

RISK MITIGATION MECHANISMS FOR LOCAL INVESTMENT

The Role of Subnational
Development Banks

Risk Mitigation Mechanisms for Local Investment

The Role of Subnational Development Banks

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ALLIANCE
OF SUBNATIONAL
DEVELOPMENT BANKS
FOR LATIN AMERICA & THE CARIBBEAN

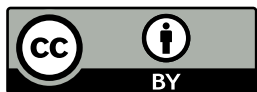


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ABSTRACT

Subnational development banks (SDBs) in Latin America and the Caribbean (LAC) provide financing to regional and local governments, subnational entities, and small- and medium-sized enterprises (SMEs), but generally lack information about how they can support the transition toward net-zero greenhouse gas emissions and environmental sustainability. This document describes how SDBs can support blended financing arrangements that combine both public and private resources, leveraging their comparative advantage in mitigating the high risks that private lenders perceive of working with actors at the subnational level. The document provides illustrative cases from both regional and international contexts of how public development banks can mobilize private capital for local economic development. It concludes with strategic recommendations for SDBs to increase sustainable financing for a just urban and territorial transition and for the Alliance of Subnational Development Banks in Latin America and the Caribbean as a platform to foster a regional dialogue that can increase financial innovation across the region.

JEL Codes: O16, O18, O54

Keywords: subnational development banks (SDBs); credit risk mitigation; private sector mobilization; just urban and territorial transition

PROLOGUE

The Alliance of Subnational Development Banks (SDBs) in Latin America and the Caribbean (LAC) is an initiative of the Coalition on Resilient Cities and Regions of the Finance in Common Summit (FICS) (Finance in Common, n.d.). It was launched in April 2021 with the objective of strengthening the capacity of SDBs in their specific mandate to finance subnational investments and improving their interventions to support urban and territorial transitions toward just, inclusive, and sustainable economies in Latin America and the Caribbean.

The Alliance is a strategic space to foster dialogue and partnerships with peers, financial and technical partners, and national and local governments around the following objectives: (i) align SDB strategies, standards, initiatives, investments, and portfolios with the UN's 2030 Agenda for Sustainable Development and its Sustainable Development Goals (SDGs) and the Paris Climate Agreement; (ii) diversify SDBs' technical and financial services offered to local governments and stakeholders; and (iii) promote sustainable investments through portfolios of urban and territorial development projects and boost urban and municipal financial markets.

The Coalition on Resilient Cities and Regions of FICS and the Alliance are both led by the Global Fund for Cities Development (FMDV) in collaboration with strategic partners. The Inter-American Development Bank (IDB), as a signatory of the joint declaration of FICS and the first source of multilateral financing in LAC, has been one of the key supporters of the Alliance of SDBs in LAC. FMDV in collaboration with the IDB organized a virtual peer-to-peer workshop on April 22, 2022, titled “Developing De-Risking and Guarantee Instruments for Subnational Development Banks: Financing a Just Urban and Territorial Transition in Latin America and the Caribbean” (see Annex II for more details).

The workshop brought together international representatives from the public sector,¹ development financial institutions (DFIs), multilateral development banks (MDBs), and UN agencies² to address the role that SDBs should have in the development of risk mitigation mechanisms for subnational projects to encourage greater participation of the private sector and thus support the development of a fair and sustainable urban and territorial transition in LAC.

This report summarizes the discussions held during the workshop with the objective of highlighting the potential of SDBs to de-risk subnational investments through a credit risk mitigation approach, showcasing successful examples in the region and abroad that can serve as a guide for SDBs, and proposing strategic recommendations for action by each stakeholder (including SDBs, MDBs, DFIs, and national and local governments).

¹ Specifically, these included representatives from Brazil's Banco Regional de Desenvolvimento do Extremo Sul (BRDE) and the Agência de Fomento do Rio Grande do Sul (BADESUL) and from Mexico's Banco Nacional de Obras y Servicios Públicos (Banobras), the Nacional Financiera (NAFIN), and Fideicomisos Instituidos en Relación con la Agricultura (FIRA).

² Representatives from the IDB, the Andean Development Corporation (CAF), the Central American Bank for Economic Integration (CABEI), the World Resources Institute (WRI), and the United Nations Development Programme (UNDP) participated in this panel.

1. INTRODUCTION: THE ROLES OF SDB'S AND THE CHALLENGES OF SCALING UP SUSTAINABLE FINANCING

Subnational development banks (SDBs) are public financial institutions whose mandate includes providing financing to regional and local governments, subnational entities, and small and medium-sized enterprises (SMEs) for the provision of local public services and infrastructure projects in their territories. SDBs play a key role in Latin America and the Caribbean (LAC) in supporting local actors through the provision of technical assistance and financing with the aim of achieving local economic development and promoting a just, sustainable, and resilient urban and territorial transition.³ SDBs can better promote the development of their territories thanks to their strategic positioning that allows in-depth knowledge of the local context, ability to coordinate with national development policies, and a strategy for channeling financing at the subnational level in local currency for initiatives that are aligned with the Sustainable Development Goals (SDGs) and the goals of the Paris Agreement. However, the current reality of most SDBs in LAC is that they are constrained by limited resources and low national and subnational budgets, forcing them to rethink the way they manage their public and concessional funding.

The transition plans toward net-zero greenhouse gas emissions and environmental sustainability require an adjustment in the actions of SDBs. Rather than being guided by a short-term vision—as traditional lending financiers of projects—SDBs need to shift to applying a long-term strategy to propose a structured response to leverage finance for the urban and territorial transition. Tackling the climate crisis and achieving sustainable development at the subnational level requires a collaborative approach involving a much broader range of public and private actors that can understand local investment opportunities and act on specific subnational risks that can be diversified. SDBs can help facilitate such collaboration by channeling resources and developing new leverage mechanisms to address the financial needs of businesses and local governments, improving both the efficiency and effectiveness of development programs and funds.

A common risk that limits lending and investment among subnational stakeholders is the perception of a higher counterparty credit risk compared to national institutions. This credit risk at the subnational level arises from the probability that local stakeholders in a financial transaction will not fulfill their contractual obligations. Local governments are limited by fiscal constraints, and the high turnover of authorities that changes priorities during the mandates increases investors' risk perception. Subnational public companies and local SMEs do not have the financial solvency and credit history necessary to ensure stable and timely returns that allow for long-term financing and investment opportunities valued according to appropriate risk-return levels.

³ According to the Public Development Banks (PDBs) and Development Financing Institutions (DFIs) Database (<http://www.dfidatabase.pku.edu.cn/>), in LAC there are approximately 85 PDBs, of which 23 institutions have a subnational level of ownership. There are also PDBs with a national level of ownership whose mandate is to finance and support local governments and regions. Among them are: Banobras in Mexico, Findeter in Colombia, CAIXA and BNDES in Brazil, and BICE in Argentina.

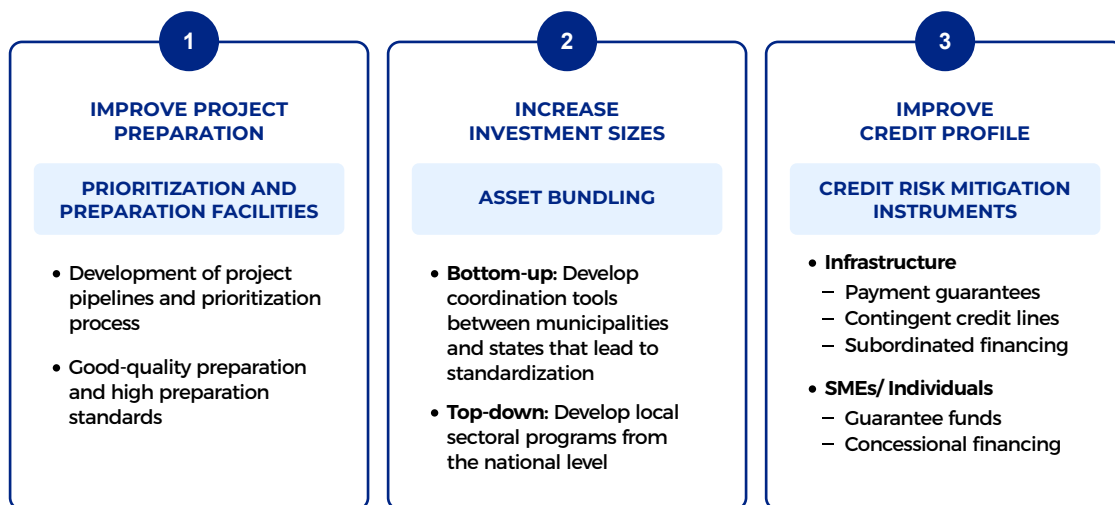
At the subnational level, investment opportunities lack volume since projects tend to be small, which reduces the opportunities to reach investors who are typically interested in large-scale projects. In addition, there is still insufficient capacity in government and the private sector at the local level to prepare and structure investment-worthy projects that are affordable and financially viable.

In this context, SDBs in LAC are positioned to act as efficient vehicles to channel funding from national governments and DFIs at subnational level and support the increase of private sector participation in the finance of the urban and territorial transition toward a sustainable economy through credit risk mitigation mechanisms of governments, companies, and individuals at the local level. SDBs can help mitigate the credit risk of local governments that have low solvency and liquidity to carry out infrastructure projects for sustainable cities through financial instruments that can be offered to private sector developers interested in participating in a concession or public-private partnership (PPP) agreement. To encourage the development of the SME sector, SDBs can support local entrepreneurs through guarantees that will improve their credit risk profile, targeting the development of the productive sector that invests in green and resilient activities and takes measures against the effects of climate change. Finally, SDBs can also help reduce the financing risk of low-income people who live in rural areas and who do not have credit history by designing credit lines with concessional funding to foster micro-businesses and enhance territorial inclusion.

2. BOOSTING PRIVATE INVESTMENT THROUGH CREDIT RISK MITIGATION STRATEGIES

Improving the credit profile of borrowers through risk enhancement mechanisms can increase the confidence of investors and providers of capital by reducing the real and perceived risk of investment losses. Focusing on improving credit risk at the subnational level is particularly important because it helps local institutions, projects, businesses, and individuals access new sources of capital, and it does not limit them to relying solely on available public budgets and little local government support. Also, the credit enhancement support strategy has a catalytic effect in which lenders develop internal capabilities and credit ratings that will help them continue to access new sources of financing independently and sustainably over time.

Figure 1. SDBs' Key Areas of Intervention for Reducing Investment Risk



Source: Authors' elaboration.

There are three key areas of intervention where SDBs can help local actors reduce credit risks and improve their chances of obtaining financing. These include project preparation, asset bundling, and credit risk mitigation instruments (see Figure 1).

- 1. Project Preparation:** Developing a portfolio of well-prepared and high-quality projects is essential to attract the attention of the local and international financial sector. This is achieved by developing project prioritization and preparation groups and/or facilities that have good institutional capacity and high planning and preparation standards.
- 2. Asset Bundling:** The bundling of investment projects is also key to achieving a critical mass that allows costs to be reduced and risks to be diversified. Homogenization is important to reduce transaction costs and can be done through the coordination of states and municipalities (bottom-up approach) or through the development of sectoral programs of local projects under certain guidelines from the national level (top-down approach).

3. **Credit Risk Mitigation Instruments:** Improving the credit profile of beneficiaries through financial risk mitigation instruments can support the channeling of funding from DFIs at subnational level, attract private investment to infrastructure, and give companies and individuals access to financing.

The development of credit risk mitigation instruments can be an effective tool for SDBs to channel resources to support the development of subnational markets. The creation and implementation of de-risking instruments can serve as a valuable tool to direct resources toward bolstering local economies and stimulating private sector involvement. Local and regional economies often depend on the success of SMEs and micro-businesses. Credit risk mitigation instruments can encourage financial institutions to lend to these enterprises; this in turn fuels economic growth, job creation, and poverty reduction within the region. SDBs can play a pivotal role in catalyzing private sector participation in local development projects. By developing effective credit risk mitigation instruments, these banks can provide private investors with the confidence needed to invest in sustainable infrastructure, renewable energy, and other critical sectors that contribute to economic development.

SDBs could design financial instruments tailored to the specific needs of their communities. They could focus on supporting economic infrastructure and services and both SMEs and individuals.

1. **Economic Infrastructure and Services:** Financial instruments geared to improve the credit profile of public entities and PPP-type projects. These include:
 - **Payment guarantees:** An irrevocable promise by a third party to reimburse the creditor/investor if a public entity fails to pay the principal and/or interest up to a certain amount.
 - **Contingent credit lines:** A financial instrument that guarantees ex ante the repayment of a debt obligation to the creditor/investor through cash resources in the event of a severe exogenous shock (e.g., natural disaster, political or economic turmoil).
 - **Subordinated financing:** Financing with lower priority of repayment offered at a discounted rate and/or other non-commercial terms.
2. **SMEs and Individuals:** Financial instruments geared to improve the credit profile of local companies and individuals to access affordable credit. Among these instruments are:
 - **Guarantee funds:** Provide third-party credit risk mitigation to lenders through the absorption of a portion of the lender's losses on the loans made in case of default.
 - **Concessional financing:** Financing offered at below-market conditions to promote the development of special programs by blending with other sources of financing.

3. EXAMPLES OF CREDIT RISK MITIGATION MECHANISMS

There are successful mechanisms at the regional and international level in which public development banks and DFIs have been able to identify challenges at the subnational level and propose concrete solutions to promote sustainability and economic development. While the examples presented in this section are structured in specific local contexts that have their own particularities, they can serve as a guide for decision makers who are working to develop their own risk mitigation programs and mechanisms. The highlighted international experiences are divided into two groups. The first group is made up of examples of improving financing of subnational governments (regions and municipalities) that focus on the optimization of local resources and private capital mobilization through credit enhancement schemes. The second group shows specific examples of improving financing for local development actors, who through credit risk mitigation instruments can access affordable commercial financing for the development and growth of their initiatives and businesses.

3.1. FINANCING SUBNATIONAL GOVERNMENTS

3.1.1. Banobras' Experience in Mexico Supporting the Financing of Infrastructure and Services in States and Municipalities

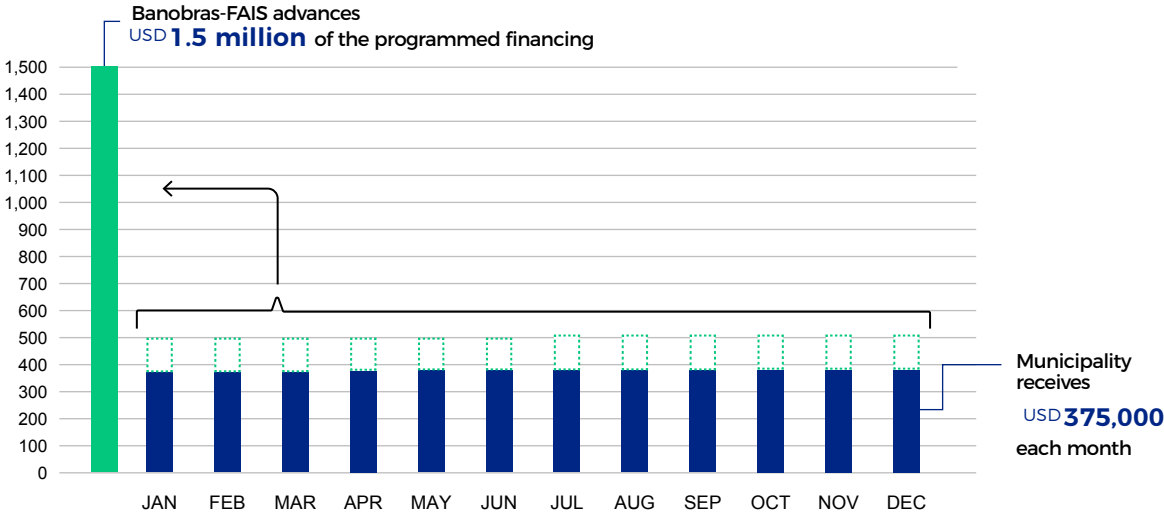
Mexico's National Bank of Public Works and Services (Banco Nacional de Obras y Servicios Públicos, or Banobras) is one of the main public banks in the region in financing and promoting infrastructure projects and public services. Banobras plays a crucial role in the economic and social development of the country by providing financing and expertise for various projects that contribute to the growth and well-being of the nation. Its mission is to facilitate the development of infrastructure, transportation, urban development, and other critical sectors in Mexico. Among its offerings, Banobras provides a series of programs focused on states, municipalities, and decentralized public organizations to improve the quality of life of the population and increase competitiveness at the subnational level.

Banobras-FAIS Program

The Banobras-FAIS Program allows up to 25 percent of municipalities' multiannual financing quota that comes from the Social Infrastructure Contribution Fund (Fondo de Aportaciones para la Infraestructura Social, or FAIS) to be advanced for investment in social infrastructure. The program grants the acceleration of the use of FAIS resources that correspond to the municipalities during an established period. Financing is carried out under competitive market conditions with a fixed interest rate, determined based on the rating obtained by the credit structure. The term of the credit is extended until the last effective month in which the current administration receives resources from the FAIS.

This financial scheme is designed to provide municipalities with better planning opportunities for their public works programs, with a specific emphasis on projects that have greater social impact such as drinking water, sewerage, sewer system, electrification, basic infrastructure in the educational sector and the health sector, housing improvement, and urbanization. For example, if in a specific year a municipality has access to financial resources equivalent to USD 6 million from FAIS—disbursed in 12 contributions of USD 500,000 each throughout the year—the municipality will be able, through the Banobras-FAIS Program, to receive an advance at the beginning of the year of up to USD 1.5 million (25 percent) of the total financing amount, reducing each contribution equally (see Figure 2).

Figure 2. Example Banobras-FAIS Program



Source: Authors' elaboration based on information from Banobras.

Timely Payment Guarantees and Contingent Credit Lines to Municipalities and States

The Timely Payment Guarantees (Garantías de Pago Oportuno, or GPO) are designed to improve the credit rating of municipalities and states. Using Banobras' local AAA credit rating, the guarantee can help reduce borrowers' credit risk, which can lead to long-term financing at better terms and conditions. Another credit risk mitigation instrument offered by Banobras is the contingent credit line. This can cover commercial banks in cases where a municipality or state cannot cover debt service obligations, or concessionaires in cases where the payment obligations of the public entity are not met.

To access the GPO, an administration trust and an identified source of payment are required. In addition, it is necessary for the established trust to have at least a local BBB rating and a reserve account that will be used. An example of the use of the GPO at the subnational level is the bank loans obtained by the State of Coahuila in 2018. According to the rating agency Fitch (Fitch Ratings, 2020), thanks to Banobras' GPO, the state's commercial financing structure obtained a credit rating five times higher than Coahuila's own credit rating.

Banobras' contingent credit lines are notoriously favorable for their irrevocable nature, which affirms the payment to lenders/investors and encourages their interest in participating in subnational projects. Recent examples include, among others, (i) the contingent credit line that Banobras granted to the City Council of Morelia to cover the differences between the level of real and expected income generated in the concession for the construction, operation, maintenance, and exploitation of the public parking lot in the former city bus terminal; (ii) the contingent credit line to the Municipality of Tlalnepantla, State of Mexico, destined to guarantee the payment of the construction works and equipment of the semi-deep collector, pumping plant, and collectors of the San Javier River; and (iii) the contingent credit line granted to the Municipality of Tlajomulco de Zúñiga, Jalisco, intended to cover the lack of liquidity in the payment of services of the water and sanitation project structured under the PPP scheme.

Loans for Debt Restructuring and Refinancing

With the purpose of improving the financing conditions of municipalities and states, Banobras offers this type of loan to optimize resources through refinancing and restructuring options for current debt that improve credit and liquidity conditions of borrowers. The resources released through Banobras financial instruments must be reinvested by subnational governments in infrastructure projects that help the reactivation of local economies.

In addition to offering competitive rates, the instrument is flexible since it can reach terms of up to 20 years, with monthly payment amounts determined according to the payment capacity of the borrower (municipality or state).

3.1.2. NAFIN Program to Support Mexican States

Nacional Financiera (NAFIN) is a public development financial institution in Mexico that aims to promote the economic and financial development of the country, especially supporting micro, small, and medium-sized enterprises (MSMEs) in the productive sector. NAFIN works with banks, limited-purpose financial entities, and other financial institutions to provide credit and support to businesses.

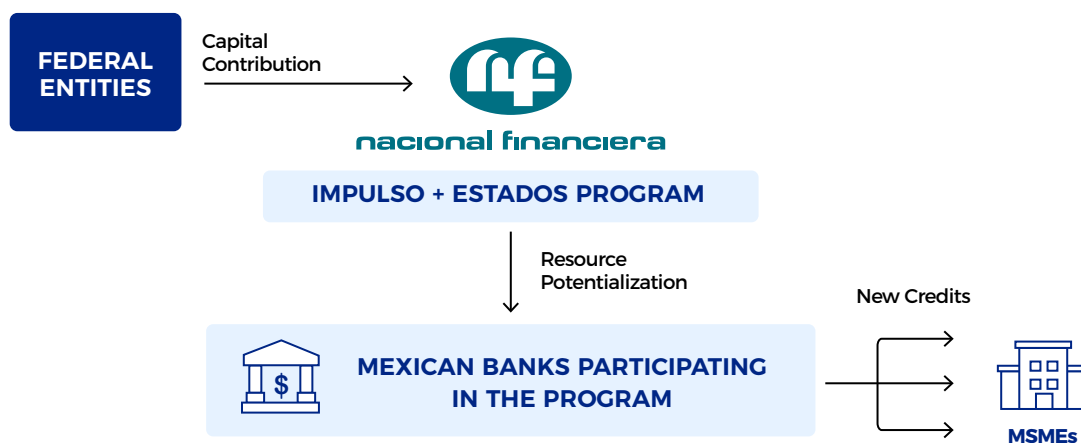
The Impulso NAFIN + Estados program was born as an initiative in which Mexican states leverage NAFIN's financial structure to potentialize their resources and generate a greater volume of credit for their MSMEs. This financing is intended to support the reactivation of regional economies and the preservation of jobs, promoting strategic sectors such as manufacturing industry, commerce, and services, among others.

The program adopts the following mechanism (see also Figure 3):

1. Federal entities contribute to NAFIN with a defined contribution.

2. Based on the characteristics of the states and the sector for which a line of credit is to be designed (commerce and services sector, industry, etc.), NAFIN calculates the “resource potentialization” leverage coefficient that will generate the state resources.
 - a. NAFIN partially guarantees the loans of the first-tier banks that are part of the program (Association of Mexican Banks).
 - b. Leverage, or potentialization, is calculated based on the probabilities of loss that allow NAFIN to measure the need for collateral.
3. Banks that have an agreement with NAFIN to participate in the Impulso NAFIN + Estados program grant credits to MSMEs.

Figure 3. Impulso NAFIN + Estados Program



Source: Authors' elaboration based on information from NAFIN.

3.1.3. BADESUL Program for Safer Cities

BADESUL is a development agency linked to the Secretariat of Economic Development of the State of Rio Grande do Sul in Brazil (Secretaria de Desenvolvimento Econômico, or SEDEC). As a subnational development entity, BADESUL provides financing to cities to finance investments in projects (except for those in the housing sector because specific legislation prohibits its participation). To mitigate the credit risk of cities, BADESUL uses guarantee schemes approved by law⁴ that allow states and municipalities to use advances of tax revenues or budget funds as collateral in credit contracts.

⁴ See Lei Complementar No. 101/2000 at https://www.planalto.gov.br/ccivil_03/leis/lcp/lcp101.htm.

In the case of the use of future taxes as a guarantee scheme, cities' value added tax on sales and services (Imposto sobre operações relativas à circulação de mercadorias e sobre prestações de serviços de transporte interestadual, intermunicipal e de comunicação, or ICMS) that returns from the federal government to the municipalities through specific accounts can be used as collateral in a credit operation with BADESUL. If a municipality seeks credit with BADESUL, the bank analyzes the municipality's collection projection based on historical activity in recent years, seeking collateral coverage of approximately 130 percent of the requested credit. If eligible, BADESUL accepts these resources as a guarantee or even as a means of payment for the financing. The operational advantage of using this type of guarantee is that the approval system is agile and does not require a rigorous credit analysis by the National Treasury because the funds used are originally generated by the city.

There are also other similar guarantee schemes, such as the use of future resources from the Municipal Participation Fund (Fundo de Participação dos Municípios, or FPM) as collateral for a credit operation. Although the mechanics of the guarantee are the same, these types of schemes are more difficult to use. The requirements are higher, and a more rigorous analysis is needed for approval by the National Treasury because the resources come from the federal government budget.

The use of future taxes as a guarantee scheme has been very successful not only in the State of Rio Grande Do Sul but also in other regions of the country with cities that have stable tax revenues. BADESUL has used the guarantees to support and strengthen its BADESUL Safer Cities program (Cidades Mais Seguras; see Table 1), leveraging the future resources of the cities to provide lines of credit with better financing conditions. Additionally, BADESUL's development strategy focuses on giving more financial advantages to programs that support innovation, sustainability, security, and other areas that are still perceived as risky or less profitable.

Table 1. BADESUL Safer Cities Program Details

Beneficiaries	Municipalities of Rio Grande do Sul
Maximum Financing Value	a) Up to R\$300,000, for municipalities with up to 10,000 inhabitants b) Up to R\$500,000, for municipalities with 10,001 to 20,000 inhabitants c) Up to R\$1,000,000, for municipalities with 20,001 to 50,000 inhabitants d) Up to R\$2,000,000, for municipalities with 50,001 to 100,000 e) Up to R\$3,000,000, for municipalities with more than 100,000 inhabitants
Credit Participation	Up to 100% of the financeable value
Financing Cost	Selic + 6% p.a.
Term	Up to 60 months, with a 12-month grace period
Guarantees	Payments from the earnings of ICMS taxes

Source: Authors' elaboration based on information from BADESUL.

3.1.4. AFD Guarantee Program for Sustainable Cities

In 2021, the French development agency AFD (Agence Française de Développement Group), together with the European Union, developed the Cityriz program to support African private and public banks in financing subnational sustainable, resilient, and inclusive infrastructure projects through a credit guarantee system. The guarantees serve to reduce African banks' perceived risk in lending to municipalities, particularly intermediate-sized cities.

The Cityriz program seeks to diversify local government financing by promoting access to long-term loans in local currency and municipal bonds. This will allow cities in Africa to obtain financing tailored to their local economies and specific needs, to be able to develop sustainable urban infrastructure.

The main characteristics of the Cityriz program guarantees are:

- Partial guarantee with coverage of up to 50 percent risk of non-payment
- Warranty cost transferred to end customers (local governments)
 - The cost is quoted based on: Program financing cost + Administration expenses + Risk margin (Partial risk of the guarantee + Risk margin of the AFD)
- Collateral must be used as final loss security (i.e., all recovery procedures before implementation of collateral must be carried out by the lending bank)
- The final financing cost for end customers will be calculated on an individual basis, as most local governments do not have a developed financing history

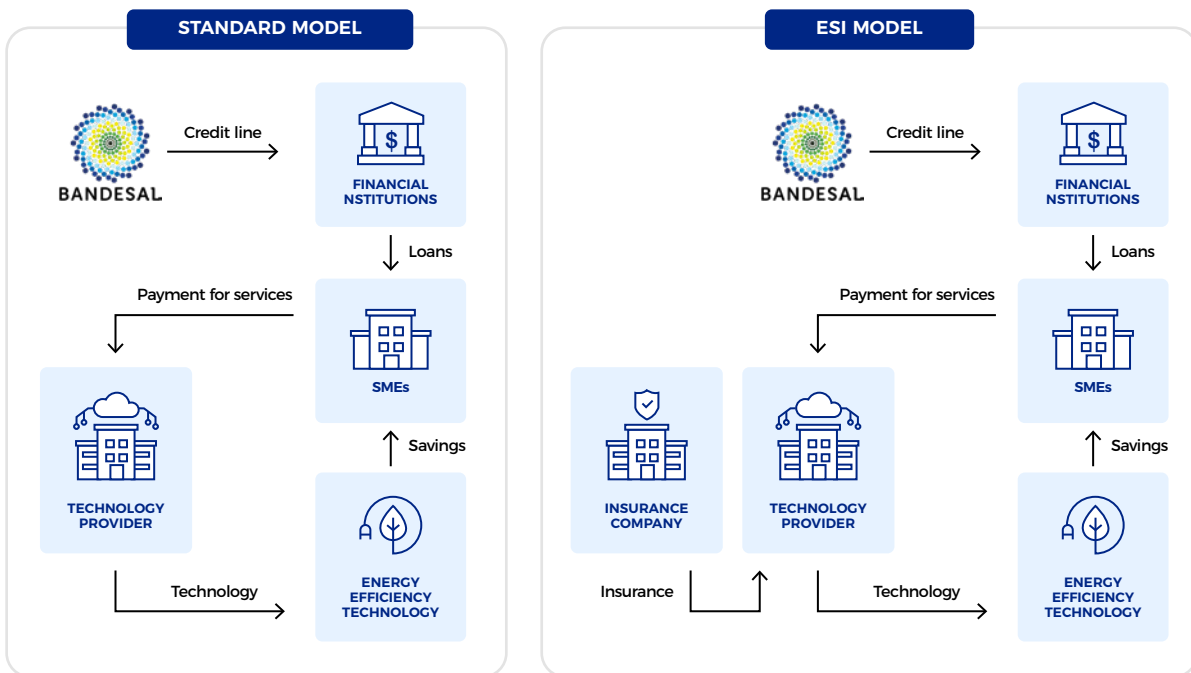
3.2. FINANCING LOCAL DEVELOPMENT ACTORS

3.2.1. Credit Line to Support Energy Efficiency Projects in El Salvador

The Public Development Bank of El Salvador (Banco de Desarrollo de El Salvador, or BANDESAL) plays a crucial role in supporting sustainable economic development and promoting access to financial services in the country. BANDESAL, with the support of the IDB and the resources of the UN's Green Climate Fund (GCF), developed a program to support the financing of energy efficiency projects to reduce greenhouse gas emissions and promote the country's sustainable development (BANDESAL, 2022).

Through this program BANDESAL structured a line of credit for financial institutions (FIs) that provide loans to SMEs that invest in energy efficient infrastructure. SMEs can access credit under two models: (i) the Standard Model and (ii) the Energy Savings Insurance (ESI) Model. In the Standard Model, the energy savings project is validated by a specialized company that verifies that the expected savings are technically feasible. This gives certainty to the FI that grants the credit, reducing the risk of the project because the repayment of the debt is based on the expected savings. In the ESI Model, in addition to validation from an expert company, an insurance provider guarantees the performance and committed savings or energy generation for the contract duration, thus providing incentives for investors and technology providers that have been approved by the ESI Program. The two models are illustrated in Figure 4.

Figure 4. BANDESAL Energy Efficiency Program Models



Source: Authors' elaboration based on information from BANDESAL.

This initiative targets SMEs seeking to fund projects for modernizing their equipment, thereby enhancing productivity and competitiveness. These projects aim to reduce electricity consumption, promote the adoption of renewable energy sources, and contribute to the reduction of greenhouse gas emissions.

3.2.2. BNDES Loan Guarantee Program for SMEs in Brazil

Since 2010, the Brazilian Development Bank (Banco Nacional do Desenvolvimento, or BNDES) has operated the Investment Guarantee Fund (Fundo de Garantia de Investimento, or FGI) that offers guarantees for MSMEs that request loans from accredited financial institutions, with a coverage of between 10 percent and 80 percent of the value of the loan and up to a maximum of 10 million Brazilian reais per company. Credit guarantee schemes provide guarantees on loans to borrowers (in this case SMEs) by covering a portion of the risk of loan default. In case of default by the borrower, the lender (the accredited financial institution) recovers the value of the collateral from the Guarantee Fund.

BNDES guarantees have allowed SMEs to access financing under better conditions with longer terms, fewer approval requirements, and even lower interest rates, because accredited financial institutions have viewed favorably the value and credit enhancement of the de-risking instrument (BNDES, 2020). BNDES FGI guarantees can be used in market financing or in combination with BNDES credit programs. For example, FGI can support the BNDES Climate Fund Program with guarantees for the purchase of machinery and production equipment with high energy efficiency and that contribute to the reduction of greenhouse gas emissions (BNDES, 2022).

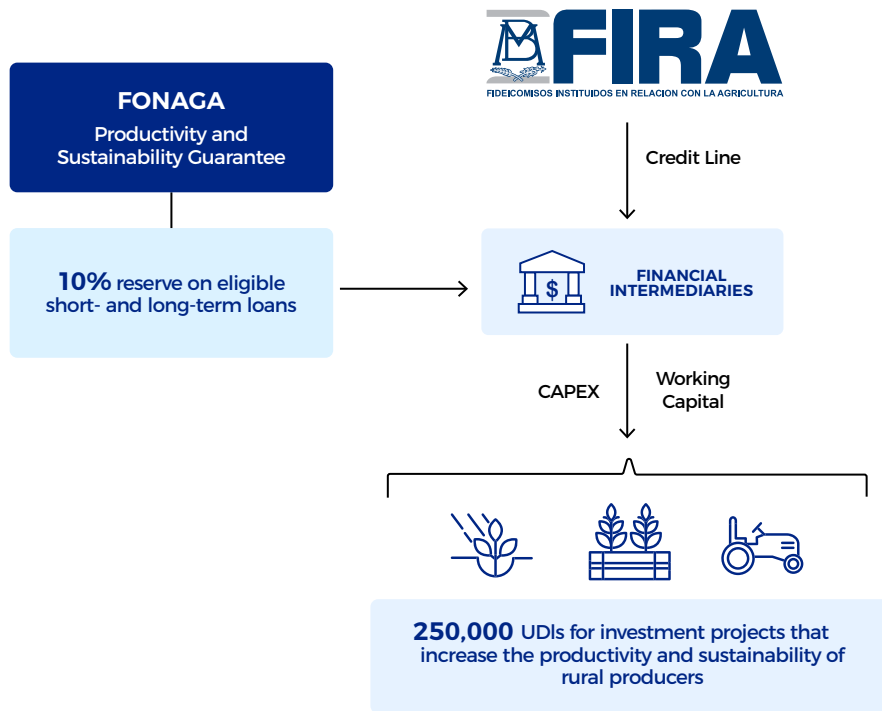
3.2.3. FIRA and FONAGA Guarantees to Support Mexico's Agricultural and Rural Sector

Fideicomisos Instituidos en Relación con la Agricultura (FIRA) is a Mexican financial institution created to promote the development of the agricultural and rural sector in Mexico. FIRA operates as a public trust that is under the supervision and regulation of the Secretariat of the Treasury and Public Credit (Secretaría de Hacienda y Crédito Público, or SHCP) and Banco de México. Its development model is based on an extensive network of FIs who serve as the conduit to facilitate the delivery of financing to producers and companies. Through funding and guarantees, FIRA facilitates banks and non-bank financial institutions (NBFIs) to extend credit to producers, entrepreneurs, merchants, and suppliers in the agri-food sector as well as any other productive activity in rural Mexico.

FIRA guarantees partially cover the credits granted to borrowers, distributing the risk proportionally between FIRA and the FIs. FIRA offers individual guarantees *pari passu*, with coverage of up to 65 percent of the approved credit. In the event of non-compliance, FIRA pays the FI the percentage of the contracted guarantee. FIRA also offers portfolio guarantees, where the guarantee covers a percentage of the FI's loan portfolio. These guarantees can be structured as a first loss guarantee or as a second layer of coverage that is triggered only in cases where a guarantee mechanism or first loss fund exhausts its resources.

To promote the development of the Mexican agricultural sector, there are also other financial instruments such as the guarantees of the National Guarantee Fund for the Agricultural, Forestry, Fishing, and Rural Sectors (Fondo Nacional de Garantías de los Sectores Agropecuario, Forestal, Pesquero y Rural, or FONAGA), which together with FIRA promotes the productivity and sustainability of the productive sector. FONAGA offers complementary guarantees to facilitate less developed producers' access to formal credit from FIs that operate with FIRA. FONAGA has different modalities based on credit amounts and programmatic focus. For example, as shown in Figure 5, FONAGA has a Productivity and Sustainability Guarantee that in a FIRA lending structure offers FIs a 10 percent reserve on eligible short- and long-term loans of up to 250,000 investment units (Unidad de Inversión, or UDIs) per borrower.

Figure 5. FONAGA Productivity and Sustainability Guarantee Structure



Source: Authors' elaboration based on information from BANDESAL.

4. RECOMMENDATIONS FOR THE ALLIANCE TO SUPPORT THE DEVELOPMENT OF RISK MITIGATION INSTRUMENTS FOR SDB'S IN LAC

SDBs have the opportunity to make a greater impact on the sustainable and resilient development of their cities and territories through the development of credit risk mitigation instruments aimed at mobilizing additional financing from the private sector. To support this process, the Alliance of SDBs in LAC fulfills a fundamental role in identifying concrete actions to be taken. This section presents the main recommendations proposed for the Alliance.

PROMOTE STRATEGIC ALLIANCES AND ASSOCIATIONS TO BRIDGE THE GAP BETWEEN THE SUPPLY AND DEMAND FOR FINANCING AT THE SUBNATIONAL LEVEL.

Multilateral development banks, development financial institutions, and international organizations have been strategic allies in supporting SDBs by facilitating access to financing and strengthening their technical capacity. MDBs, especially, offer a wide spectrum of support for subnational entities that, thanks to their knowledge of the local context and the particularities of their territory, provide high added value that allows the MDBs to adjust collaboration to suit the local institutional capacity and required technical needs. In particular, the IDB has been a key player both in improving the technical design of financial products and in the institutional strengthening of treasury departments, ministries of finance, and other key economic and financial public institutions through adjustments to their regulatory frameworks to increase SDBs' financial autonomy.

Priority should be given to strengthening the capacities of SDBs in project finance and aligning the objectives of local authorities with the needs of specific sectors. The IDB together with the Latin American Association of Development Financing Institutions (ALIDE) has developed a Regional Sustainable Infrastructure Development Group dedicated to supporting public banks in Latin America and the Caribbean to improve their capacities to structure and finance infrastructure projects; the focus is on how public banks can provide de-risking instruments to improve bankability and mobilize more private finance for infrastructure projects aligned with the SDGs. The Alliance should provide support to its members to strengthen their institutional capabilities to structure and finance projects.

ENCOURAGE THE SHARING OF INFORMATION AND BEST PRACTICES ACROSS ORGANIZATIONS.

Strategic partnerships can support the generation of a regional agenda and could even promote the creation of an institution specifically designed to absorb credit risks, which could be a catalyst for private sector support for local projects. One example is the intervention led by the World Resources Institute (WRI) in Mexico City, where multi-stakeholder working groups were formed to agree on the scope of the water and sanitation intervention in their city and to guide its implementation. These group discussions were key to defining and structuring the technical and financial feasibility and achieving the required political support.

Likewise, in terms of financial instruments, developing a coordinated effort between multilateral institutions, financial institutions, and SDBs would be essential to promote the development of new financing mechanisms, innovative solutions, and green financing, which go hand in hand with the economic and social recovery after the pandemic. MDBs have supported the generation of new knowledge on the local public sector financing market in the region with the objective of identifying good practices and innovative financial products that SDBs can develop. For instance, the IDB fosters inter-institutional dialogue through various networks (Cities Network, Financial Innovation Lab, Green Finance for LAC, etc.) and offers specialized training and knowledge products available to SDBs through technical cooperation agreements and its innovation laboratory (IDB Lab). The Alliance should develop proposals for new financial institutions, mechanisms, and products to support SDBs to mobilize private capital to local projects.

LEVERAGE FINANCIAL AND TECHNICAL SUPPORT AND CREDIT STATUS OF MDB'S.

MDBs can provide technical and financial support to SDBs to develop de-risking instruments and promote the issuance of thematic bonds with AAA guarantees. MDBs provide low-cost loans and AAA guarantees to support thematic bond issuance, develop PPPs, or expand credit guarantee funds for SMEs. The support from a AAA-rated institution can be incorporated into the SDBs' de-risking strategy to pass through the credit quality and the crowd-in effect of MDBs.

Furthermore, SDBs could increase funding for development through more innovative instruments such as thematic bonds with an MDB guarantee.⁵ The involvement of MDBs in providing credit guarantees for subnational thematic bonds could provide an additional layer of security for investors. This can help reduce the perceived risk and improve the credit rating of these instruments, thus facilitating access to capital on more favorable terms. In this process, MDBs can also support the development of green bond frameworks that can help guarantee investors the use of resources for purposes aligned with environmental and social sustainability. The Alliance should foster dialogue with MDBs offering financing and guarantees.

⁵ One such example is Ecuador's sovereign social bonds program; see <https://publications.iadb.org/en/5-key-points-ecuadors-sovereign-social-bonds>.

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ANNEX I. OTHER EXAMPLES OF DE-RISKING MECHANISMS

This annex includes examples of public institutions that use risk mitigation mechanisms to mobilize additional resources from the private sector. Despite not having a specific subnational focus, these examples can be a reference of how SDBs could design financial programs and instruments that can help promote local development and a just, sustainable, and resilient urban and territorial transition.

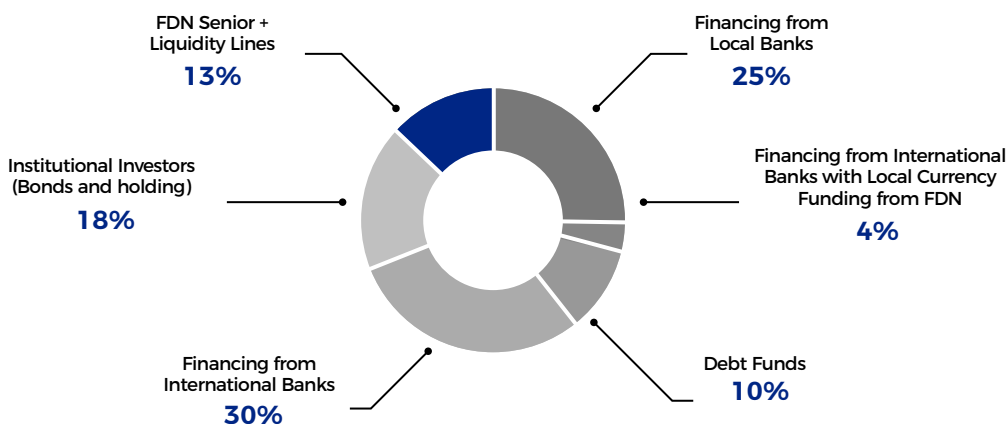
A1. FDN De-Risking Role in Colombia's Highway Concession Program

Financiera de Desarrollo Nacional (FDN) has played an important role in the mobilization of private capital funding for Colombia's road program. The institution, which was created in 2011 to support the development of the national infrastructure sector, offers innovative financial products that can leverage additional financing and enables the participation of the private sector in the infrastructure sector of Colombia. Among the different risk mitigation instruments, FDN offers guarantees for infrastructure projects and a multipurpose liquidity facility that targets the de-risking and leverage of new capital.

For PPPs, guarantees are offered to support the equity contributions of sponsors and to secure the financial closure process of an infrastructure project. It gives debt providers assurance that a project sponsor will make the equity contributions in a project finance-type structure, which must come before the disbursements of the financial debt agreements (Vassallo, 2018). FDN also offers partial guarantees to cover a percentage of the payment obligation of a project infrastructure bond, improving the credit profile of the transaction and facilitating access to new sources of financing through capital markets. The multipurpose subordinate facility works as an additional source of liquidity throughout the life of a project that is activated in the event of a shortage of cash or liquidity, derived from a deficiency in traffic or delays in the timely payment by the National Infrastructure Agency (ANI).

The FDN has played a very important role in the 4G highway financing program. The institution contributed 4,330 billion Colombian pesos, or 13 percent of the total financing with senior debt, liquidity lines, and guarantee instruments (see Figure 6).

Figure 6. FDN Financing Support of the 4G Highway Concession Program



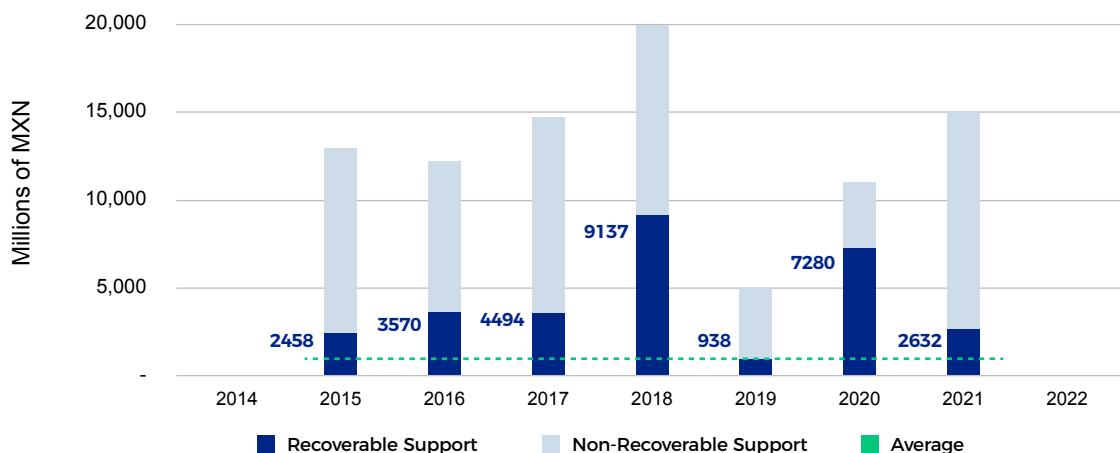
Source: FDN corporate presentation, June 2022.

A2. FONADIN Private Capital Mobilization in Mexico's Infrastructure Sector

Mexico's National Infrastructure Fund (Fondo Nacional de Infraestructura, or FONADIN) was created in 2008 as a coordination vehicle for investment in infrastructure. It seeks to maximize and facilitate the mobilization of private capital through a risk mitigation model that makes projects with social profitability and/or with low economic profitability bankable.

Among its main activities is granting what are referred to as "recoverable" financial instruments, which includes venture capital funding, subordinated loans, guarantees, and reimbursable funding for technical studies. These activities contrast with concessional lending and grants referred to as "non-recoverable" instruments. During the period from 2015 to 2021, the percentage allocated to risk mitigation instruments averaged 32 percent, which highlights the importance and the demand of this type of product (see Figure 7).

Figure 7. FONADIN's Use of Risk Mitigation Instruments



Source: Banobras (2021).

Subordinated and/or convertible loans are designed to improve the financing conditions of commercial lending by improving the project's flow of capital available for debt repayment and coverage ratios. The financing offered by FONADIN in this type of instrument can extend to cover the term of the concession, with a partial participation limited to a maximum of 24 percent of the total investment in the project or 30 percent of the total value of the debt (FONADIN, 2022).

FONADIN also supports the participation of the private sector in infrastructure, especially local construction companies, with guarantees for infrastructure project loans or bond issuances. The guarantees reduce the credit risk profile of the project, and if the scheduled payments are not met the guarantee covers the scheduled payments until the accumulated amount reaches the initial coverage established in the contract.

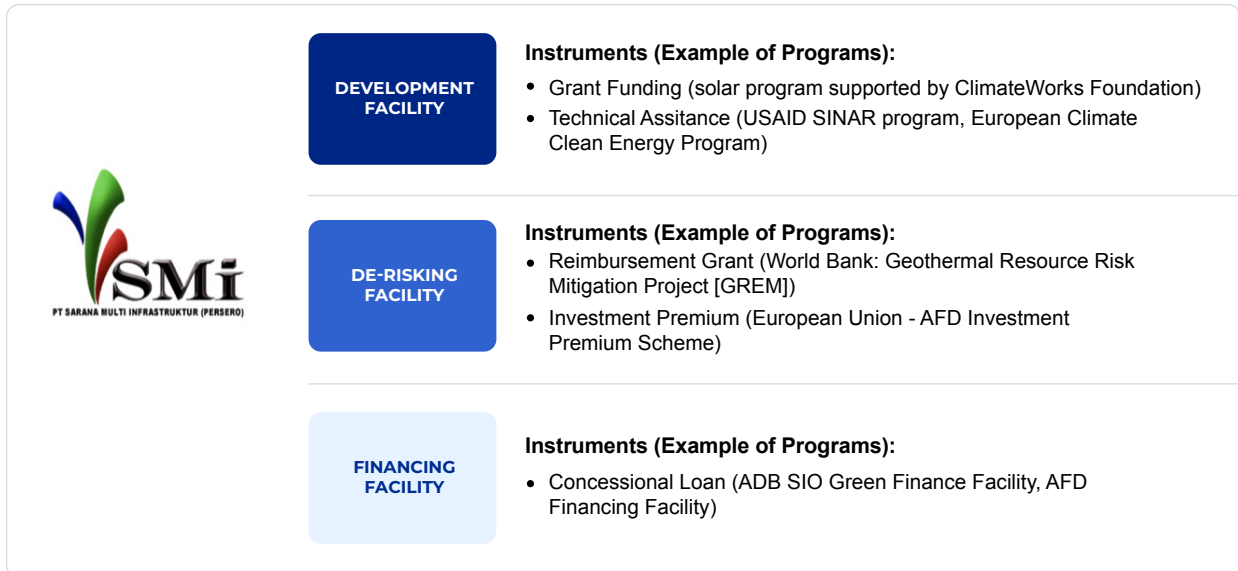
A3. PT SMI Blended Finance Instruments

PT SMI (PT Sarana Multi Infrastruktur) is an Indonesian state-owned enterprise (SOE) that specializes in providing infrastructure financing and development services. It was established in 2009 as a subsidiary of the Indonesian Ministry of Finance with the goal of supporting the government's infrastructure development initiatives. PT SMI is characterized by offering blended finance solutions that seek to: (i) offer consulting and project development services to improve the preparation quality and bankability of projects, (ii) use multiple funding sources to reduce project risk, and (iii) create synergies and collaboration with strategic partners.

The blended finance implementation model of PT SMI includes three types of facilities (Figure 8):

1. **Development Facility (focused on early-stage risks):** Offers grants to cover the costs of project preparation and technical assistance to build capacity to achieve financial, economic, and social objectives.
2. **De-Risking Facility (focused on financing and credit risk):** Offers reimbursable grants that aim to reduce credit risk by replacing the non-refundable portion of loan payments by project owners and provides support to subsidize capital expenditures (investment premium) to reduce project investment risk.
3. **Financing Facility (focused on competitive and long-term financing):** Offers concessional loans with and without government guarantees to enable long-term business financing on competitive financial terms.

Figure 8. PT SMI Blended Finance Instruments



Source: Authors' elaboration based on information from PT SMI.

ANNEX II. PEER-TO-PEER WORKSHOP AGENDA

Developing De-Risking and Guarantee Instruments for Subnational Development Banks

*Financing a Just Urban and Territorial Transition
in Latin America and the Caribbean*

April 22, 2022

09:00 – 11:30 (LIMA/BOG/MEX)

10:00 – 12:30 (EDT)

16:00 – 18:30 (CEST)

EVENT AVAILABLE IN ENG/ESP/PT

BACKGROUND

Public development banks (PDBs) at all levels (multilateral, regional, national, and subnational) play a fundamental role in financing the implementation of global development agendas, in particular the Sustainable Development Goals (SDGs) and the goals of the Paris Agreement. Faced with the need to reduce the risk of subnational investments and mobilize additional private capital, PDBs must develop guarantee mechanisms and de-risking instruments to allow greater access to financing under better conditions.

Subnational development banks (SDBs) are public development banks or financial institutions supported by national or state/subnational governments, with a specific mandate to provide financing to local and regional governments and local actors such as small and medium-sized businesses (SMEs). The Alliance of Subnational Development Banks in Latin America and the Caribbean aims to strengthen the capacities of SDBs to close the financial gap to implement the SDGs and the objectives of the Paris Agreement at the local level and encourage sustainable urban and territorial development in the region.

This multi-sector alliance is an initiative of Finance in Common, the world summit that brings together 500 public development banks committed to financing the implementation of global agendas. It brings together the SDBs and their institutional and financial partners to strengthen SDBs' capacity to expand and improve their services offered to local governments and local actors and to consolidate portfolios of sustainable local projects around four objectives:⁶

⁶ The Joint Declaration of the Alliance of Subnational Development Banks of Latin America and the Caribbean brings together the common goals and values of its members. The document is available at:
https://financeincommon.org/sites/default/files/2021-08/Declaration%20of%20the%20Alliance%20of%20Subnational%20Development%20Banks%20in%20Latin%20America%20and%20the%20Caribbean_0.pdf

- Align SDBs' initiatives, investments, and portfolios with the UN's 2030 Agenda for Sustainable Development, the SDGs, and the Paris Agreement;
- Promote sustainable investments through portfolios of urban and territorial development projects and boost urban and municipal financial markets;
- Develop a strategic space for dialogue with peers, development institutions, national and local governments, and technical and financial partners in the region; and
- Strengthen the strategic role of the SDBs and the contribution of the Alliance to the global agendas in international forums.

To increase their financial intermediation function at the subnational level, subnational development banks must implement guarantee mechanisms and de-risking instruments adapted to the specific risks they face in relation to the subnational market, such as:

- Risks related to political contexts, such as electoral cycles;
- The adaptation of their mandates to the public interest in the financing of specific sectors and projects, and their countercyclical function during economic crises;
- “Creditworthiness,” solvency, solidity, and sustainability of the financial structures of their clients;
- Financial and managerial capacities of local governments, maintenance, and project management;
- Lack of suitable service operators;
- Insufficient local projects (in terms of scale and preparation); and
- Risks related to the sources of financing of SDBs (currency volatility, limited sovereign guarantees, risk aversion of local capital investors).

SDBs have a better understanding of local governments and their needs, as well as local stakeholders such as SMEs that play a critical role in generating jobs and income throughout the Latin American region. They have a better understanding of the life cycles of local projects, as well as their technical and financial viability. SDBs help overcome information asymmetries, which are a major obstacle to investment by the private financial sector. Thanks to their ability to assess the creditworthiness of local governments and actors, SDBs have the potential to encourage subnational investments from private sources that lack knowledge and experience in financing local governments and subnational actors.

For these reasons, there is great potential for the development banks of Latin America and the Caribbean to develop various guarantee mechanisms and risk reduction instruments together with their financial and technical partners to expand their intervention at the subnational level.

WORKSHOP OBJECTIVE

This workshop of the Alliance of Subnational Development Banks of Latin America and the Caribbean will allow the exchange between peers and partners on existing strategies and approaches, inspiring experiences and recommendations for the development of guarantee mechanisms and de-risking instruments for better financing of sustainable development, including a just urban and territorial transition in Latin America and the Caribbean and in other parts of the world.

The event is part of the Joint Finance Summit initiative, and the results of the discussion will form the basis of a knowledge product to be presented at the Third Joint Finance Summit, which will take place in Abidjan, Ivory Coast in October 2022.



AGENDA

WORKSHOP CO-ORGANIZER: INTER-AMERICAN DEVELOPMENT BANK (IDB)

MODERATED BY: DR. BARBARA SAMUELS, Executive Director, Global Clearinghouse for Development Finance (GlobalDF) and Senior Adviser to FMDV, the Secretariat of the Alliance of SDBs

09:00 (LIMA/BOG/MEX): Welcome and Opening Remarks

- **Mr. Juan Antonio Ketterer**, Head of the Connectivity, Markets and Finances Division, IDB

09:05 – 09:25 PART I: Presentations

- RESULTS OF THE STUDY CARRIED OUT BY AFD ON LAC SUBNATIONAL DEVELOPMENT BANKS
 - **Mr. Bertrand de Dianous**, Head of the Local Finance and Decentralization Unit, AFD
- THE ROLE OF MDB'S IN SUPPORTING SDB'S
 - **Mr. Juan Martinez**, Senior Specialist in Structured Finance in the Institutions for Development Sector, Connectivity, Markets and Finances Division, IDB

PART II: REGIONAL EXPERIENCES AND DISCUSSION

09:25 – 10:20 ROUNDTABLE 1: Experiences of SDBs in the development of guarantee mechanisms and de-risking instruments

These experiences could include the financing of local and regional governments, SMEs, and support for the creation of PPPs.

- **EXPERIENCE #1: Mr. André Gotler**, Deputy Director of Operations, Banco Regional de Desenvolvimento do Extremo Sul (BRDE)

- **EXPERIENCE #2: Mr. Francisco Amador Ramírez**, Director of the Financing and Technical Assistance Center, Banco Nacional de Obras y Servicios Públicos (Banobras)
- **EXPERIENCE #3: Ms. Diana Aidee Robles**, Deputy Director of Guarantees, Nacional Financiera (NAFIN)
- **EXPERIENCE #4: Mr. Jose Antonio Cortes Barrientos**, Deputy General Director of Business Promotion, Fideicomisos Instituidos en Relación con la Agricultura (FIRA)
- **EXPERIENCE #5: Mr. Diego Paiva**, Superintendent of the Public Sector, Agência de Fomento do Rio Grande do Sul (BADESUL)
- **PEER DISCUSSION**

10:20 – 11:15 ROUNDTABLE 2: Financial and technical partner recommendations for the development of guarantee mechanisms and de-risking instruments for SDBs

- **Mr. Joan Prats**, Lead Finance Specialist, Connectivity, Markets and Finance Division, IDB
- **Mr. Alejandro Soriano**, Senior Executive of Productive and Financial Sectors, CAF
- **Mr. Miguel Mendez**, Head of Strategic Alliances and International Cooperation, CABI
- **Mr. David Bronzwaig Kravzov**, Green Finance Coordinator, WRI
- **Ms. Tenke Andrea Zoltani**, Senior Thematic Debt Adviser, Sustainable Finance Hub, UNDP
- **PEER DISCUSSION**

11:15 – 12:30 Conclusions, Next Steps, Closing Remarks

- **Mr. Sergio Gusmão Suchodolski**, President Director, Paulista Development Agency, Desenvolve SP
- **Mr. Jean-François Habeau**, FMDV Executive Director, Alliance of SDBs Secretariat

