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IFAD
Investing in rural people

Approach Paper: Lending to Subnational Entities in the Context of IFAD's New Business Model

Addendum

Note to Executive Board representatives

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For: **Information**

I. Comment from the Chinese delegation and Management response

1. **We appreciate the document and the efforts to try to explore lending business and tailor its offering in response to a Member State's request to serve its development needs. And at the same time, we agree with the comprehensive risk analysis on this respect, an explicit and enforceable sovereign guarantee out of a prudent consideration, and the legal consideration for this. We notice that IFAD has periodically provided financing to subnational governments and national development banks (NDB) since the early 1980s, we would like to know the relevant performance and the impact of those lending operations, which if is optimistic, we will agree that we should give it an explicitly legal confirmation through a most authoritative way, so as to expand such an operation in the future.**

Response

2. Our response was coordinated between IFAD's operations, finance and evaluation teams, and included feedback from related country programme evaluations and project performance assessment documents. Overall, the limited experience gained in IFAD operations to date has been positive, with some learning points to be incorporated in future arrangements, as follows:

(i) Subnational lending loans has proved a very effective development tool in one country, although often on a longer timeline than expected, but with clear results and impact on institutions building and sustainable rural poverty reduction.

(ii) Operational efficiency indicators and systems used for monitoring state and municipality projects may be weaker than mechanisms employed at national level, and this needs to be taken into account in design and implementation.

(iii) Teaming up with a subnational partner created strong ownership.

(iv) Project effectiveness and efficiency were rated as satisfactory, with programmes successfully achieving objectives and meeting major targets.

(v) Efforts to reach underserved states got off to a slow start, but more progress was made towards the end.

II. Comments from the German delegation and Management responses

3. **We take note of the approach paper exploring options for lending to subnational entities supported by sovereign guarantees.**

4. **How do you see this proposal in the context of IFADs mission? How do you see IFADs risk mitigation – even with sovereign guaranties – in the case of external shocks that even might affect upper middle income countries (UMICs)?**

Response

5. Accepting guarantees does not imply IFAD will deviate from its current approach in dealing with the credit risks inherent in its operations. As stated in the proposed new approach, IFAD will conduct a thoughtful analysis of potential guarantors to assess their creditworthiness. An assessment of their capacity and ability to respond in the event of the guarantee being called in will also be performed.

6. To avoid excessive risk arising from accepting guarantees, a portfolio approach will be adopted, together with a risk management perspective. Not only will cases be scrutinized and strictly assessed on an individual basis (ensuring the guarantor's external credit rating is strong), but the Fund's overall exposure to guarantors from UMICs will be also limited in line with the existing portfolio. It is important to note that, as of end-2019, UMICs represented 15 per cent of the portfolio (including China, which accounts for 7 per cent) and only 1 per cent of these countries are under close monitoring (watchlist) due to economic constraints or potential financial deterioration. Furthermore, more than 50 per cent of the UMICs' outstanding exposure is rated investment grade Baa3 or above, according to our internal ratings, which represents a relatively sound level compared to the overall portfolio. Nonetheless, management regularly monitors the potential financial deterioration of borrowers (including UMICs) and the impact on capital utilization.

7. **We propose to further elaborate on the rationale and experience of IFAD and its peers regarding lending to national development banks. For instance, what would be IFAD's additionality?**

Response

8. Taking the example of the Small Industries Development Bank of India (SIDBI) Foundation for Micro Credit (SFMC), IFAD's long-term loan funds were able to underpin the bank's long-term debt capitalization, making it easier for it to mobilize funds in the financial market to onlend to microfinance institutions (MFIs). The support helped to meet the ever-increasing demand of the microfinance sector and leverage future growth. The funds received from IFAD helped the bank in lending to partner MFIs at reasonable interest. The collateral-free loans extended to MFIs for onlending to the poor made a major contribution to bringing about substantial poverty elimination and reducing the vulnerability of microfinance services users, particularly women.

9. Collaboration between IFAD and SIDBI has contributed to the development of a more formal, extensive and effective microfinance sector serving the poor – mainly women – at national, rural and semi-urban areas, and to the establishment of an environment enabling the development of sustainable MFIs.

10. One of the most important aspects of the programme is the leveraging of IFAD resources. With US$22 million from IFAD, loan funds totalling US$141 million were leveraged for the microfinance sector.

11. The Government of India provided a sovereign guarantee by signing an agreement with IFAD. SIDBI is repaying the IFAD loan on schedule.

12. Risks identified during design as well as mitigation measures were included in the Programme Loan Agreement. Being a financial institution. SIDBI comes under the oversight and supervision of the Central Bank (Reserve Bank of India).

13. **Ask management to further elaborate the respective trade-offs between (i) amendment of the agreement establishing IFAD and (ii) interpretation of the agreement by the Executive Board. Opening a debate on agreement interpretation might become a slippery slope: If deemed necessary, agreement should be amended – according to ordinary legal procedures.**

Response

14. The respective trade-offs would be as follows:

    (i) In order to amend the Agreement Establishing IFAD (AEI), the President would have to refer the amendment proposal to the Executive Board, which should submit its recommendations to the Governing Council in 2021. Although this process takes time, it has the advantage of ensuring clarity and certainty.

    (ii) Any question concerning the interpretation or application of the provisions of the AEI arising between any Member and the Fund, or between Members of the Fund, must be submitted to the Executive Board. Any Member may then require that the Executive Board's consequent decision is referred to the Governing Council, whose decision is final. The option of interpretation may be considered less cumbersome, particularly considering that: (i) the Executive Board has already implicitly interpreted section 1(b) of Article 7 of the AEI by reviewing and approving projects with subnational entities since the 1980s on ad hoc basis; and (ii) this implicit interpretation is in line with IFAD's new strategic priorities and directions. The option of interpretation invites more technical debate but could be perceived as less political than amending the AEI.

15. **We appreciate the paper's short but useful analysis of potential risks. Emphasize that this approach should be risk-neutral to IFAD, i.e. supported by enforceable sovereign guarantees and comprehensive mitigation of any governance, accountability, reputational risks.**

Response

16. IFAD will need an enforceable sovereign guarantee and carry out due diligence to address issues related to governance, national laws and regulations, and potential reputational risks. IFAD's legal framework will need to be updated with guidelines on how to execute a sovereign guarantee. In addition, IFAD will have to engage in a more robust dialogue with countries where such an arrangement is envisaged. The talks would aim to ensure that such nations have the appropriate national legislation and regulations to honour IFAD's privileges and immunities and allow the Fund to enforce a sovereign guarantee without requiring its execution in a local court.

17. **We recommend to take into account that risk portfolio might become very complex and less transparent. With IFAD's management still building capacity in risk management, not put too much burden on risk strategies.**

Response

18. Dealing with sub-sovereign lending with the support of explicit guarantees is embedded in the current Capital Adequacy Policy, which establishes a limitation framework to contain concentration risk in the portfolio. Management has also developed indicative operational thresholds for dealing with countries based on their exposure (loans or guarantees) and credit risk, thus ensuring that capital utilization is effectively monitored. As far as other technical metrics, the risk management unit follows best international practices (Basel) and rating agencies' methodologies.

III. Comments from the United States delegation and Management responses

19. **We are concerned that IFAD has no precedent for the execution of a sovereign guarantee and no legal framework in place for the enforcement of such a guarantee. We feel that this exposes IFAD to additional risks, and have questions about IFAD's capacity to implement, monitor, and enforce operations under this proposed lending structure.**

20. **We think it's important to remember that IFAD is still undergoing its formal credit rating process. It seems premature to be considering a significant shift to its model, and one that would take it away from its core mandate (and that has the potential to affect its Members' support).**

Response

21. IFAD's approach to subnational entities needs to be gradual. IFAD will also consider the creditworthiness of each operation based on a comprehensive due diligence and credit assessment. Moreover, the Fund will require an explicit and enforceable sovereign guarantee that meets IFAD's criteria. Those safeguards aim to mitigate any potential increase in credit risk deriving from such operations and potentially affecting IFAD's credit rating outcome. The objective in facilitating this type of financing is to increase the number of eligible borrowers to better fulfil IFAD's mandate. The Fund will take all the necessary steps to avoid deviating from its core mandate, such as setting specific limits to the overall exposure in subnational entities.

22. **Furthermore, we are concerned about the possibility of gradually phasing in lending to subnational entities without a sovereign guarantee, and do not feel that this is appropriate for IFAD to consider. Please outline additional costs to IFAD's capital if this were to be considered.**

Response

23. At this stage, IFAD engages with subnational entities only if they have the support of an explicit and enforceable sovereign guarantee that meets IFAD's criteria. In addition, IFAD will conduct a comprehensive credit assessment of each operation and of the guarantor in order to ensure that no additional risks are being taken. If IFAD decides to lend to subnational entities without sovereign guarantee, assessments should be similar to the ones applicable to the private sector. IFAD would be required to carry out the required credit and due diligence processes to guarantee a borrower's creditworthiness. Specific internal rating criteria would apply. Pricing, capital charges and provisions should also reflect the lack of a sovereign guarantee.

24. **It seems that the focus of these activities is on emerging markets. We, however, would prefer any changes to IFAD's tools to focus more activities on poorer economies.**

Response

25. This tool would be open to all borrowers meeting the criteria established.

26. **Lastly, we note that Management highlighted that this option would not be linked to IFAD's future borrowing architecture. Can this point be clarified? How would this lending option be linked to the performance-based allocation system for core and borrowed resources?**

Response

27. Management is considering the implementation of this mechanism during the Eleventh Replenishment of IFAD's Resources (IFAD11) and therefore solely through the resources available under the performance-based allocation system. Currently the allocations do not distinguish between core and borrowed resources. In the future, resources would come from whichever funding source is providing the allocation.

IV. Comments from the French delegation and Management responses

28. **We would like to thank management for this paper. Please find our remarks below:**

29. **We would very much appreciate more details and examples on the types of subnational loans that were accepted by the Board: how many of such projects were accepted during the past cycles (IFAD10 and IFAD11)? What type of monitoring was conducted?**

Response

30. Under IFAD10, the Executive Board approved two loans to state governments in Brazil – one to Maranhão in December 2016, and the other to Pernambuco in March 2018, both with federal guarantees. Under IFAD11, no loans have been approved for Brazil so far.

31. In granting its guarantees, the federal government closely monitors the borrowing capacity of the states, mainly based on indebtedness and liquidity. In fact, during IFAD10 it tightened its criteria and did not permit the above projects to be signed. As a result, the commitment for the Maranhão project was cancelled and the signing period for the Pernambuco intervention was extended to December 2020. We have been assured that the state is working on meeting the criteria and that signing will be possible this year.

32. Since IFAD started subnational lending in Brazil many years ago, this format has repeatedly proven highly effective in terms of rural poverty reduction and institution building. At the same time, the presence of federal guarantees for subnational loans has left the risk for IFAD unchanged.

33. **What would be the advantage of amending the Agreement or confirming the implicit interpretation rather than pursuing the case-by-case approach that has been followed until now (if we understand correctly), perhaps with a formalized guideline?**

Response

34. Amending the AEI or confirming an implicit interpretation, as opposed to continuing with the case-by-case approach followed so far, would provide more clarity on this matter. Under the AEI, only the Governing Bodies are entitled to take a view on this matter.

35. IFAD's legal framework would then need to be updated with guidelines on how to execute a sovereign guarantee. In addition, IFAD would have to engage in a more robust dialogue with the countries where such a mechanism is envisaged. These talks would aim to ensure that the nations involved have adequate national legislation and regulations to honour our privileges and immunities and allow IFAD to enforce a sovereign guarantee without requiring its execution in a local court.

36. The AEI does not explicitly envisage lending to sub-sovereign entities, with or without sovereign guarantee. Further, a detailed analysis of the minutes of the AEI's drafting process shows that no consensus was reached on this issue by Member States then. The charters of some multilateral development banks explicitly allow lending to sub-sovereign entities with or without sovereign guarantees. The option of Members amending the AEI would provide some clarity on this matter and on IFAD's mandate. But the option of interpretation could be less cumbersome, particularly if Members consider that: (i) the Executive Board has already implicitly interpreted section 1(b) of Article 7 of the AEI by reviewing and approving projects with subnational entities since the 1980s on ad hoc basis; and (ii) this implicit interpretation is in line with IFAD's new strategic priorities and directions. The option of interpretation invites more technical debate but may be perceived as less political than amending the AEI.

37. **We would also appreciate more detailed and precise information as to the means that IFAD could use to monitor the governance, transparency and capacities of the subnational entities.**

Response

38. IFAD will undertake a due diligence process, including the analysis of institutions' strategy, senior management, organizational structure, among other governance aspects guaranteeing standards and industry best practices in the sector envisaged (e.g. banking practices for NDBs). The involvement of an institution in capital markets and the presence of a credit rating will also provide information on the extent to which that entity needs to fulfil regulatory and market requirements. Political risk, transparency, and corruption indicators in the country, as well as the government's past experience with IFAD projects, will also inform the subnational entity's level of potential risk.

V. Comments from the Mexican delegation and Management Responses

39. **We thank you for this paper, which is clear and comprehensive. This approach could formalize something that IFAD has been doing in the past years -namely, that the Executive Board has already approved projects to subnational entities.**

40. **This also represent a business opportunity to IFAD to increase its borrowers, and we assume this would imply a loan with regular rates, which is beneficial to the Fund.**

41. **This approach could put IFAD closer to the beneficiaries, supporting in a way the community driven approach.**

42. **Nevertheless, some important safeguards must be put in place, like shielding IFAD from a possible default from a subnational entity or NDBs, or having an automatic trigger for the sovereign guarantee. Additionally, it should be clear that some countries do not allow this direct lending to subnational entities, as mentioned in paragraph 24. All this is mentioned in the document and that should be part of the starting point.**

43. **On the question of the options regarding the Agreement Establishing IFAD, we think is important to reach a consensus first on the substance of the proposal and then agree on which option to take.**

44. **In short, we support a decision to pursue this opportunity, taking into account all the safeguards needed.**

Response

45. IFAD management appreciates the positive support expressed by Mexico. It concurs that important safeguards need to be put in place and has included various such safeguards in the document, including the need for enforceable sovereign guarantees. These would only be put in place for countries able to engage in subnational lending according to their national policies and procedures and able to meet the criteria established by IFAD.