| | |
|---|---|
| Document: | EB 2020/129/R.23 |
| Agenda: | 8(c) |
| Date: | 9 March 2020 |
| Distribution: | Public |
| Original: | English |

**E**

Investing in rural people

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

**Note to Executive Board representatives**

Focal points:

Technical questions:

**Alvaro Lario**
Associate Vice-President
Chief Financial Officer and Chief Controller
Financial Operations Department
Tel.: +39 06 5459 2403
e-mail: a.lario@ifad.org

**Ruth Farrant**
Director
Financial Management Services Division
Tel.: +39 06 5459 2281
e-mail: r.farrant@ifad.org

**Benjamin Powell**
Director and Treasurer
Treasury Services Division
Tel.: +39 06 5459 2251
e-mail: b.powell@ifad.org

**Malek Sahli**
Senior Regional Finance Officer
Financial Management Services Division
Tel.: +39 06 5459 2545
e-mail: m.sahli@ifad.org

Dispatch of documentation:

**Deirdre Mc Grenra**
Chief
Institutional Governance and Member Relations
Tel.: +39 06 5459 2374
e-mail: gb@ifad.org

Executive Board — 129th Session
Rome, 20-21 April 2020

For: **Review**

# Contents

# Abbreviations and acronyms

| | |
|---|---|
| ADB | Asian Development Bank |
| COSOP | Country Strategic Opportunities Programme |
| DMC | developing member country |
| EBRD | European Bank for Reconstruction and Development |
| IBRD | International Bank for Reconstruction and Development |
| IDA | International Development Association |
| IDB | Inter-American Development Bank |
| IFC | International Finance Corporation |
| IFIs | international financial institutions |
| LEG | Office of the General Counsel |
| NDB | national development bank |
| PCIF | Policies and Criteria for IFAD Financing |
| SDGs | Sustainable Development Goals |
| USAID | United States Agency for International Development |

# Executive summary

1. In response to the statement made by Brazil at the 127th session of the Executive Board – in which it suggested that IFAD consider lending directly to subnational governments and to national development banks (NDBs) – and in line with the Executive Board's subsequent request that Management submit a discussion paper at its 129th session in April 2020, this approach paper analyses opportunities for offering more tailored support as part of a country-level programmatic approach.

2. The term "subnational entities" is generally understood to include subnational governments and related public entities such as NDBs. The term "subnational government" is usually defined as all levels of government below the national (central, federal, etc.) level, such as state, regional and/or provincial governments, depending on the political, financial and administrative structure of the country (see annex II). **This approach paper is restricting its scope to direct lending operations to subnational governments at the state or provincial level and NDBs.**

3. Numerous multilateral and bilateral agencies, bilateral donor programmes and private sector foundations already offer financing directly to subnational entities under either a separate programme focusing on infrastructure investments or existing public/private sector financing windows, depending on the availability of sovereign guarantees. IFAD has periodically provided financing to subnational governments and NDBs since the early 1980s.

4. This paper provides an overview of the opportunities for offering subnational financing instruments with sovereign guarantees to subnational governments and NDBs. All non-sovereign financing instruments for subnational entities, including NDBs without a sovereign guarantee, are excluded from the scope of this approach paper.

5. There are risks for IFAD in dealing with subnational entities and NDBs in terms of mandates and financial, legal, operational and governance aspects:

   (i) Member States may question the idea of serving upper-middle-income countries in some instances rather than low-income countries because it might entail a possibility of mission drift. However, IFAD would only consider this lending option on the basis of a comprehensive due diligence and credit assessment undertaken in response to a Member State's request to serve its development needs in a more mature manner, irrespective of its income category or lending terms category. It should also be noted that this option would not be linked to IFAD's future borrowing architecture.

   (ii) From a legal point of view, the Agreement Establishing IFAD does not explicitly provide for lending to subnational entities, with or without a sovereign guarantee, whereas some multilateral development banks explicitly mention this in their charters. Depending on feasibility, demand and risk appetite, there are two legal options in this regard: (i) amend the Agreement and submit a request for approval to the Governing Council in 2021; or (ii) request the Executive Board to provide a broad interpretation of "developing States" in section 1(b) of article 7 of the Agreement.

   (iii) The assessment of the financial risk posed by subnational entities, including NDBs, should take into account the borrower's ability to access funds, to issue bonds and to manage its debt efficiently at different maturities, as well as the institutional or political risk, which could be in the form of regulatory and/or legal risk. From a legal standpoint, the enforceability of a sovereign guarantee is a complex matter and should be dealt with on a case-by-case basis (depending on project structure, default risk and history, type of borrower and type of guarantor). The experiences of other organizations have

shown that the execution of sovereign guarantees may not be exempt from certain conditions or constraints and may be driven by political discussions.

(iv) Risks relating to governance, monitoring and evaluation should also be identified and managed. In considering lending directly to subnational entities with a sovereign guarantee, including NDBs, consideration would have to be given to the possibility that the subnational entities' operations might not be aligned well with the country strategic opportunities programme (COSOP) or that the entities might not have the relevant institutional resources, governance structure or requisite levels of transparency or accountability to permit implementation. Furthermore, additional mitigation is required in dealing with non-governmental bodies such as NDBs, even when such entities have a sovereign guarantee. In the event that consideration were to be given to lending to subnational entities, including NDBs, without a sovereign guarantee, the risks would have to be assessed in a different manner than the one envisioned in this approach paper.

6. Management's view is that IFAD **should engage with subnational entities, including NDBs, only with the support of an explicit and enforceable sovereign guarantee that meets IFAD's criteria**. The expansion of such engagement to include NDBs without an explicit and enforceable sovereign guarantee would have to be phased in gradually, as it would require additional assessments to measure their creditworthiness and implementation capabilities.

7. Moreover, there must be certain criteria in place for dealing with subnational governments. Based on the full buy-in of their national governments, criteria could include: the restriction of access to Member States that are eligible for IFAD loans, have a sufficiently strong credit rating and are able to perform the necessary due diligence to provide sovereign guarantees; the application of a penalty (which would be agreed upon by the parties in advance) if a guarantor does not fulfil the terms of the guarantee; and the establishment of IFAD's right to charge additional fees to cover the cost of the due diligence process and the greater set of risks embedded in the operation. A penalty could include, for example, a trigger to accelerate repayments on the entire sovereign portfolio should indemnification not be immediately forthcoming.

8. Should the Executive Board wish Management to pursue this topic further, an additional document will be prepared no later than December 2020 to provide a more in-depth analysis and research on the related aspects, such as the possible demand for such arrangements and the experiences of other organizations, and to present recommendations for onward transmission to the Governing Council in February 2021, as appropriate.

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

## I. Context

1. The Third International Conference on Financing for Development, held in 2015 in Addis Ababa, marked a paradigm shift in development finance. Participants committed to scaling up international cooperation to strengthen the capacities of municipalities and local authorities and to work towards developing domestic capital markets using blended finance instruments across key development sectors, including those led by subnational entities.

2. With a view to achieving IFAD's mission of reducing rural poverty, tackling food insecurity and mitigating its underlying causes related to climate change and fragility, the Fund's vision of its contribution to the achievement of the Sustainable Development Goals (SDGs) was presented to Member States in 2019 in the document "IFAD 2.0". The vision encapsulated in that document focuses on building upon the enhanced business model rolled out in IFAD11 for a country-level programmatic approach that fosters systemic changes and offers tailored support that takes into consideration countries' different development stages and identified priorities and needs. The aim is to listen more effectively to countries' voices and develop solutions that are better adapted to local contexts.

3. IFAD's financial instruments have not yet been fully adapted to the evolving circumstances, as its sovereign lending operations for public sector financing do not explicitly address countries' needs for decentralized budgetary arrangements, since subnational governments and their agencies play an essential role in the provision of rural development support. In some cases, as national governments seek to improve their own fiscal and budgetary balances, countries are urging development agencies to support them directly at the subnational level by, inter alia, lending to subnational entities with or without sovereign guarantees.

4. During the 127th session of the Executive Board, Brazil[1] called upon the Board to consider broadening the scope of IFAD financing by allowing IFAD **to lend directly to** subnational governments and national development banks (NDBs). This suggestion was based on a consideration of IFAD's proximity to subnational governments, the opportunity to respond to an existing and possible future demand in a way that would bolster ownership of the funded projects and the prospect of cofinancing leverage that could be of benefit to IFAD and its work with other international financial institutions (IFIs).

5. This approach paper is being submitted to the Audit Committee and the Executive Board for review. It presents an initial assessment of the associated business opportunities and constraints; a review of the institutional, financial, legal, governance, and monitoring and evaluation considerations; and conclusions based on the foregoing elements along with a proposal concerning the way forward.

## II. Business opportunities and constraints in lending to subnational entities

6. Several multilateral and bilateral agencies,[2] bilateral donor programmes[3] and private sector foundations[4] have already identified the critical gap in subnational development financing and in recent years have been offering loans and credit

[1] See annex I.
[2] The International Finance Corporation (IFC), the European Bank for Reconstruction and Development (EBRD), the French Development Agency, and the United States Agency for International Development (USAID) U.S. International Development Finance Corporation.
[3] UK Aid Direct/Department for International Development, and USAID.
[4] The Rockefeller Foundation, the Bill & Melinda Gates Foundation, and the C40 Cities Climate Leadership Group.

enhancement instruments directly to subnational entities, along with technical assistance programmes to improve access to finance for infrastructure development and targeted non-traditional development resources to improve cities' development capacity.

7. IFC's support was initiated through the Subnational Finance Programme (2003) – a joint World Bank/IFC programme that provided subnational financing without a sovereign guarantee. The programme aimed to support investments across infrastructure sectors and public services, working through subnational governments, state-owned enterprises, financial intermediaries and public-private partnerships. More recently, IFC has begun to roll out its global Cities Initiative, which aims to make cities more competitive by: (i) strengthening institutions and regulations; (ii) improving critical infrastructure and environmental sustainability; (iii) fostering skills and innovation; and (iv) expanding access to finance. The Initiative seeks to combine financial and advisory support by working with both subnational governments and private investors. IFC has supported subnational governments and state-owned enterprises through 46 investments totalling US$2.1 billion (fiscal years 2008-2017), most of which was for infrastructure projects. This was equivalent to about 2 per cent of IFC's total commitments during that period. IFC's financial support was concentrated in transport, ports, the power sector and water/wastewater. Most of the financing was provided between fiscal years 2009 and 2014 in countries not served by the International Development Association (IDA). While IFC offered a varied range of financing instruments – including senior or subordinated loans in foreign or local currency on a commercial basis, the IFC B-loan syndication programme, partial credit guarantees and long-term capital equity – the majority (78 per cent) of the financing consisted of loans (54 per cent in foreign currency, 24 per cent in local currency). This programme has now been merged with IFC infrastructure financing operations.

8. The major regional multilateral development banks, such as the Asian Development Bank (ADB), Inter-American Development Bank (IDB), African Development Bank and the Development Bank of Latin America (CAF), provide loans to subnational governments (state, provincial and municipal governments and public entities other than central governments) with a sovereign guarantee through the public sector window. Without a sovereign guarantee, the transaction falls under the heading of private sector/non-sovereign operations. Financial details are not usually specified for subnational entities, but in the cases of ADB and IDB, it appears that subnational operations without a sovereign guarantee are not yet substantial in terms of volume. In 2018, of the US$106.0 billion and US$93.4 billion of total ADB and IDB outstanding loans, respectively, the majority (more than 90 per cent) had been made to sovereign borrowers (member countries and, with the sovereign guarantee of the relevant member country, to government agencies or other public entities), while only 5.1 and 6.4 per cent had been made to privately held, state-owned or subnational entities without a sovereign guarantee.

9. The option of lending to subnational entities could put IFAD in a better position to respond to the demand for support from its borrowing Member States. By providing financing to subnational governments, it could be in closer proximity to its target group and help to build implementation capacities for local public service delivery. Efficiency in terms of both time and financial resources could be gained by working directly with implementing partners that would otherwise have to receive the resources through a cascade of agreements. This would also open up an opportunity to capitalize on the technical and financial implementation capacities of subnational partners, especially as, in some instances, NDBs have specialized units that support sustainable rural development efforts in poor communities or finance climate-smart development work. This could also be an opportunity to participate in larger development programmes that national governments may have delegated

to subnational entities and to mobilize cofinancing, as the majority of multilateral and bilateral financial institutions provide financing to subnational entities. In some cases, this approach could also entail greater political stability, which allows for a longer time line for truly transformative investments.

10. There are three possible types of financing that IFAD could consider offering to the various kinds of subnational entities (see annex II):

    (i) A financing instrument for subnational governments (at the state or provincial level) using allocated resources of the country that is providing a sovereign guarantee;

    (ii) A financing instrument for NDBs using allocated resources of the country that is providing a sovereign guarantee. In this case, in addition to the assessments that would be undertaken in the case of subnational governments, IFAD would conduct additional assessments of the institutions' creditworthiness and implementation capabilities;

    (iii) Any other financing for subnational entities such as state-owned enterprises and NDBs without a sovereign guarantee, although this option is excluded from the scope of the present approach paper.

11. This type of lending could be applied to various replenishment sources, such as core contributions and borrowing. A demand for this type of lending has been expressed by Argentina, Brazil, Ecuador, India and Mexico in the case of subnational governments and by Brazil, Mexico and Peru in that of NDBs.

Box 1
**The case of Brazil**

IFAD has been lending to Brazilian states for almost 40 years, with independently certified positive results and impacts. The Government of Brazil considers lending to subnational entities to be mission-critical for IFAD, while stakeholders consider it to be the only cost-effective way to contribute to rural poverty reduction in the north-eastern part of the country, as there are strong disincentives for federal government institutions to provide externally sourced financing. Since this applies to all IFIs, it also limits IFAD's opportunities for mobilizing cofinancing.

12. Nonetheless, even for the first type of financing operation (see subparagraph (i) above), it should be noted that lending to subnational governments might have to be limited in scope or might not be an option at all for countries in which autonomous financing activities are restricted by law. For example, in some countries, direct lending to subnational governments might be illegal.

Box 2
**The case of Pakistan**

In Pakistan, although loans are already being taken out by the provinces, the federal government provides the corresponding guarantee and consequently is the signatory to financing agreements.

Box 3
**The case of India**

In India, borrowing by state governments from external agencies is subject to the approval of the national government. There is no direct lending to states or subnational bodies; all requests are channelled through the Ministry of Finance, which then deducts the debt payments from the states' resource allocations. For parastatal bodies, the Ministry of Finance provides the sovereign guarantee, but the parastatal agency is responsible for the repayment of the loan. This was the arrangement used for the IFAD National Microfinance Support Programme, which was implemented by the Small Industries Development Bank of India.

13. In some other countries, direct lending to subnational governments is restricted and subject to certain conditions and monitoring by the federal or national government.

Box 4
**The case of the Philippines**

In the Philippines, local governments are supposed to have at least 60 per cent of their regular annual revenues generated from local sources. They are allowed to contract loans directly from multilateral financial institutions created under multilateral treaties or agreements to which the Philippines is a signatory. In addition, total debt servicing is not to exceed 20 per cent of their regular annual revenues.

# III. Risk management, legal implications and safeguards

## A. Considerations relating to political oversight and the avoidance of mission drift

14. Subnational debt markets can be a powerful force for a country's development.[5] In the context of IFAD's evolving business architecture, lending to subnational entities could represent an opportunity for increasing the number of eligible borrowers while keeping the focus on tackling poverty among small-scale rural producers.

15. Despite the existing and potential demand for this type of operation, Member States and donors might consider the idea of serving upper-middle-income countries in some instances rather than low-income countries as entailing the possibility of mission drift. However, IFAD would only consider this lending option on the basis of a comprehensive due diligence and credit assessment undertaken in response to a Member State's request to serve its development needs in a more mature manner, irrespective of its income category or lending terms category.

## B. Financial considerations

16. Regions or states depend on a certain degree of fiscal autonomy, yet they are nonetheless dependent on government transfers and the ability to take on debt. NDBs enjoy more independence in managing their resources, as they maintain their own independent balance sheets. The national government's control and oversight of businesses may be only partial, depending on the nature of the services they provide (i.e. some utility companies are exposed to the risk of a change in the rates they charge being imposed by the national government).

17. Subnational entities are exposed to two broad types of risks: (i) idiosyncratic risk, depending on the entity's stand-alone economic fundamentals, its fiscal position and/or debt profile, governance and management; and (ii) systemic risk, deriving from the operating environment, which could be captured by the sovereign's own creditworthiness and the degree of market insulation and fiscal autonomy of the subnational entity (including fiscal oversight from the national government).

18. In dealing with subnational entities, the credit risk assessment prepared to measure their ability or willingness to service their debt should take into account the borrower's ability to access funds, to issue bonds and to manage its debt efficiently at different maturities, as well as the institutional or political risk, which could be in the form of regulatory, currency and/or legal risks.

19. In assessing these risks, there is a distinction to be made depending on the type of support provided by the state or national government. There can be two types of support:

    (i) **Implicit support.** Most NDBs are wholly owned by the state. However, some of these institutions run their commercial operations independently (some with their own rating), and the support they receive from the state may be limited or perceived as only implicit, depending on the strategic importance or role of the entity in the economy of the country.

[5] Through delegated monitoring by financial intermediaries and through debt placed directly with investors, subnational debt markets account for about 5 per cent of GDP in Argentina and Brazil. See "Building Subnational Debt Markets in Developing and Transition Economies: A framework for Analysis, Policy Reform, and Assistance Strategy," Policy Research Working Paper Series 2339, the World Bank.

(ii) **Explicit guarantees.** Some subnational entities operate under an unconditional and irrevocable guarantee from the state to support debt obligations or other types of borrowing, as well as other obligations.

20. From a risk point of view, IFAD **could engage with subnational governments, including NDBs, but only with the support of an explicit enforceable sovereign guarantee that meets IFAD's criteria.** From a legal standpoint, the enforceability of a sovereign guarantee is a complex matter and should be dealt with on a case-by-case basis (depending on project structure, default history and risk, type of borrower and type of guarantor). IFAD has no precedent for the execution of a sovereign guarantee, and there is no legal framework in place for the enforcement of such a guarantee. It could be argued that the possibility of executing a sovereign guarantee may be a limited one even if it contains all the features mentioned in the section below. In addition, a guarantor could bring its case before a local court, and the immunity of IFAD could be challenged. The limited experiences of other organizations have shown that often the execution of sovereign guarantees is a matter of political negotiation and can depend on the qualitative metric of willingness to pay. Because of these factors, this kind of exposure should be considered to be riskier than engaging directly with sovereign entities, and the preferred creditor treatment may not be applicable.

21. In other cases, however, such as in Brazil, sovereign guarantees are triggered automatically on the very day that a guaranteed loan falls into default.

22. Sovereign guarantee agreements should explicitly document the obligations assumed by the guarantor and should include the following features:

(i) **Irrevocability.** The guarantee should be legally effective, and the guarantor should be prohibited from terminating the guarantee unilaterally;

(ii) **Unconditionality.** The guarantee should be unconditional, irrespective of the value, genuineness, validity or enforceability of the guaranteed obligations;

(iii) **Timeliness**. The guarantee should provide for the punctual payment of any and all sums falling due under the loan agreement, whether at stated maturity, by acceleration or otherwise, and for the punctual performance of all the other obligations of the borrower;

(iv) **An on-demand clause.** The guarantor should be under an obligation to indemnify the beneficiary immediately on demand.

23. The guarantee should cover the entire nominal amount of the underlying loan to the subnational entity and any losses resulting from the non-payment of interest or failure to make any other type of payment.

## C. Legal considerations regarding the Agreement Establishing IFAD

24. The Agreement Establishing IFAD[6] does not explicitly provide for lending to subnational entities, with or without a sovereign guarantee. Further, a detailed analysis of the minutes of the meetings at which the Agreement was drafted shows that no consensus was reached on this issue by the Member States at the time. However, the Executive Board has approved projects involving the provision of financing to subnational entities on several occasions and, by doing so, has implicitly approved a broad interpretation of the Agreement on this issue.

[6] Section 1 (b) of article 7 of the Agreement Establishing IFAD states the following: "Financing by the Fund shall be provided only for the benefit of developing States that are Members of the Fund. Such financing may be provided directly to developing Member States or through intergovernmental organizations in which such Members participate or to, or through, private sector organizations and enterprises. In the case of a loan to an intergovernmental organization, the Fund may require suitable governmental or other guarantees."

25. The charters of some multilateral development banks (see annex III for a detailed comparative analysis of the charters of the International Bank for Reconstruction and Development [IBRD], IDA, EBRD, IDB and ADB) explicitly allow lending to subnational entities, with or without a sovereign guarantee.

26. If, on the basis of a demand and pricing analysis, an evaluation of IFAD's risk appetite, the potential implications of rating discussions (as well as of the political dimension, which should also be considered), and in the light of the ongoing discussions regarding IFAD's risk management framework, Management were to propose lending to subnational entities, two legal options would be available:

    - **Option 1**: **Amendment of the Agreement.** The President could refer the proposals made by a Member State to amend the Agreement to the Executive Board, which should submit its recommendations thereon to the Governing Council in 2021.

    - **Option 2: Confirmation of the implicit interpretation of the Agreement.** As provided in article 11, section 1(a) of the Agreement: "Any question of interpretation or application of the provisions of this Agreement arising between any Member and the Fund or between Members of the Fund, shall be submitted to the Executive Board for decision. If the question particularly affects any Member of the Fund not represented on the Executive Board, that Member shall be entitled to be represented in accordance with regulations to be adopted by the Governing Council." Article 11, section 1(b), indicates that: "Where the Executive Board has given a decision pursuant to subsection (a), any Member may require that the question be referred to the Governing Council, whose decision shall be final. Pending the decision of the Governing Council, the Fund may, so far as it deems necessary, act on the basis of the decision of the Executive Board." The Executive Board has already implicitly interpreted this section by reviewing and approving such projects periodically since the 1980s. Moreover, this interpretation is in line with the new IFAD strategic priorities concerning a broader scope of recipients, instruments and sources of funding.

## D. Considerations relating to governance, monitoring and evaluation

27. In lending directly to **subnational governments and NDBs with a sovereign guarantee**, the arrangements and procedures provided for in the design framework should be applicable in the same way as they are for transactions with central governments. Nevertheless, certain additional monitoring and evaluation risks would need to be considered that would require a more thorough analysis and due diligence assessment during design, especially if the borrower was a non-governmental body such as an NDB. In addition, the lack of an agreed framework with governments on the enforceability of sovereign guarantees would be a particular concern.

28. **The risk of weak alignment with the country strategic opportunities programme (COSOP)** should be considered as the project is implemented at the subnational level. It would be important to verify the relevance of the subnational lending operation in the country context and its alignment with the COSOP in advance. If ad hoc opportunities were to arise during the course of a COSOP implementation period, the associated changes should be reflected in the COSOP at the time of the annual or midterm review.

29. Any **risk related to the level of robustness of subnational entities in terms of capacities, institutions and incentives for good governance, transparency and accountability** should be monitored. These capacities would require the support of adequate human resources and civil service management, sound transparency, accountability and anticorruption arrangements. Some of the

lessons learned from other IFIs indicate that some federal governments prefer to use investment project financing for subnational lending operations since their experience with this instrument is more varied in terms of results/impacts than with other operational instruments. This preference is explained by the fact that, in some contexts, a federal government may neither have the authority nor the capacity to oversee the implementation of the public policy reforms subsumed under such operations or to verify the quality of the resulting improvements in service delivery; in such cases, a government may therefore place a premium on the IFI's own supervision and implementation support under the investment project financing instrument to satisfy itself of the value added of such operations.

30. There is also a risk that **overall project preparation and implementation times and costs could increase**, given the greater complexities involved in dealing with subnational entities and their possible lack of previous experience in working with multilateral development banks. These challenges should be mitigated and minimized through repeated engagement in facilitated policy dialogue and coordination efforts with subnational governments, the possible development of long-term partnerships with selected ones and the sharing of experiences across programmes, states and provinces to enhance effectiveness while controlling costs.

## E. Considerations relating to lending terms and financing conditions

31. Currently, the Policies and Criteria for IFAD Financing and the set of related lending terms do not consider subnational entities.

32. If the Member States' decision is to pursue this opportunity, a further analysis of the implications for lending terms and the changes needed to related legal texts would need to be conducted.

33. There would have to be certain criteria in place for dealing with subnational entities, such as:

    (i) The corresponding national governments should buy in to the process with IFAD, rather than leaving the subnational entities to take the lead and full responsibility;

    (ii) Due diligence, including a credit assessment, should be conducted on a case-by-case basis in line with a defined minimum set of criteria, and only Member States that meet those criteria would be allowed to provide sovereign guarantees on loans granted by IFAD to subnational entities in those countries;

    (iii) A guarantor that failed to fulfil the terms of the guarantee would be subject to penalties, which would have been agreed upon beforehand. Such penalties could include, for example, a trigger to accelerate repayments on the entire sovereign portfolio should indemnification not be immediately forthcoming;

    (iv) IFAD would be entitled to charge additional fees to cover the cost of the due diligence process and the greater set of risks embedded in the operation.

# IV. Conclusions and the way forward

34. Lending to subnational entities would represent an opportunity for IFAD to extend its spectrum of borrowers, mobilize internal and external cofinancing and tailor its offerings to individual countries' needs and economic trajectories. It is essential to establish an early assessment of the potential demand for IFAD12, which has not been done at this stage. Such an assessment would shed light on the best way to pursue these opportunities and would be of help in identifying the most applicable framework.

35. At the same time, as IFAD is conducting its first credit rating exercise, it is important to continue to ensure the Fund's protection from financial risk and to maintain related safeguards. It is therefore recommended that, at this stage, IFAD **should engage with subnational entities, including NDBs, only with the support of an explicit sovereign guarantee that meets IFAD criteria regarding its enforceability.** The expansion of such operations to include NDBs without an explicit sovereign guarantee could be gradually phased in at a subsequent stage, as it would require additional assessments of their creditworthiness, implementation capabilities and related financial, operational and reputational risks.

# Statement by Brazil at the 127th session of the Executive Board

## Brief statement for information by Brazil[7]

**Outcome:**

- The Board noted the proposals shared by the representative for Brazil – for consideration at a future session – that IFAD be allowed to: (i) lend directly to subnational governments; and (ii) lend directly to NDBs to stimulate demand for loans and enhance country ownership of IFAD's operations in Brazil and possibly in other countries.
- Members expressed appreciation for the proposals but indicated that there would be a need to consult with their capitals on the matter. Members agreed to Management's proposal to submit a discussion paper at the first session of 2020. Management was asked to include information on the practices of other IFIs, the potential impact on credit ratings and the implications for Member States that have no credit rating.

1. The representative for Brazil stated that the discussions held during the session had already demonstrated the need to go beyond business as usual and consider broadening the scope of IFAD financing.

2. Referring to his country's proposals, the representative underscored that, although the two proposals had been made together, they should be viewed independently of each other. First, linkages between IFAD and subnational governments could stimulate demand and bolster their ownership of projects. Second, with respect to NDBs, Brazil saw this as a way of boosting cofinancing, leveraging IFAD's resources and increasing joint efforts with other financial institutions, resulting in more robust and impactful operations.

[7] See document EB 2019/127.

# Definitions of national and subnational entities

1. General government includes three subsectors:
   (i) The national (central/federal) government and related public entities;
   (ii) State or provincial ("federated") governments and related public entities;
   (iii) Regional and local governments and related public entities.
2. **Central government.** The government of a unitary state, or a country that does not give significant power to regional divisions
3. **Federal government.** The government of a federal state, or a country that gives significant power to regional divisions
4. **Subnational government.** All levels of government (state and regional/local governments) below the national level regardless of the political, financial and administrative structure of the country. This term therefore encompasses any intermediate (e.g. district, state, regional, provincial) and local governments as well as semi-independent government organizations (e.g. parastatals) at the subnational level.
5. **Regional government.** A group of governments that could be defined as a county, more than one county, one municipality, more than one municipality, a council of governments or more than one council of governments
6. **Municipality.** A municipal corporation, a city, town, borough, or incorporated village
7. **National development bank (NDB).** A financial institution created by a country's government that provides financing for the purpose of the country's economic development
8. **State-owned enterprise**. A corporate entity recognized by national law in which the state has significant control through full, majority or significant minority ownership

# Charter provisions on subnational lending of selected multilateral and bilateral creditors

| World Bank | |
|---|---|
| Charter | **IBRD**<br>1. IBRD Articles of Agreement, article III, section 4.[8]<br>2. IBRD Articles of Agreement, article III, section 4(i).[9]<br>While the Articles of Agreement provide that the member or the central bank or some comparable agency of the member acceptable to the Bank **must provide** this **guarantee**, the Bank requires the **guarantee of the member** for the following reasons:<br>(a) The Bank's desire to have the full faith and credit of the member behind the guarantee;<br>(b) The fact that Guarantee Agreements contain undertakings that a central bank could not validly undertake or effectively comply with; and<br>(c) The Bank's desire to create, by the Guarantee Agreement, a contractual relationship under public international law that will not be subject to impairment as a result of restrictions or provisions of the laws of the member.<br>**IDA**<br>1. IDA Articles of Agreement, article V, section 2(c).[10]<br>2. IDA Articles of Agreement, article V, section 2(d).[11] |
| Policies, rules and operational manuals | **IBRD**<br>1. **Borrower.** Under its Articles of Agreement, IBRD may lend to: (a) a member country; (b) a political subdivision of a member; and (c) any business, industrial or agricultural enterprise in the territories of a member.<br>2. **Guarantor.** If the member in whose territory the project is located is not itself the borrower, **the member must guarantee** the payment of the principal and interest and other charges on the loan. When a member guarantees a loan, it does so as a principal debtor and not merely as a surety. Thus, IBRD may call directly on the guarantor for payment and is not required to first exhaust its remedies against the borrower. When the member effectively controls the entity in charge of implementing and operating the project, IBRD requires the member to guarantee performance as well as repayment. (Staff should **consult with the Office of the General Counsel [LEG]** for guidance on the application of this paragraph.)<br>**IDA**<br>1. **Borrower.** Under its Articles of Agreement, IDA may lend to: (a) a member country; (b) the government of a territory included within IDA's membership; (c) a political subdivision of any of the foregoing; (d) a public or private entity in the territories of a member or members; and (e) a public international or regional organization.<br>2. **Guarantee.** Although IDA **normally does not provide** credits to entities **other than a member country**, if it were to do so, its Articles of Agreement provide that it **may,** at its discretion, **require** a suitable **governmental or other guarantee.**<br>OP 7.00 - Lending Operations: Choice of Borrower and Contractual Agreements: https://policies.worldbank.org/sites/ppf3/PPFDocuments/Forms/DispPage.aspx?docid=1681<br>Operational Manual: https://policies.worldbank.org/sites/PPF3/Pages/Manuals/Operational%20Manual.aspx<br>3. **Investment project financing** provides IBRD loans, IDA credit/grant and guarantee financing **to governments** for activities that create the physical/social infrastructure necessary to reduce poverty and promote sustainable development.<br>4. **Development policy financing** provides IBRD loans, IDA credits/grants and guarantees budget support **to governments or a political subdivision** for a programme of policy and institutional actions to help achieve sustainable development, shared growth and poverty reduction. |
| Loan Agreements, Guarantee Agreements and General Conditions | 1. **Loan Agreement.** For each loan, the Bank and borrower enter into a Loan Agreement that sets forth the amount of the loan or credit and the terms and conditions on which it is made.<br>2. **Guarantee Agreement.** If IBRD makes a loan to an entity other than the member country concerned, it enters into a Guarantee Agreement with the member, which sets forth the member's contractual obligations as guarantor. Additional undertakings made by the guarantor to facilitate the achievement of the loan's purposes are set forth in the Guarantee Agreement. |

[8] "The Bank may guarantee, participate in, or make loans to any member or any political sub-division thereof and any business, industrial, and agricultural enterprise in the territories of a member."
[9] "(i) When the member in whose territories the project is located is not itself the borrower, the member or the central bank or some comparable agency of the member which is acceptable to the Bank, fully guarantees the repayment of the principal and the payment of interest and other charges on the loan."
[10] "(c) The Association may provide financing to a member, the government of a territory included within the Association's membership, a political subdivision of any of the foregoing, a public, or private entity in the territories of a member or members, or to a public international or regional organization."
[11] "(d) In the case of a loan to an entity other than a member, the Association may, in its discretion, require a suitable governmental or other guarantee or guarantees."

| | |
|---|---|
| | 3. The Loan and Guarantee Agreements incorporate by reference the applicable General Conditions. Since the General Conditions are approved by the Executive Directors, any amendment of their provisions requires **clearance by the LEG** Vice-President, who also decides whether approval by the Executive Directors is also required. The Loan, Guarantee and/or Project Agreements incorporate, as applicable, guidelines **such as** the Guidelines: Procurement under IBRD Loans and IDA Credits; Guidelines: Selection and Employment of Consultants by World Bank Borrowers; and Guidelines for Conversion of Loan Terms for Fixed-Spread Loans.[12] |
| **African Development Bank** | |
| Charter | 1. Agreement Establishing the African Development Bank - 2016 edition, article 14, section 1.[13]<br>https://www.afdb.org/en/documents/agreement-establishing-african-development-bank-2016-edition |
| Policies, rules and operational manuals | 1. African Development Bank Group's Policy on Non-sovereign Operations<br>https://www.afdb.org/en/documents/document/policy-on-non-sovereign-operations-109578<br>2. Revised Financial Guidelines for Sovereign-Guaranteed Loans<br>https://www.afdb.org/en/documents/document/revised-financial-guidelines-for-sovereign-guaranteed-loans-27100 |
| Loan Agreements, Guarantee Agreements and General Conditions | **Section 1.01 Application of General Conditions**<br>(a) These General Conditions set forth the terms and conditions applicable to: i) any Loan Agreement entered into between the Bank and one or more Regional Member States; ii) any Guarantee Agreement entered into between the Bank and a Regional Member State in connection with the conclusion of a loan; and iii) any other agreement to which the Bank is a party and which provides that these General Conditions are applicable. (b) If the Loan Agreement is entered into between a Regional Member State and the Bank, references in these General Conditions to the Guarantor and the Guarantee Agreement shall be disregarded. c) Additional conditions may be included in the Loan Agreement or the Guarantee Agreement, having regard to the nature of the Project.<br><br>**Section 1.02 Inconsistency with Loan and Guarantee Agreements**<br>If any provision of any Loan Agreement, Guarantee Agreement or any other agreement to which these General Conditions are applicable is inconsistent with a provision of these General Conditions, the provision of the Loan Agreement, the Guarantee Agreement or the other agreement, as the case may be, shall prevail.<br>1. General Conditions Applicable to the African Development Bank Loan Agreements and Guarantee Agreements (Sovereign Entities)<br>https://www.afdb.org/en/documents/document/general-conditions-applicable-to-the-african-development-bank-loan-agreements-and-guarantee-agreements-sovereign-entities-8149<br>2. General Conditions Applicable to the African Development Bank Loan Agreements and Guarantee Agreements (Non Sovereign Entities)<br>https://www.afdb.org/en/documents/document/general-conditions-applicable-to-the-african-development-bank-loan-agreements-and-guarantee-agreements-non-sovereign-entities-8151 |
| **EBRD** | |
| Charter | 1. Chairman's Report on the Agreement Establishing the European Bank for Reconstruction and Development, article 11.[14]<br>2. Agreement Establishing the European Bank for Reconstruction and Development, chapter III, article 11, section 3 iii) a).[15]<br>3. Agreement Establishing the European Bank for Reconstruction and Development, chapter III, article 14.[16]<br>https://www.ebrd.com/news/publications/institutional-documents/basic-documents-of-the-ebrd.html |

[12] See OP/BP 11.00, Procurement, and OP 3.10, Loan Charges, Currencies and Payment Terms of IBRD Loans and IDA Credits.
[13] "In its operations, the Bank may provide or facilitate financing for any regional member**, political subdivision** or any agency thereof or for any institution or undertaking in the territory of any regional member as well as for international or regional agencies or institutions concerned with the development of Africa."
[14] "This Article establishes the ways the Bank shall carry out its purpose and functions, including in relation to regional projects. In describing recipients of Bank financing and assistance, and in setting limits on Bank financing and assistance to **the state sector**."
[15] "The **state sector** includes national and local Governments, their agencies, and enterprises owned or controlled by any of them."
[16] "Where the recipient of loans or guarantees of loans is not itself a member, but is a **state-owned enterprise**, the Bank **may, when it appears desirable**, bearing in mind the different approaches appropriate to public and state-owned enterprises in transition to private ownership and control, **require the member or members** in whose territory the project concerned is to be carried out, or a public agency or any instrumentality of such member or members acceptable to the Bank, **to guarantee** the repayment of the principal and the payment of interest and other fees and charges of the loan in accordance with the terms thereof. The Board of Directors shall review annually the Bank's practice in this matter, paying due attention to the Bank's creditworthiness."

| ADB | |
|---|---|
| Charter | The political subdivision could be an eligible borrower of loan.<br>Please see the Agreement Establishing the Asian Development Bank, chapter III, article 11.[17]<br>Where the recipient of loans or guarantees of loans is not itself a member, the Bank may require that the member guarantees the repayment of the principal and the payment of interest and other charges on the loan in accordance with the terms thereof.<br>Please see the Agreement Establishing the Asian Development Bank, chapter III, article 15, paragraph 2.[18] |
| Policies, rules and operational manuals | Operations Manual: https://www.adb.org/documents/operations-manual<br>Operations Manual Bank Policies (BP):<br>• When making a loan to a **non-member**, a guarantee by the relevant member is the most effective means of protecting ADB's interests.<br>• When ADB makes a loan to an agency, instrumentality, or **political subdivision** of a member, it must examine in detail the borrower's standing in terms of the full faith and credit of the developing member country (DMC) government. To the extent that such standing falls short of the full faith and credit of the DMC government, the fullest protection against default may be possible **only through** securing for the loan **a guarantee from the DMC government**.<br><br>Operations Manual Bank Policies and Procedures (Non-sovereign operation), A, (2)(iv):<br>To be eligible for ADB **non-sovereign financing**, the proposed recipient must be:<br>(iv) **a local government** or **other sub-sovereign entity** (including municipalities and other forms of local government) that can contract and obtain financing independently from the sovereign. |
| Loan Agreements, Guarantee Agreements and General Conditions | Ordinary Operations Loan Regulations Applicable to Regular Loans Made from ADB's Ordinary Capital Resources (1 January 2017)<br>https://www.adb.org/documents/ordinary-operations-loan-regulations-1-jan-2017 |

[17] "Subject to the conditions stipulated in this Agreement, the Bank may provide or facilitate financing to any member, or any agency, instrumentality **or political subdivision** thereof, or any entity or enterprise operating in the territory of a member, as well as to international or regional agencies or entities concerned with economic development of the region."
[18] "Where the recipient of loans or guarantees of loans is not itself a member, the Bank may, when it deems it advisable, require that the member in whose territory the project concerned is to be carried out, or a public agency or any instrumentality of that member acceptable to the Bank, guarantee the repayment of the principal and the payment of interest and other charges on the loan in accordance with the terms thereof."