joint initiative of the EIU and MIF (see Table 1).[5] Of the 19 countries in the study, six facilitate and implement PPP projects at the sub-national level. Brazil tops the list for this indicator. Many Brazilian states have their own PPP laws and regulations, resulting in heterogeneity among state frameworks and institutional setups. Mexico has a state-driven regulatory framework. The country has a lower ranking than Brazil because transparency and regulatory capacity are generally lower, partly due to a more politicised business environment at the local level. In some countries, such as Chile, Colombia and Peru, a unitary legal framework requires sub-national projects to be planned and co-ordinated with central government agencies. In the remaining countries, the regulatory framework is largely absent or overly cumbersome, or there is no interest in PPPs.

Chart 3. PPIs in Latin America: by Type



Source: World Bank's PPI projects database

Chart 4: PPIs In Latin America: By Country



Source: World Bank's PPI projects database

2.8 Sub-national governments are at a disadvantage in PPIs in general and PPPs in particular. First, short election cycles increase the risk of contract repudiation, as SNGs have less incentive to behave. Second, SNGs do not control key elements for success. For example, in the Argentina water PPI, VAT increases absorbed productivity improvements. The gain went to the government, not to the users. Third, higher risks are often managed through fiscal contingent liabilities by contracting governments, but SNGs are poorly positioned to absorb these given their fiscal situation.

Table 1: Environment for PPPs; the Infrascope Index

	Sub National Ranking	Sub- National Index	National Index	National Ranking
Brazil	**1**	**75**	**73.2**	**2**
Argentina	**2**	**50**	**27.5**	**12**
Chile	**2**	**50**	**79.3**	**1**
Colombia	**2**	**50**	**53.7**	**5**
Mexico	**2**	**50**	**58.1**	**4**
Peru	**2**	**50**	**67.2**	**3**
Dominican Rep.	7	25	23.7	16
Ecuador	7	25	14.2	18
Guatemala	7	25	42.4	6
Jamaica	7	25	25.4	13
Paraguay	7	25	24.5	15
Trinidad & Tobago	7	25	29.9	11
Uruguay	7	25	31.8	9
Costa Rica	7	0	32.3	8
El Salvador	14	0	30.6	10
Honduras	14	0	24.6	14
Nicaragua	14	0	16	17
Panama	14	0	34.6	7
Venezuela	14	0	4.2	19

Source: Evaluating the environment for public-private partnerships in Latin America and the Caribbean: The 2010 Infrascope, the Economist Intelligence Unit, The Economist.

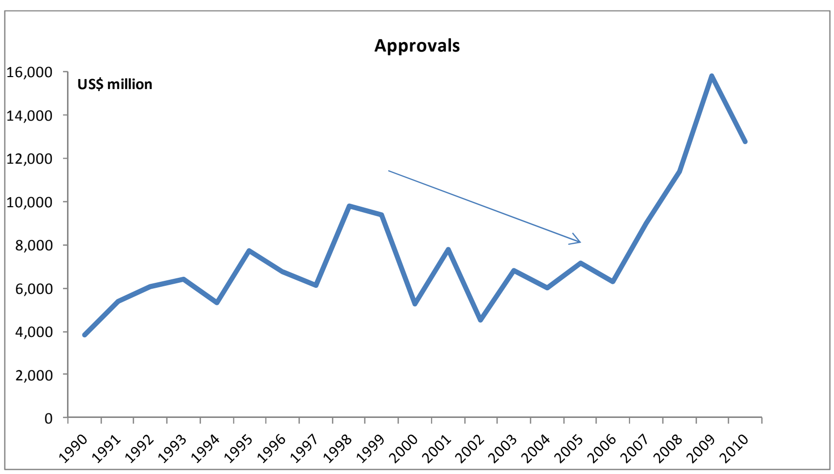
2.9 Furthermore, as mentioned above, many investments under the jurisdiction of local governments may be economically justified but fall short of financial viability. This gap partly reflects the inability to increase user fees to commercial levels, where infrastructure projects involve externalities that are not captured in direct financial returns. An innovative program in India, the Viability Gap Funding scheme, meets the financing gap through a capital grant –up to 20% of the capital cost– from the federal government to the private company (51% owned by the private sector) involved in a sub-national PPP project.[6] The federal grant can be complemented with one from the sub-national government. This program recognises that the infrastructure gap cannot be filled by the public sector alone and that a significant infrastructure gap is hindering development. By attracting private capital as well as the technical and managerial efficiencies associated with it, a government subsidy to a PPP sub-national infrastructure project can have high development return.

2.10 In sum, sub-national governments have particular difficulties with PPI, including for PPPs. PPI by sub-national governments is very small in aggregate in low income countries, and it is not very widespread even in middle income LAC countries. The market generally requires improvements in financial management, regulatory frameworks, and infrastructure management, including the corporatisation of sub-national enterprises and enhanced corporate governance. Often the economic and financial returns diverge significantly in infrastructure investment under sub-national governments' jurisdiction. Although various types of sub-national enterprises –from non-commercial to fully commercial– can be found, the typical sub-national service provider is usually far from a formal private enterprise.

III. IDB'S RATIONALE AND OBJECTIVES FOR NGS LENDING TO SUB-NATIONALS

3.1 The change in the scope of eligible sectors for non-sovereign loans was part of the response by the Bank to a fall in the overall demand for its loans that began in the late 1990s (see Chart 5). The Bank responded to the falling demand by attempting to be more flexible by introducing new lending modalities for sovereign loans, including a SWAP option for investment loans, among other actions in its *New Lending Framework: 2005-8* approved in 2005 (see AG-5/05). The increase in the scope of work of the private sector arm of the Bank was the complementary action for non-sovereign loans.

Chart 5. IDB Lending



Source: Bank's data warehouse. This chart includes loans and gaurantees (SG and NSG). It escludes grants, samll projects, project preparation facilities, and MIF operations.

3.2 The Board of Governors expanded, through resolution AG-05/06 on April 2006, the scope of eligible sectors and borrowers for Bank financing without sovereign guarantees, subject to the existing 10% statutory limit of outstanding loan balances.[7] The reform eliminated the previous restrictions that limited NSG lending only to infrastructure, capital markets and trade finance (see Box 2). The expansion of eligible borrowers included sub-national public and semi-public agencies that are partially or majority owned by the public sector. The approval of the expanded mandate was partially conditional on Board of Executive Directors approval of operational guidelines and a business plan. The Bank responded quickly, and in late July and early August 2006 the Board of Executive Directors approved an integrated business plan (document GN-2400-10) and the revised NSG operational guidelines (GN-2400-12). [8]

Box 2: Changes brought about by the 2006 Policy.

	2005	2007
Eligible sectors	Infrastructure, capital markets, trade finance.	All sectors of the economy
Eligible clients	Privately owned enterprises	Private and state owned enterprises (national and sub national)
Products	Operations in US$	US$ and local currency, refinancing
Limits	Upper limit of US$75 million per operation	US$200 million (for highly developed projects up to US$400 million) Maximum of one third of total cumulative (2007-10) lending to sub national entities

3.3 The Bank had begun a discussion of the pro and cons of including sub-nationals in NSG lending when it approved the Bank's sub-national development strategy in 2002. The strategy had come out strongly against extending NSG loans to sub-national entities: *[t]here are no advantages to Bank lending without this guarantee. All of the Bank objectives concerning sub-national development can be accomplished through operations with sovereign guarantee*"GN-2125-1). The conclusion was based on the perception of a moral hazard problem leading to incentives for excessive sub-national borrowing that would require bailouts from central governments. There was some disquiet among members of the Board on this position. Thus, PEC "*... recommended that Management should prepare a study on this issue*."

3.4 In response, in 2004, Management softened its stance and provided a list of alternative modalities and a review of the practices of other Multilateral Development Banks (see GN-2125-5). The specific alternatives formally proposed were: (i) creating a specialised fund within the Bank; (ii) using credit enhancement to enable borrowers to access capital markets; and (iii) counting the loans against the private sector quota or requesting a special quota. Counting the loans against the existing private sector quota was the preferred choice. The Board also "*agreed that the proposal should be redrafted to focus exclusively on lending to state and municipal enterprises providing public services. Broader support to sub-national governments should not be included. Potential development impact should be analyzed more strongly, as should managing the moral hazard of central government bailout and debt sustainability*."

3.5 As noted previously, the institutional form of sub-national service providers often does not take the form of an enterprise comparable to a private sector firm, and the service is often financed from general fiscal revenues rather than exclusively from the fees charged for the service. Thus, this decision excluded as potential clients a large proportion of the actors at the sub-national level.

A. Assumptions and expected results

3.6 Two assumptions underlying the initiative were that there was a large and growing market and that the expansion would have positive effect on the Bank's role in development. With regard to the market (see CA-466-1) it was argued that: (i) the "middle market" of projects is growing but not reachable by the IDB's existing set of instruments; (ii) the full range of private/public options should be available, as this will help member countries use their sovereign guarantees more efficiently by not supporting projects that can be structured as NSG; (iii) countries in the Region are becoming more decentralized, with authority for revenue collection moving to sub-sovereigns; (iv) mixed PPPs are being adopted more frequently; (v) most governments are operating within highly constrained fiscal environments that limit the assumption of sovereign guaranteed debt; and (vi) eligibility will help sub-sovereign entities attract private sector participation into public-private partnerships (from the operational guidelines GN-2400-11).

3.7 The initiative was also expected to have beneficial effects on the Bank. It was argued that: (i) the expansion of NSG lending would help the Bank exercise discipline in its recourse to sovereign guarantees; (ii) the Bank would assist in the progression of sub-national entities from fully sovereign loans to non-sovereign IDB lending; (iii) the Bank's Country Strategies would identify such candidates for movement from SG to NSG; and (iv) the new approach to non-private borrowers would allow the Bank to support projects that previously would have been ineligible, i.e., those that were not yet fully private but could be structured soundly as NSG loans.

3.8 Thus, the 2006 non-sovereign loan expansion to sub-national entities was based on expectations of a large and growing market. However, concerns that sub-national operations could crowd out pure private operations led to the placing of an upper limit on such lending: up to a maximum of one third of total NSG lending for the 4-year period 2007-2010. The Business Plan for 2007-2010 was less optimistic, as it assumed that sub-nationals plus national state owned enterprises would represent at most 15% of the expected total increase of NSG lending during this period, of US$4 billion. The Business Plan further dampened expectations of sub-national operations by identifying business opportunities only in the energy, transport and water and sanitation sectors, with low, low, and medium degrees of opportunity, respectively.

B. Guidelines and Operational Policy

3.9 The Business Plan was not based on a detailed market analysis to determine whether and which sub-national actors would be optimally targeted by non-sovereign and sovereign lending by the Bank, hence adequately meeting the financing needs of sub-nationals. A coordinated revision of policy for both arms of the Bank was not done. A critical input for design of SCF's guidelines was therefore missing.

3.10 A number of specific design issues needed to be resolved in the guidelines of NSG sub-national loans: institutional responsibility, including for execution-supervision (local office vs. headquarters), procurement (private sector vs. public systems of the Bank), local currency, credit standards and approval process, and coordination with VPC and VPS. For each of these issues the Bank decided to treat state and municipal enterprises on par with private enterprises. The guidelines essentially did not differentiate NSG sub-national loans from other NSG operations. The Bank assumed sub-national enterprises could move towards a commercial footing through the sovereign window of the Bank, graduating eventually to the private sector window. No specific organisational unit was to be responsible for this type of borrower; instead SCF was organised along sector lines. Most of the staff continued to be located in headquarters, and supervision of all NSG loans was assigned to a unit in headquarters rather than local offices. Procurement was to be based on each country's private sector commercial codes as all NSG loans are. No special local currency instrument was devised. Credit standards embodied in the screening process and the approval process were to be the same. Pricing of the loans was based on the same criteria as loans to private borrowers, i.e. based on terms of "B" lenders among other criteria. No specific formal institutional process was set up to coordinate with VPS and VPC in lending to state and municipal enterprises. Risk assessment continued to be made within VPP rather than by an independent entity.

3.11 As argued above, this type of borrower is fairly unique. Sub-national enterprises are often far from being commercial enterprises. The sustainability of their investments often depends upon wider issues like tariff/fee reform and the change in and/or proper enforcement of regulation, and commercial discipline and full cost recovery are often underdeveloped. Furthermore, tariff increases for full cost recovery may not be desirable depending on the poverty profile of users. These complex features are not a good fit with the transaction-based, opportunistic *ad hoc* deal making of SCF, with involvement often near the closure of the deal.

3.12 In sum, the decisions to exclude sub-national governments and to treat NSG sub-national loans the same as to other NSG loans severely limited the potential market to the few state and municipal enterprises that were already on par with private eligible enterprises.

IV. IMPLEMENTATION

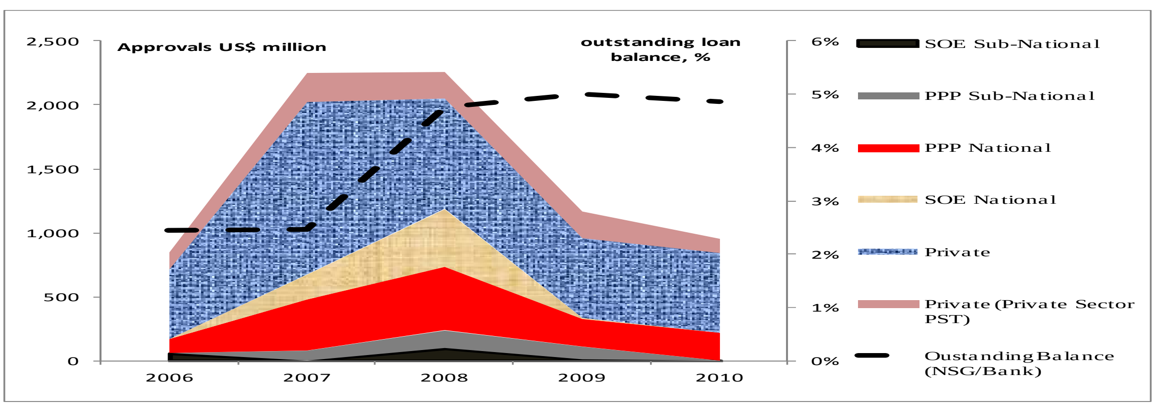
4.1 The Bank implemented the general expanded mandate for NSG lending successfully. About 23% of the total number (34 out of 148 NSG loans) and 9.8% of the dollar value (US$0.65 billion out of US$6.6 billion) of approvals from 2007 to 2010 were in the newly eligible areas. Furthermore, the Bank managed to minimise implementation problems, and there was no material deterioration in credit risk.

4.2 Chart 6 shows the dollar value of total non-sovereign approvals, borrower composition, and actual outstanding loan balance. The marked decline in approvals in 2009-10 was due to the heavy demand for sovereign loans, as Latin America was hit by the global crisis which squeezed out non-sovereign lending. The squeeze led to the cancelling of some projects with approved mandates and the dropping of some projects from the pipeline, a negative signal to the markets whose ramifications are too early to judge. Despite this supply constraint, the cumulative approvals of US$6.6 billion during 2007-2010 surpassed the expected US$4 billion specified in the Business Plan of 2006.

4.3 The expansion in the volume of lending, however, was not accompanied by a major increase in loans to sub-national clients. SCF does not have a formal definition of non-sovereign sub-national loans and does not identify loans as such. Therefore, for the purposes of this evaluation OVE has defined these operations as (i) loans to public entities that are partially or wholly owned by a sub-national government (the strict definition) and (ii) PPP operations where the counterpart to the private company is a sub-national government or sub-national firm (the extended definition). Although PPPs would not be strictly counted under the ownership definition of NSG sub-sovereign lending given that the legal borrowers are private concessionaires, these loans help to promote the financing objectives of sub-sovereign actors. Thus, an argument can be made that PPP support can be considered when attempting to assess more broadly the Bank's NSG support for sub-sovereign borrowers.

4.4 Using these definitions of non-sovereign sub-national operations, few operations have been approved (see Chart 6). The danger of a breach of the upper limit of one-third of total NSG loan approvals or the 10% upper limit in the Business Plan was never present. Actual approvals of NSG sub-national loans were only 2% and 4% of total number of approvals, using the strict and expanded definitions respectively.

Chart 6: Non-Sovereign Operations: Approvals and Outstanding Loan Balance



Source: IDB data warehouse. This chart includes: (i) private sector investments, (ii) private sector guarantees, (iv) private sector supplementary loans, and (v) private sector PST (TFFP). From 2007 to 2010, 48 TFFPs (32.4% of total number of approvals) were approved for US$753.5 million (11.4% of total US$ amount of approvals).

4.5 From 2007 to 2010 OVE identified three NSG loans to sub-sovereign borrowers (out of total of 148 NSG loans) and three PPPs where the counterpart was a sub-national entity, although the PPP in Ecuador was cancelled and one direct NSG loan was approved in late

2006. Table 2 gives the basic information on the individual non-sovereign sub-national loans[9]. None of the identified operations has evaluation documents, i.e., Expanded Project Supervision Reports (XPSRs), hence ex post development effectiveness has not been measured for these operations.

Table 2. Main Characteristics of Individual Non-Sovereign Sub-National Loans

Operation Number	EC-L1026	BR-L1079	BR-L1228	BR-L1070	BR-L1158	CO-L1080
Name	Baba Hydroelectric Project	São Paulo Metro - Linha 4 Project	Rodoanel Oeste	Celtins Investment and Refinancing Program	Corporate Loan for the Companhia de Saneamento Básico do Estado de São Paulo	Social Financing Program EPM-UNE
Country	Ecuador	Brazil	Brazil	Brazil	Brazil	Colombia
Borrower Classification	PPP	PPP	PPP	Public Ownership	Public Ownership	Public Ownership
National Level	Sub-National	Sub-National	Sub-National	Sub-National	Sub-National	Sub-National
Operation Type	Private Sector Investment	Private Sector Investment	Private Sector Investment	Private Sector Investment	Private Sector Investment	Private Sector Investment
Approval Year	2007	2008	2009	2006	2008	2009
Department	SCF	SCF	SCF	SCF	SCF	OMJ
Sector	Energy	Transportation	Transportation	Energy	Sanitation	Private Sector Development
Currency	USD	USD	USD	USD	USD	USD
Original Approved Amount (US$)	78,062,000	128,681,000	100,000,000	60,000,000	100,000,000	10,000,000
Operations (A Loans)	1863A/OC-EC: 78,062,000	1989A/OC-BR-1: 69,181,000 1989A/OC-BR-2: 59,500,000	2211A/OC-BR: 100,000,000	1816A/OC-BR: 60,000,000	1983A/OC-BR: 100,000,000	2217/OC-CO: 10,000,000
Disbursed Amount	-	**69,181,000**	**100,000,000**	**60,000,000**	**100,000,000**	-
Cancellation	78,062,000	-	-	-	-	-
Available Balance	-	59,500,000	-	-	-	10,000,000
B Loan	9,747,000	283,400,000	200,000,000	20,000,000	150,000,000	
Operations (B Loans)	1863B/OC-EC: 9,747,000	1989B/OC-BR-1: 240,000,000 (*) 1989B/OC-BR-2: 43,400,000	2211B/OC-BR: 200,000,000 (*)	1816B/OC-BR: 20,000,000 (*)	1983B/OC-BR-1: 100,000,000 (*) 1983B/OC-BR-2: 50,000,000 (*)	-
Project Cost	195,200,000	515,400,000	1,200,000,000	246,000,000	3,000,000,000	40,000,000
Status	Cancelled	Active	Completed	Completed	Completed	Active
Borrower (Lender in case of Guarantees)	Fideicomiso Mercantil Hidropacífico	Concessionaria de Linha 4 do Metro de Sao Paulo S.A.	Concessionaria do Rodoanel Oeste S.A.	Companhia de Energia Electrica do Estado do Tocantis	Companhia de Saneamiento Basico do Estado de Sao Paulo (SABESP)	Empresas Públicas de Medellín, E.S.P.
% Public	43.2%	0.0%	0.0%	30.0%	50.3%	100.0%
Counterpart (Owner in case of SN, Grantor in case of PPP)	Comisión de Estudios para el Desarrollo de la Cuenca del Río Guayas (Grantor), Hidronación S.A. (Public source), Fideicomiso Proyecto Multipropósito Baba (investment vehicle)	Government of the State of São Paulo	Government of the State of São Paulo	State of Tocantins	State of São Paulo	Municipality of Medellin
XPSR Exercise	**Not Closed**	**after 2011**	**after 2011**	**after 2011**	**after 2011**	**after 2011**
A Loan / Project Cost	40%	25%	8%	24%	3%	25%
Mobilization Ratio (B Loans / A Loans)	0.12	2.2	2.0	0.33	1.5	-

Source: Bank's data ware house and loan documents

A. Two examples

4.6 To illustrate different approaches to support sub-national service delivery, described below are two NSG loans: a loan to a private concessionaire when the counterpart is a sub-national entity and a loan to a sub-national enterprise.

4.7 The first sub-national PPP by the Bank was a loan in 2008 for the Sao Paulo Metro for its Line 4. The IDB tailored two-phase long-term financing to the private sector concessionaire responsible for operating and maintaining the metro line. So far only the first phase has disbursed. According to the loan document, the project was expected to have an important demonstration effect, to be pro-poor, and to have a positive impact on the environment.[10]

4.8 A KNL study highly lauded the project and cited three lessons:[11] (i) PPPs allow projects that otherwise would not have been realised; (ii) private sector through PPP can participate in the railway system; and (iii) a balanced distribution of risks is key to attract private investors. However, so far the project does not appear to have had a demonstration effect in the sense that it provided a model emulated elsewhere by the Bank, nor has it, so far, led to Carbon Emission Reduction Credits due to displacement of fossil fuel from automobile usage. Furthermore, the Sao Paulo Metro company has received sovereign loans from both the Bank and IBRD before and after the NSG operation, and IFC serves as the principal advisor for the structuring and implementation of the Line 4 Project. It is not therefore an example of graduation as envisaged in the approval document of the initiative. Finally, in contrast to the KNL findings, the government of the State of Sao Paulo has decided against repeating the PPP model, under which the state is responsible for the construction of the line and the private consortium is responsible for the operation, including the purchase of trains and implementation of the communication system. According to the Sao Paulo government in its announcement of new proposed PPPs, any new PPP will be more conventionally tailored with the private partner taking responsibility for the whole package.[12]

4.9 The direct loan, in 2008, to a sub-national public enterprise was to SABESP, a water and sanitation company. The company is 50.3% owned by the State of Sao Paulo, with the rest traded on both Novo Mercado and New York Stock Exchange. It serves over 360 of the 645 municipalities of the state plus the city of Sao Paolo. The company's capital requirements in water services are usually financed by tariffs, but these requirements often require some form of subsidy from the public sector. The company had previously received two sovereign loans totalling US$900 million from the Bank. The origination of this project occurred while the company was discussing a third sovereign loan with the Bank, which was approved one year later in 2009.

4.10 The IDB non-sovereign loan financed part of the capital expenditure program of the company and refinanced some company debt. The loan is fully disbursed. Since SABESP is the first sub-national enterprise to receive a SNG loan, this loan provides lessons for future NSG operations with state-controlled companies. In order to leverage the Bank's knowledge, the project team included staff and co-leaders from both SCF/INF and INE/WSA. In terms of procedures, the negotiation took more time than standard NSG operations with private companies because SABESP, as a public company, had to follow longer approval processes. In terms of procurement policies, SABESP received both SG and NSG operations and thus had to follow procurement rules for both types of loans, which could be an important issue in future operations. Another potential issue regards corporate governance. State-controlled companies usually do not have the obligation to publish financial information, though this issue did not arise in this case as SABESP is publicly traded. Finally, in terms of internal coordination of IDB departments, from initial contact to disbursement the operation took a few months longer than standard private operations. Nonetheless, internal coordination was considered successful by the participating departments.

4.11 A careful reading of the KNL study of the project reveals the general shortcomings of the Bank's institutional framework.[13] "*Effective and timely knowledge sharing between the staff with experience with NSG lending and SG operations would improve the viability of the Bank's effort to encourage state-controlled companies to make a transition from SG to NSG lending, both to strengthen their own financial structure and to free up the government's capacity to guarantee/provide other loans. Bank staff should be prepared to discuss with their counterparts and/or with clients companies the relative merits of SG and NSG options.*" "*The structuring process of NSG operations for state-controlled companies would benefit from proactive communication and coordination among staff with expertise in NSG lending and private sector financial institutions and staff with expertise in the country, the sector and the entity that will receive the loan. "Planned, proactive communication targeted at state-controlled clients is deemed relevant. In order to provide more accurate information on how the Bank structures development operations without SG it will be important to have an IDB briefing session as well as information available in a website that would prevent later problems in communications and coordination.*" To date this advice that has not been taken up by the Bank.

B. Factors affecting delivery

4.12 It is clear that the Bank's existing set-up is inadequate for a substantial delivery under this initiative. The key binding constraints includes the institutional framework, the competitiveness of SCF loans, and SCF's screening criteria.

4.13 With regard to the institutional set up, the decision was made not to create a dedicated entity responsible for this market, in contrast to IFC/IBRD and EBRD (see below). It was considered unnecessary, as the sovereign arm of the Bank would be responsible for reducing constraints in the sub-national market through improvements in financial management, regulatory frameworks, and infrastructure management including corporate governance. Once achieved, sub-national entities would be prepared for the non-sovereign arm of the Bank. There are examples of joint teams in SCF loans. A number of staff have moved between the two arms of the Bank. Cordial working relations exist between VPP and VPS. A formal annual programming exercise between VPC and VPP has been formed. But it has not worked. So far there are no examples of graduation. Instead, many sub-national governments still lack the prerequisites for typical NSG lending. Furthermore, the higher cost to the Bank of preparing sub-national NSG operations (see Table 3) combined with the absence of a dedicated unit may have resulted in crowding out of such operations as the Bank attempted to meet the planned increase of NSG operations.

Table 3: Non-Sovereign Loans' Time and Costs

Index Description	All NSG	Borrowers - Non - Sovereign /a PPP	PPP - National	PPP - Sub National	Public	Public - National	Public - Sub-National	Private
Preparation Time (months)								
From NSG elegibility to mandatte tetter	3.7	3.8	4.0	3.4	2.3	1.5	3.6	3.9
From mandate Letter to approval	7.9	12.2	12.6	11.1	5.8	6.5	4.6	7.3
From NSG elegibility to approval	12.0	17.2	18.5	14.4	8.5	8.7	8.1	11.4
From pipe start to approval	9.6	13.8	13.8	13.9	8.7	9.0	8.0	8.8
From approval to first elegibility	4.8	5.6	6.1	3.2	3.6	4.0	3.0	4.8
From first elegibility to first disbursement	1.9	2.4	2.9	1.0	1.4	1.0	2.0	1.8
Costs								
Preparation cost (per US$ million approved)	1,365	1,615	1,541	1,917	1,002	843	1,949	1,331
Preparation cost (per operation)	83,931	162,756	166,465	151,628	96,091	92,389	107,199	65,575

Source: IDB data ware house and loan documents

4.14 A second factor is the lack of competitiveness of NSG lending terms to the borrower. For the borrower NSG loans have much higher transaction, capital, and financial costs than alternative sources (whether from fiscal transfers, national or sub-national development banks, or the Bank's sovereign loans). In addition to charging commercial interest rates, transaction costs include up-front fees, use of expensive external technical experts, use of New York law and relatively expensive external legal counsel, and extensive reporting requirements and covenants. High quality sub-national firms often have access to better terms from private sector funding. Interviews with SCF staff indicate that this situation often holds in Brazil, Chile, and Costa Rica.

4.15 Currency mismatch is also a cost. The document CA-466-1 specifically mentioned the importance (paragraph 4.12) of enhancing the Bank's ability to provide financing in local currency since many sub-nationals' revenue streams are denominated in local currency. Yet there are no examples of local currency NSG loans to sub-national entities, and the Bank has yet to reconcile its overall risk management policies with the need to offer a more practical and more broadly available local currency lending product.

4.16 Furthermore, while EBRD loans are often part of low cost packages that include low interest loans from other sources and grants (see below), SCF packages include only other commercial lenders (the "B" loans in its operations). The lack of access to donor funding for SCF loans puts the Bank at a disadvantage relative to peer institutions. The absence of grant resources also means that SCF has reduced capacity to foster lending opportunities and engagement earlier in process of project development. The potential source of such funds through the Bank's Office of Outreach and Partnerships, ORP, has not yet been tapped.

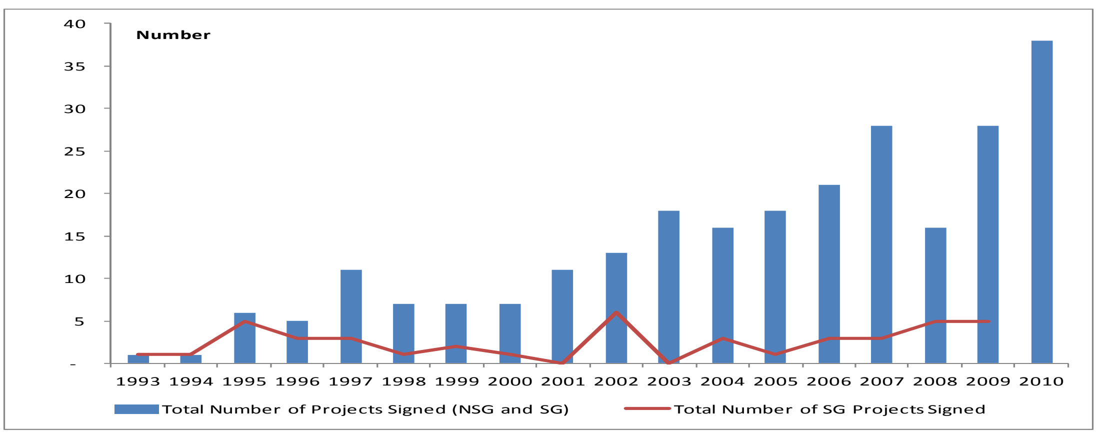
4.17 The third factor explaining low delivery is the exclusion of lending to most sub-national entities and the screening process used by SCF to determine eligibility for sub-national enterprises. The eligibility criteria in NSG Operational guidelines essentially exclude typical sub-national public enterprises. According to the 2011-15 Business Plan, clients must "*... comply with, among other aspects, the following: a) Be creditworthy in its own right; b) Meet the Bank's development and additionality criteria; and c) Have strong corporate governance, including an active independent board and adhere, depending on the nature of the borrower and its corporate structure, to the following guiding criteria:*

i) Experienced and independent management; ii) Appropriately-independent corporate governance; iii) Fully audited and transparent financial accounts; and iv) An arms-length financial and fiscal relationship with government authorities (where applicable). Therefore, "*By definition, these eligibility criteria exclude Bank NSG financing of certain types of public or semi-public entities such as in the following circumstances: a) State-owned enterprises (SOEs) that receive significant subsidies from the government and/or do not charge economically significant prices for their goods and services since these types of SOEs do not meet the "arms-length" test; b) Sub-nationals and municipalities that are relying on their source of repayment from general taxes or subsidies from the government; and c) Since the focus of NSG financing in the productive sectors is exclusively on private sector projects and entities, productive sector entities and projects that are controlled by a government cannot benefit from IDB NSG financing.* (see paragraphs 3.15 and 3.16). These are the very characteristics of typical sub-national enterprises, as discussed above.

V. THE EXPERIENCE OF OTHER MULTILATERAL DEVELOPMENT BANKS

5.1 The EBRD is the most the most successful among multilaterals regarding non-sovereign lending to sub-national entities.[14] From 2007 to 2010, it has approved about 28 sub-national operations per year (see Chart 7) with about 18% being sovereign loans. In 2010 it approved 38 sub-national projects worth €507 million.

Chart 7: MEI Activity, Number of Projects, over Time



Source: EBRD Database of Projects Signed and Special Study "Municipal and Environment Infrastructure Operations Policy Review", 2010.

5.2 Box 3 provides a summary of the operational policy of MEI/EBRD. EBRD is unlike SCF in a number of ways. It has a specialised unit, Municipal Environment Infrastructure, MEI, dedicated to municipalities[15]. MEI lends both with non-sovereign and sovereign terms, although with the latter decreasing over time. It can lend directly to municipalities. It can corporatize sub-national entities and ensure an appropriate revenue stream through tariff adjustment (step by step towards full cost or towards just operational cost recovery) during the implementation of the project. It can lend for municipal services that have fiscal subsidies. It can structure the operation with co-financing that reduces the effective cost to the borrower, as the overall package for a project includes its own market rates plus lower rate loans from other entities (e.g. European Investment Bank) and/or grants (often bilateral donors, or specialised funds like the European Union Cohesion and Structural Fund). It places high importance in having its "bankers" on the ground in the countries; of the 34 professionals, 50% are in the field. It engages in policy and regulatory reform through TCs with sub-national governments. It places special emphasis on projects with environment benefits. Finally, credit risk assessment is made by an independent entity in EBRD. Interviews with staff suggest that MEI operations do not have materially higher risk than other EBRD operations, though the nurturing and continuous engagement by MEI staff in their operations often implies higher labour costs relative to other EBRD operations.

Box 3: Summary of EBRD's Municipal and Environment Operational Policy (2004)

"EBRD's overall approach towards transition in its countries of operation:
• Decentralisation
• Commercialisation
• Environmental improvement

The main strategic and operational objectives in the EBRD's MEI Policy (2004) are:
• Extend the use of standard "products" to Russia / intermediate / early transition countries.
• Build on experience in the water sector to expand the portfolio into other sectors.
• Promote private sector solutions.
• Promote commercialisation / improved efficiency of municipal services.
• Extend the use of existing "products" to small municipalities.
• Institutional strengthening through TC.
• Address affordability through grant co-finance.
• Increase access of municipal service companies to capital.
• Improve project implementation, disbursements, etc.

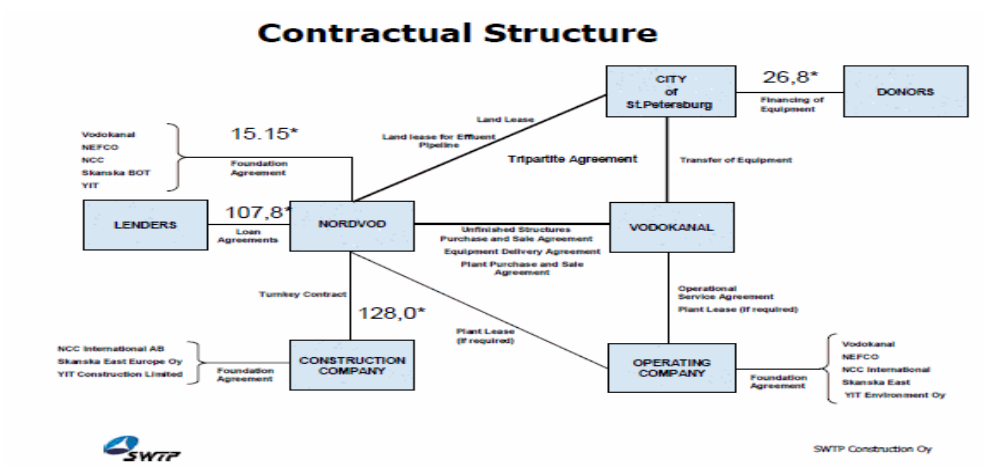
The Policy (2004) has much emphasis on Technical Co-operation (TC) and policy dialogue. Other points in the MEI Policy include:
• A move into sectors that are not based on full cost recovery, but would benefit from commercialised approaches, such as urban transport.
• A move into sectors that have strong environmental benefits, such as district heating and solid waste management (including waste to energy).
• An emphasis in the more advanced countries on new products (e.g. guarantees revenue bonds).
• A move into new sectors such as urban regeneration and housing in more advanced countries.
• The promotion in early transition countries of the concepts in the MEI Policy (e.g. decentralisation, commercialisation) through demonstration projects."

Source: Special Study. Municipal and Environmental Infrastructure Operations Policy Review, May 2010, Evaluation Department, EBRD.

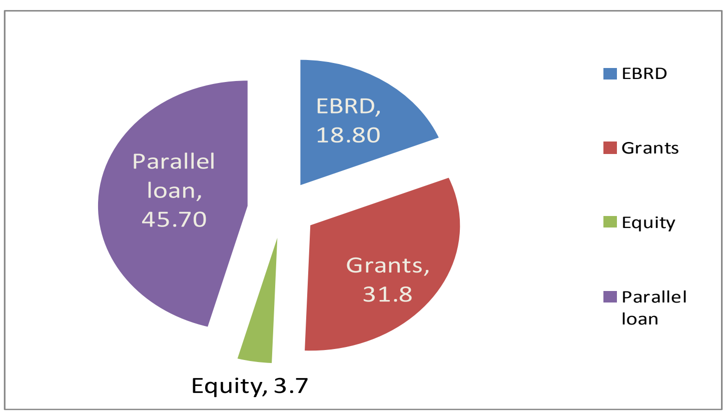
5.3 Box 4 provides an illustrative example of an MEI operation that IDB cannot do under current rules and practice. Although EBRD lends at commercial rates, it forms a package that includes lower rate loans, equity, and grants, a package that reduces the costs to the borrower. In 2002, the EBRD approved a private sector investment operation for €$35.45 million for the St. Petersburg South-West Water Treatment Plant. The borrower, Nordvod, was a liability special purpose company incorporated in the Russian Federation. Nordok is owned by The Nordic Environment Finance, Vodokanal of St. Petersburg, and the Consortium (Group of Nordic construction companies). The

Construction Company is a limited liability company under Finish law, owned by the Consortium. Ecovod, a Special Purpose Company, was established by Vodokanal and the Consortium. The project sought to complete the construction of the treatment plant and start its operation. The construction had started in 1987 but was interrupted in 1991. Given the project's complexity and significant financial needs, the project involved a total of 14 different financial sources. The total cost of project was estimated at €$188.7 million, €$121.79 million (64.5%) of which was provided through loans, €$60 million (31.8%) through grants, and €$6.95 million (3.7%) through equities. Three entities participated in the project's construction and operation: (i) Nordvod as the owner of the company during the construction; (ii) the Construction Company that constructed, commissioned, and completed the plant; and (ii) Ecovod that operates the plant under a 12-year Operational Service Agreement.

Box 4: MEI/EBRD St Petersburg South-West Water Treatment, Russia



St. Petersburg South-West Waste Water Treatment Plant: The Financial Package



Source: St. Petersburg South-West Waste Water Treatment Plant, Russian Federation, Operational Performance Evaluation Review (April 2007), EBRD.

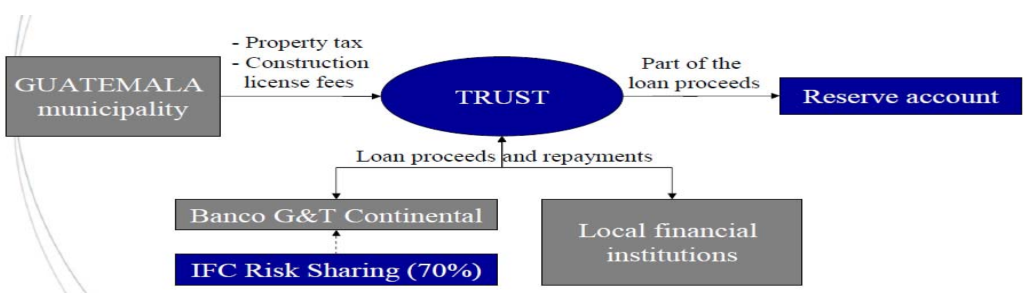
5.4 Box 5 provides another example, the Tbilisi Transport project, which again shows the role of grants and illustrates that full cost recovery through tariff adjustment is neither an eligibility criteria nor an aim of MEI operations, unlike SCF projects. The affordability exercises by MEI consider not only repayment capacity of the borrower but also the ability to pay of end users.

Box 5: EBRD's Tbilisi Public Transport Project, Georgia.
A €5.3 million non-sovereign loan to the Bus Company, supported by the City as a guarantor, helped in obtaining a public service contract (PSC) between the City and the Bus Company. The loan proceeds were to be used for the procurement of buses, spare parts, and the rehabilitation of workshops ("the Investment"). The Dutch Government's Development-Related Export Transactions Programme ("ORET") provided a grant for €250,000 to procure 22 second-hand DAF buses. A €450,000 technical cooperation ("the TC") financed from the Early Transition Countries ("ETC") Fund was for institutional strengthening. As most bus companies in the world operate with subsidies, the objective was to implement a tariff policy to cover only 70% of the Company's costs. The 70% target was not reached, though fares doubled in 2007.
Source: Tbilisi Public Transport Project, Georgia, Operation Performance Evaluation Review, OPER No. PE09-460T, June 2010.

5.5 Another peer multilateral is the IFC of the IBRD. The IFC has been less successful than MEI/EBRD in terms of lending operations. The dollar value of sub-national projects has averaged 1.5% yearly of the average annual total approvals of US$10.7 billion from 2007 to 2010. IFC and the SCF are more similar than MEI/EBRD. However, unlike the IDB, IFC has a department, Sub-National Finance Department, which is a combined initiative of IFC and the World Bank, dedicated to sub-national borrowers of non-sovereign loans. Unlike IDB it can lend to municipalities and has resources for advisory services, i.e. it has two windows for financing and technical assistance. Such technical assistance allows project facilitation, upstream transactions, and market development and capacity strengthening.

5.6 Boxes 6 and 7 provide two examples of operations by IFC. The IFC operation with Guatemala City's transport system, shown in Box 6, is in principle excluded by IDB's existing guidelines, as it was a direct loan to a municipality where the revenue stream to repay the loan was from property taxes rather than revenue from fees applied to transport services.

Box 6. IFC Operation with Guatemala City

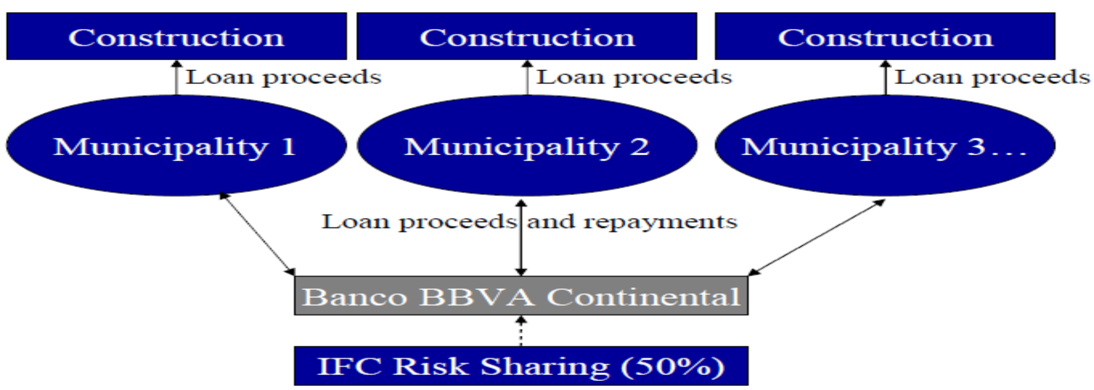


Source: Slides 35-37 of Sub National Finance: Overview of Programs and Instruments March, 2009. IFC

5.7 The package consisted of (i) a 10-year syndicated loan for US$36.7 million secured by a mechanism that aggregated property taxes and construction licenses in a separate trust account to service specific Municipality of Guatemala City debt; (ii) a local currency loan from *Banco G&T Continental* for US$9.5 million; and (iii) a risk sharing agreement for single credit exposure for 70% of the total bank exposure of US$9.5 million. The claimed development effects included the financing of critical urban transport infrastructure that reduced travel times and congestion in one of the largest cities in Central America, leading to improvement in the lives of some 180,000 daily users, many from the poorest segments of the population who depend on public transportation to reach their employment. It introduced a new source of commercial funding that does not rely on sovereign guarantees to municipalities in Central America, enhanced municipal financial management practices and diversified funding sources through WBG technical assistance, and created an entry point for a leading Guatemalan bank to participate in the municipal financing business.

5.8 Box 7 summarises an operation with a commercial bank for a credit line to municipalities in Peru. Although this type of operation would not necessarily be excluded by the IDB's guidelines, there are no examples of similar operations by SCF. The operation financial structure consisted of (i) up to US$40 million whereby WBG would risk share up to 50% of the loans originated by BBVA to sub-national governments for infrastructure project finance and (ii) a local currency loans from *Banco BBVA Continental*. The claimed development effects included the creation of an entry point for a leading Peruvian bank to reach the underserved municipal financing market, the enablement of sub-national governments to access long-term local currency commercial financing for critical infrastructure projects, and the use of the leverage of WBG expertise to improve the quality and sustainability of local infrastructure and public services. It benefited over 75,000 people through accelerated investments in critical local infrastructure.

Box 7: IFC Operation with BBVA (Peru) to Finance Municipal Infrastructure



Source: Slides 38-40 of Sub National Finance: Overview of Programs and Instruments March, 2009. IFC

5.9 These two peer multilaterals have attempted to adjust to key characteristics of the sub-national market. Their instruments not only include loans to sub-national governments and their enterprises, but also additional services that are aimed at developing the actors in the market towards greater commercialization, thereby facilitating PPI. The importance placed on this agenda is reflected in the fact that they each have a dedicated organisational unit.

VI. Summary and Recommendations

6.1 Approvals of sub-national NSG operations in IDB have been modest. The experience of the last four years reveals that there is not, as expected, a large and growing sub- national market for the Bank's NSG loans. There are disincentives to both supply and demand. On the demand side –that is, from the view of the borrowers– the NSG product offered by the Bank is more expensive, has shorter tenors, requires more time, greater effort and expertise, and is more intrusive (reporting convents and on-payment defaults) than SG loans. For existing high quality sub-nationals, i.e., those that pass the NSG existing credit standards, more competitive terms are often available from national and sub-national development banks and sometimes local capital markets (as in Costa Rica, Chile, and Brazil).

6.2 On the supply side, the Bank's credit-screening standards reduce the Bank's supply to a limited number of sophisticated non-sovereign enterprises that are already on par with private firms, thus narrowing the market. In addition, given that sub-national operations have higher transaction costs, they appear to have been squeezed out as SCF attempted to meet its ambitious expansion plan regarding the volume of lending.

6.3 Going forward, the Bank needs to decide between two options. One option is the status quo. This option places little importance for the Bank in using non-sovereign lending for improving local services and increasing investment. With so few operations approved to date, and a generalised opinion –based on interviews– hat opportunities are scarce, future operations may be few in number and may involve smaller-sized operations and costs to the Bank. A reading of the recently approved Private Sector Strategy (GN-2598-6, June 2011) suggests that the Bank prefers this option, as the document fails to mention sub-national entities in any meaningful way. With the Bank at the cusp of a major increase in non-sovereign lending under IDB-9, this "no change" option has an obvious virtue.

6.4 If, however, the Bank's considers that this is an agenda that needs to be more aggressively pursued, the *status quo* is not appropriate. In this case changes are likely to be needed in the institutional framework, borrowing costs, and screening criteria to better suit the characteristics of the sub-national market. The relatively more successful case of MEI/EBRD is an example of a delivery system designed to meet those characteristics.

6.5 Given that effective public service delivery is critical for poverty reduction, low gross capital formation is hindering development in the Region, and decentralisation has increasingly placed investment decisions for infrastructure services at the sub-national level, OVE believes that this market should be a concern for IDB. A comparison with peer multilaterals suggests that the Bank could do better.

6.6 OVE thus recommends that IDB's management:

(i) To understand the potential market for sub-national lending, analyse and map eligible and excluded sub-national entities in client countries under alternative policy scenarios for both SG and NSG operations;

(ii) Review the guidelines and practices of peer multilaterals, particularly EBRD, to determine the desirability and feasibility of emulating them, considering the characteristics of the sub-national market in the Region; and

(iii) Propose changes to existing policy and guidelines (institutional framework, costs to the borrower, and eligibility criteria) such that the Bank can better serve the currently excluded sub-national enterprises through NSG lending.

Endnotes

1 As recorded in the report of the PEC Chair in GN-2400-12, dated August 2, 2006.

2 Chapter 1. Descentralización y Sostenibilidad Fiscal Subnacional en América Latina. Descentralización y sostenibilidad Fiscal Subnacional: Los Casos de Colombia y Perú. (eds. M. de Valle, A. Galindo). BID, 2010.

3 Mello, L (2010), "Fiscal Decentralization and Public Investment: The Experience of Latin America", OECD Economics Department, Working Papers No 824. OECD Publishing. http://dx.doi.org/10.1787/5km347r2hhbp-en

4 Infrastructure in Latin America and the Caribbean: Recent Developments and Key Challenges. M. Fay and M. Morrison, World Bank, 2007.

5 Scoring: 0=The legal framework does not allow regional or municipal entities to concession public works, or in practice the requirements are extremely cumbersome;1=The legal framework allows regional and municipal entities to concession public works, but technical capacity or political will is lacking; 2=A few successful examples of regional or municipal concessions exist, but capacity and projects at this level across the country are generally weak; 3=A significant concessions programme has been developed at a municipal or regional level, with good implementation capacity and institutional design; 4=An important and diverse (in terms of sectors and locations)concession programme has been developed at the municipal or regional level, and it benefits from a homogeneous framework, good local implementation capacity and institutional design.

6 See: "Scheme and Guidelines for Financial Support to Public Private Partnerships in Infrastructure", Ministry of Finance, Government of India, 2008. http://www.pppinindia.com/pdf/scheme_Guidelines_Financial_Support_PPP_Infrastructure-english.pdf

7 Under IDB-8, 1994, the Bank launched the private non sovereign window with a 5% of commitment limit, in 1998 the ceiling was changed to 5% of outstanding loan balance (excluding emergency loans), and in 2001 the ceiling was raised to 10% of the aggregate outstanding amount of loans and guarantees (excluding emergency loans). IDB-9 proposes replacing gradually the existing limit to one where risk capital requirements for NSG operations will not exceed 20% of the Bank's equity.

8 These were tweaked in 2009, see OP-234.

9 Celtins ("the borrower") is a concessionaire and operates under a 30-year concession granted under the Federal Concession Law. Therefore, CELTINS is not a sub-national PPP. However, OVE classified this operation as a sub-national public enterprise (the strict definition) due to the fact that State of Tocantins has 30% of the shares of Celtins (70% is owned by a private company, Rede S.A.). In addition, OVE identified several loans to concessionaries; however the counterparts/grantors to the private companies are not sub-national governments. For example: ATE II (BR-L1034), Borrower: ATE II Transmissora de Energia S.A. Counterpart: Agência Nacional de Energia Elétrica, Brasil. El Dorado International Airport (CO-L1029). Borrower: Sociedad Concesionaria Operadora Aeroportuaria Internacional S.A. Counterpart: National Aviation Authority. Finally, there are three OMJ loans to Peruvian municipal microfinance institutions, *Cajas* Ica, Sullana and Maynas that configure lending to sub-national entities (these operations are in local money). The CMACs (Cajas Municipales de Ahorro y Crédito) operate at a sub-national level. However, they are private companies ("Sociedades Anonimas'). According to the OVE's definitions, they were classified as "private borrower"

10 "*The Bank's leadership in this pilot project will create a demonstration effect for the private financing of PPP projects region-wide*." Paragrarph 1.1 and "*Another critical benefit of the Project will be the potential for poverty reduction through the improvement in transportation access for low-income populations. A major part of the low-income population lives in the suburbs of São Paulo (including the western sections of Line 4) where job opportunities are less available and access to public transportation is critical for economic mobility*." Paragraph1.7, and "*As the Project will be run on electricity derived primarily from hydro power, new metro projects*

in São Paulo would be able to apply for Carbon Emission Reduction credits (CERs) due to the displacement of fossil fuels from automobile usage." Paragraph 1.8.

[11] See: "Lecciones sobre la Asociación Publico Privado en la creación de una nueva línea de Metro. El caso del Metro de San Pablo", Sector de Conocimiento y Aprendizaje, Octubre 2010.

[12] See: http://www.revistaferroviaria.com.br/index.asp?InCdEditoria=11&InCdMateria=12422

[13] Source: Bank meets challenges of working with state-controlled clients in non-sovereign guaranteed operations (KNL note, July 2009).

[14] For more information on MEI/EBRD policy and projects see: "Municipal and Environment Infrastructure Operations Policy Review", Special Study. Evaluation Department, EBRD, May 2010.

[15] "EBRD MEI sector covers direct revenue-earning services, such as water supply, waste-water collection and treatment, solid waste management, district heating, natural gas distribution and urban public transport. Infrastructure, such as urban roads, and environmental clean-up operations, which are not directly revenue-earning, are also included. Generally, the provision, financing and management of these municipal and environmental services are the responsibility of local or regional governments. EBRD MEI sector also covers environmental services, such as industrial and hazardous waste management, that may be organised nationally or outside local government responsibility.

MANAGEMENT'S RESPONSE TO OVE'S EVALUATION OF THE BANK'S NON-SOVEREIGN OPERATIONS WITH SUB-NATIONAL ENTITIES: 2007-2010 (RE-402)

I. Introduction

1.1 Management welcomes the opportunity to comment on "An Evaluation of the Bank's Non-Sovereign Operations with Sub-National Entities: 2007-2010" (RE-402, the Report) prepared by the Office of Evaluation and Oversight (OVE) in response to a request from the Policy and Evaluation Committee (PEC) in 2009 for an evaluation of a sub-component of the Bank's expanded non-sovereign guaranteed (NSG) mandate in 2006, namely the expansion to sub-national borrowers.

1.2 Management takes note of the Report's findings and recommendations and would like to thank OVE for the usefulness of the review. While concurring with some of the conclusions highlighted in the Report, Management would like to emphasize that the Bank has followed direction provided by and applicable operational guidelines approved by the Board of Governors, the Board of Directors and Management with respect to eligibility criteria for and structuring considerations of NSG operations. Nevertheless, Management appreciates the recommendation to review certain eligibility criteria pertaining to sub-national borrowers and is taking such recommendation into consideration in the revision of the NSG operational guidelines that is currently underway, as explained in more detail in the sections below.

1.3 This document is divided into three subsequent sections. Section II provides a few key clarifications and Section III discusses each contained in the Report. Section IV outlines additional comments to the Report.

II. Key Clarifications

2.1 ***Entities***: The Report indicates that there has been "a decision to exclude sub-national governments" from NSG financing (Executive Summary and paragraph 3.12). Management would also like to clarify what type of "entity" is eligible for NSG financing under the IDB's Operational Guidelines for Non-Sovereign Guaranteed Operations: Revised Version (GN-2400-11), dated August 1, 2006 (NSG Operational Guidelines). Management also wishes to emphasize that the Board of Governors document that contemplated the expansion of the NSG mandate in 2006 (CA-466-1), which led to NSG Operational Guidelines, expressly contemplated "a shift to a client-driven approach to support the universe of non-sovereign guaranteed borrowers" (paragraph 7.1). As stated in the NSG Operational Guidelines:

> "Bank NSG financing may be undertaken in any borrowing member country and may be provided to any entity regardless of the degree of private or public sector ownership, as long as such entity does not benefit from a full sovereign guarantee for

repayment of the Bank loan or guarantee being considered." (GN-2400-11, paragraph 4.1).

2.2 Neither the Board of Governors document that contemplated the expansion of the NSG mandate in 2006 (CA-466-1), nor the NSG Operational Guidelines approved by the Board later that year expressly exclude sub-national governments from NSG financing except as follows:

- In the context of general purpose financings as contemplated in footnote 3 of the NSG Operational Guidelines, which states that "References in these Guidelines to entities eligible for NSG financing are intended to apply broadly, but are not intended to include national or local governments per se for general purpose financing or Central Banks."

- An explicit objective of the NSG mandate expansion (CA-466-1) was that, on average, over a four-year period from the effectiveness of the proposal (the four-year period ranged from August 9, 2006 through August 9, 2010), at least two-thirds of new IDB resources made available under the 10 percent limit would be directed to finance project entities that have majority private sector ownership (an objective which has been met for the period). (CA-466-1, paragraph 1.5 and GN-2400-11, paragraph 4.5)

- "The focus of Bank NSG financing in productive sectors will be exclusively on private sector projects and entities". (CA-466-1, paragraph 4.10 and GN-2400-11, paragraph 4.2)

2.3 More generally, financing of sub-national governments would be excluded to the extent that such financings do not meet the NSG eligibility criteria set forth in the NSG Operational Guidelines, which are applicable to all prospective NSG borrowers. For example, the NSG Operational Guidelines restrict financing of entities that benefit from a full sovereign guarantee for repayment of the Bank loan or guarantee (as cited above), as well as entities that do not have appropriately independent corporate governance, and entities that enjoy immunities.

2.4 Management agrees that the application of corporate governance and immunities criteria currently included in the NSG Operational Guidelines need refinement so as to take into account issues that have arisen in the context of the Bank's NSG sub-sovereign lending, including the structure of a project or operation being financed and the nature of the borrower, including public, municipal and semipublic entities. Certain of these aspects have been discussed in bilateral meetings with the Board during the development of the NSG Business Plan 2012-2014 (GN-2591-3, NSG Business Plan) and Management expects to propose revised NSG operational guidelines to the Board before the end of Q1 2012.

2.5 ***Borrower Entity vs. Project/Operations***: Management would also like to clarify that although the Report includes under its "extended definition" of NSG sub-national loans

PPP operations where a counterpart to a private firm is a sub-national government or sub-national firm (paragraph 4.3); PPPs are not generally considered by Management to be sub-national operations. The expansion of the sub-national definition to encompass PPPs creates some confusion because it blurs the distinction between entities and operations/projects (i.e. nature of the borrower vs. the underlying project or operation that is being financed).

III. Comments on the Main Recommendations

A. To understand the potential market for sub-national lending, analyse and map eligible and excluded sub-national entities in client countries under alternative policy scenarios for both SG and NSG operations.

3.1 As further discussed in Section C below, Management believes that the most productive manner in which to identify potential NSG sub-national borrowers is to deepen coordination with VPC and VPS in this particular regard since VPC manages the country dialogue process and VPS works with many such potential NSG sub-national borrowers in the Bank's SG operations. Management acknowledges the Report's criticism that no specific process existed to coordinate VPS and VPP in the sub-national space and as a result of this assessment, VPS and VPP have committed to systematizing dialogue related to sub-nationals.

3.2 Management recognizes that the effectiveness of the Bank's matrix structure continues to improve and reflecting the desire to deepen coordination among VPP, VPS and VPC, the NSG Business Plan includes as one of its four strategic objectives enhancing collaboration with VPC in terms of country strategies and programming, and with VPS regarding sector expertise and intensifying synergies between Private Sector Operations (PSO) and Private Sector Development (PSD) operations (Strategic Objective #4, paragraphs 2.51-2.62).

3.3 Regarding the recommendation, Management considers that a mapping of potential sub-national entities in client countries for both SG and NSG operations would not be very illustrative. In fact, in the preliminary version of the NSG Business Plan that was noted by the PEC in November 2010 (GN-2591, paragraph 3.19), Management suggested to do just that[1]. Upon further consideration however, and given that, in principle, a sub-national entity that benefits from a full sovereign guarantee would be eligible for SG lending, the potential SG market for sub-national lending includes all such entities. In addition, considering that an essential criterion for any NSG lending relates to creditworthiness of the borrower, it would be resource prohibitive to perform a credit analysis on all potential sub-national entities to determine potential eligibility from a credit perspective. Considering that creditworthiness is not a static state and can change rapidly, such analysis would only be reliable for a short period of time. Moreover, since the Bank's NSG lending carries with it a developmental mandate (i.e. financial and non-financial additionality), the creditworthiness of a sub-national entity is not the sole consideration that would make such an entity eligible for NSG lending. In the end, Management

1 The final approved version of the NSG Business Plan 2012-2014 (GN-2591-3) does not include this task.

decided that a more fruitful course of action is to work closer with VPC and VPS to identify potential NSG sub-national borrowers.

3.4 In this recommendation, the Report makes reference to "alternative policy scenarios". This is discussed below under Section C.

B. Review the guidelines and practices of peer multilaterals, particularly EBRD, to determine the desirability and feasibility of emulating them, considering the characteristics of the sub-national market in the Region.

3.5 During the course of Management's analysis and preparation of the revised NSG operational guidelines, discussions have been ongoing with our peer institutions, including EBRD.

3.6 Management acknowledges that EBRD is a meaningful comparator and appreciates that EBRD has been very helpful in various consultations and discussions. Recognizing that EBRD does not have the same mandate as the Bank (EBRD has the mandate to invest in projects that foster transition to open market economies and not to foster development per se) and that EBRD also has products and services offerings that the Bank does not, including the ability to invest equity and significant donor resources to support its private sector and NSG operations in this space, EBRD does offer valuable lessons learnt that could be applicable to the Bank's NSG sub-national lending, which will be taken into consideration in the revised NSG operational guidelines and other initiatives related to the sub-national space.

3.7 Management has also been in consultations with the IFC and ADB regarding sub-nationals and other issues. From these meetings, as well as from EBRD's approach, it seems that our peer institutions take a more flexible approach in their work with sub-nationals than has heretofore been the case at the IDB under the NSG Operational Guidelines. Management is continuing to explore this impression and intends to provide a peer analysis on a variety of aspects when the revised NSG operational guidelines are proposed to the Board.

C. Propose changes to existing policy and guidelines (institutional framework, costs to the borrower, and eligibility criteria) such that the Bank can better serve currently excluded sub-national enterprises through NSG lending.

3.8 With respect to the Bank's institutional framework, paragraph 4.13 of the Report cites the lack of a dedicated team as a key factor that may attribute to the lack of significant NSG sub-national lending. Specifically, the Report indicates that reducing constraints in the sub-national market through improvements in financial management, regulatory frameworks, and infrastructure management including corporate governance contributes to "graduating" sub-national entities to NSG financing.

3.9 While the effectiveness of the Bank's matrix structure continues to improve, as referred to earlier in addition to VPP's and VPC's commitment to improving collaboration in terms of country strategies and programming, VPP and VPS are also committed to intensifying synergies between PSO and PSD, which should facilitate enhancing activities aimed at "graduating" sub-national entities to NSG financing, provided that country clients are supportive. Moreover, in the context of the "Client Support Services Platform" that VPP is coordinating as outlined in the NSG Business Plan, Management may consider the creation of a sub-national business line. Management expects to engage in an informal discussion on the Client Support Services Platform including proposed business lines with the Board before the end of Q1 2012.

3.10 In paragraph 3.10, the Report cites that "Credit standards embodied in the screening process and the approval process [for sub-national borrowers] were to be the same [as all NSG borrowers]. Pricing of the loans was based on the same criteria as loans to private borrowers, i.e. based on terms of "B" lenders among other criteria". The Report implies that that credit standards, the screening process and pricing should be differentiated for NSG sub-national borrowers. In paragraph 6.4, the Report recommends that the Bank reconsider its NSG screening criteria and pricing "to better suit the characteristics of the sub-national market". Management agrees with this recommendation in part, as discussed below.

3.11 As outlined earlier, in terms of eligibility criteria Management agrees that the application of corporate governance and immunities criteria currently included in the NSG Operational Guidelines needs refinement so as to take into account the structure of a project or operation being financed through the Bank's NSG operations and the nature of the borrower, including public, municipal and semipublic entities. These aspects, among others, will be reflected in the revised NSG operational guidelines that Management expects to propose to the Board before the end of Q1 2012.

3.12 In terms of costs to an NSG sub-national borrower, Management would like to clarify that the document that the Board of Governors approved as part of the NSG mandate expansion in 2006 (CA-466-1) specifies that the "Pricing of loans and guarantees for all operations without a sovereign guarantee…will continue to be based on market comparators…Pricing will therefore reflect the risk profile of the transaction to be financed by the Bank, as perceived by the markets and the Bank" (paragraph 5.7). This condition is also reflected in the NSG Operational Guidelines. Deviation from market-based pricing for NSG operations would be outside of the scope of the NSG mandate.

3.13 Nevertheless, as the Report points out, EBRD loans are often part of low cost packages that include low interest loans from other sources and grants (paragraph 4.16) and Management welcomes the opportunity to access low interest loans, as well as grants from donors in tailoring lower cost financing packages for NSG clients, including sub-national entities. Under the NSG Business Plan, VPP anticipates increased coordination with the Office of Outreach and Partnerships in donor outreach and communication in this regard (paragraphs 2.15-2.18), as well as enhanced coordination with other MDBs and bilateral agencies (paragraph 2.29).

3.14 The Report also cites that use of New York law and lack of a local currency product increases transaction costs for sub-national borrowers. Indeed, these aspects are not particular to sub-national entities and the NSG Business Plan contemplates deepening use of local law and expanding local currency capabilities as important initiatives (paragraphs 2.34 and 2.42).

3.15 The Report also cites that the use of expensive technical consultants increases transaction costs for NSG sub-national borrowers. However, so as to appropriately vet environmental, social, technical, financial and economic viability of proposed NSG operations, it is difficult to consider lessening the customary level of due diligence because the NSG borrower is a sub-national. This approach could also negatively impact the Bank's ability to mobilize B-loan participants, as the Bank is renowned for its thorough due diligence.

3.16 The Report also implies that the Bank's NSG credit review process discriminates against sub-national entities. Management upholds the approach that credit considerations (as well as other due diligence areas) should be applied with the same degree of rigour to all NSG borrowers since the credit quality of the NSG portfolio rests upon the ability of borrowers to repay IDB loans. However, as a complement to the forthcoming proposed revised NSG operational guidelines, Management is also preparing a risk appetite statement that, based on consultation with the Board, could incorporate a differentiated risk appetite approach that considers the development benefits for certain type of operations such as those involving sub-national entities.

IV. Other Comments

4.1 Although Management has additional comments to the Report, it was decided that this document should focus on the most important clarifications to be offered and discuss the Report's recommendations rather than providing detailed comments. However, Management is prepared to discuss other comments.