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Concept Note on Regional Lending Operations

Note to Transition Framework Working Group members

For ease of reference, new text added to the version presented at the first meeting of the Working Group is underlined.

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Working Group on the Transition Framework — Second Meeting
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For: Review

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Abbreviations and acronyms

AfDB	African Development Bank
COSOP	country strategic opportunities programme
GEF	Global Environment Facility
IFI	international financial institution
PBAS	performance-based allocation system
RLO	regional lending operation
SIDS	small island developing states

Concept Note on Regional Lending Operations

Recommendation for Working Group consideration

The Working Group on the Transition Framework is invited to analyse and subsequently endorse the initial proposal for IFAD's regional lending operations. This proposal may be refined based on further analysis as part of the work programme outlined in section VI below. The work programme to be undertaken during the Eleventh Replenishment of IFAD's Resources (IFAD11) will comprise: (i) finalizing an assessment of international financial institutions' practices and lessons learned on regional operations; (ii) identifying areas of demand for potential IFAD engagement and countries with an interest in piloting regional operations; and (iii) identifying pilots, necessary elements for project design and implementation, and learning areas.

The initial proposal for consideration by the working group includes the following:

Identification of pilot operations: Regional divisions will promote the concept of regional lending operations among borrowing countries as part of pipeline discussions for the IFAD11 programme of loans and grants.

Eligibility criteria: Criteria will include number of countries (likely two or more with some flexibility for single country operations with regional impact), and expected results.

Financing of pilots: Pilot regional lending operations in IFAD11 may be financed through:

1. Part or all of the performance-based allocation system allocation for each participating country as per the terms established for each country category ("red", "yellow" and "green");
2. Regional grant-financed activities designed to complement existing stand-alone IFAD loans in two or more countries; and
3. Additional sources of financing, including funding for climate change and the environment such as the second phase of IFAD's Adaptation for Smallholder Agriculture Programme, and external funding sources such as the Global Environment Facility and the Green Climate Fund.

Legal establishment: Each participating country will have a separate financing agreement with IFAD for its own loan component, which will include provisions on how the country-specific activities will contribute to broader regional project. Agreements for regional grants will be signed with selected grant recipients stipulating how the funded activities will relate to ongoing IFAD loans to each participating country during implementation of the regional lending operation.

Executive Board approval: The pilot regional lending operations will be presented to the Executive Board for approval regardless of the amounts to be financed.

Learning from the pilot: The pilot phase will emphasize learning to enhance the design of future operations; adequate resources (staff and funding) will be dedicated to this learning exercise.

The final proposal will be presented for consideration at an informal Executive Board seminar on 11 September 2018 and will be presented for endorsement at the fifth Working Group Meeting on the 29 October. If endorsed, the proposal will be included in the final Transition Framework, which will be presented to the Executive Board.

The pilots are expected to be designed and launched during 2019 and 2020. The results of the pilots will inform an enhanced approach to regional lending operations, with recommendations for additional IFAD loan and grant funding to incentivize regional activities. These recommendations will be included in the Consultation on the Twelfth Replenishment of IFAD's Resources.

Key messages

1. As countries progress, new approaches and tools are needed to address their evolving needs. Regional lending operations represent a new instrument that IFAD can tailor to countries and regions to support them in realizing their full development potential.
2. Regional lending operations address cross-border development challenges that single countries have limited incentives to address individually.
3. Regional operations have been financed by other international financial institutions (IFIs) for more than a decade and are a powerful tool when used in the right contexts.
4. Though at times requiring more coordination and attention during design and implementation, regional operations are often more successful than single-country projects, as evidenced by independent evaluations conducted by the African Development Bank (AfDB), among others.
5. ~~Successful agriculture depends on the availability of natural resources, including water, which often require regional management approaches. The same applies to pest and disease management and access to markets across national borders. A number of challenges faced by smallholders require trans-boundary and regional approaches. For example, water resource management and agricultural pests and diseases know no boundaries. These issues are exacerbated by climate change, which is increasing the reach and severity of water scarcity and floods, and the spread of invasive species and pests.~~ These are just some of several entry points to design and implement cross-border rural development projects that would be closely aligned with IFAD's mandate.
6. To pilot regional operations during the Eleventh Replenishment of IFAD's Resources (IFAD11), ~~IFAD Management~~ is proposing to leverage existing legal and financial instruments and current allocation mechanisms as further explained in paragraphs ~~13-15, and 29-32~~ 34-40. This will provide sufficient time and experience to evaluate a separate allocation mechanism or set aside as available in all other international financial institutions (IFIs). These considerations will be analysed in conjunction with the review of the performance-based allocation system (PBAS) ahead of IFAD12.

Next steps

7. The following steps are ~~foreseen~~ proposed as a lead up to the introduction of pilot regional ~~operations~~ lending operations at IFAD:
 - Further review of IFI experience with regional lending operations will be conducted.
 - ~~Approach to design and legal framework for regional operations will be defined.~~
 - An expanded concept note, including the approach to piloting regional lending operations (RLOs) in IFAD11, will be presented at the informal seminar scheduled on 11 September 2018.
 - ~~Finalization of concept note, including any needed policy revisions, in early 2019 for discussion with the Executive Board later that year. The final Transition Framework, which will be presented for endorsement by the Working Group on 29 October 2018, will include the approach for piloting RLOs in IFAD11 and next steps.~~
 - If members agree on the proposed approach to piloting RLOs in IFAD11, interim operational procedures for the pilot will be finalized by early 2019.

- ~~Pilots are expected to be launched during 2019 or 2020. It is proposed that the pilot RLO be designed and launched during 2019 and 2020.~~

I. Background

8. ~~IFAD is increasing its engagement at the regional level. In July 2017, the Secretary-General of the United Nations released the report Repositioning the United Nations development system to deliver on the 2030 Agenda – ensuring a better future for all. This report contains proposals in seven areas, one of which is a revamped regional approach for the United Nations.~~
9. ~~IFAD's development assistance has traditionally been delivered using a country-driven model. In line with the United Nations reform process, IFAD has reaffirmed its commitment to improving cooperation with regional and subregional institutions. The Fund is strengthening its organizational architecture to better implement regional approaches. As part of its decentralization, subregional hubs are being established in all five regions covered by IFAD operations, enabling IFAD to gain efficiencies and make more meaningful contributions to regional and subregional processes.~~
10. ~~In line with its enhanced regional approach, IFAD ~~recognizing~~ recognizes that regional lending operations can be a powerful tool to tackle development challenges that go beyond country borders. In a world that is increasingly characterized by global and regional economic integration, country-based solutions alone are not sufficient.¹~~
11. ~~Many of the major environmental threats to rural development challenges, such as pollution of cross-border rivers or sharing of are trans-boundary aquifers, span country borders in nature. And many goods and services required to address these threats – such as transport, disease prevention and natural resource and water basin management – are best provided at the regional level to tap into economies of scale. Efforts to tackle these challenges and harness the opportunities can only be achieved through coordination and cooperation at the regional level, ensure connectivity and extend access to goods and services. In addition, addressing these issues requires coherent regulations and standards across neighbouring countries. Multi-country solutions and pooling of resources can help leverage the resources of individual countries to achieve better and broader impact. This may be of significant benefit to small countries (such as small island developing states [SIDS]), and vulnerable countries that suffer disproportionately from cross-border challenges such as natural disasters.²~~
12. The introduction of regional operations is one of the proposals included in the Approach Paper to a Transition Framework approved by IFAD's Executive Board in December 2017. It responds to requests from Member States to widen IFAD's range of tools that can support countries in their development transition. Regional lending operations should therefore be seen as an additional tool that can provide tailor-made solutions to countries and regions facing cross-border development challenges.
13. The Approach Paper to a Transition Framework (EB 2017/122/R.34) explicitly embraces the need for IFAD regional lending support to supplement IFAD regional grants that promote regional innovation and capacity-building. The Transition Paper states that:

¹ The contribution of a regional approach to the increased effectiveness of development actions has also been stressed by high-level forums that issued the Paris Declaration on Aid Effectiveness (2005), the Accra Agenda for Action (2008) and the Busan Partnership for Effective Development Cooperation (2011).

² Regional operations might also be useful to address cross-border fragility. This area will be explored further as part of IFAD's special programme for countries with fragile situations, which will be presented to the Executive Board in April 2019.

Vulnerabilities are cross-border in nature. Regional operations are in all IFIs a fundamental part of the broader strategy to promote regional integration, justified by their high potential for development impact. Specific strategic and operational frameworks have been established to recognize the specific features of regional operations, which offer the potential for higher economic returns compared to national operations but also involve significant additional challenges compared to standard country operations. Regional operations are also effective in providing regional public goods.

14. Furthermore, in the context of the Consultation on the Eleventh Replenishment of IFAD's Resources (IFAD11), Management committed to "explore options for regional lending operations" (IFAD11 commitment 3.6, monitorable action 36) and the institution aims to be ready to implement a first pilot during IFAD11.
15. Since IFAD ~~intends~~ Management proposes to pilot regional operations in IFAD11, these pilots will be designed by ~~leveraging~~ deploying currently available financial instruments, i.e. loans through the PBAS as well as the limited use of grants through the regional grants and loan component grants window. The experiences from IFAD11 will inform any adjustments to the PBAS³ and finance policies to support regional lending operations for IFAD12 and beyond.

II. Overview of regional lending operations

16. Regional lending operations have been ongoing for some time in other IFIs. These operations typically involve at least three countries in the same region, although exceptions are made for operations involving fewer countries in certain contexts, e.g. countries with fragile situations. RLOs may also ~~typically~~ involve (non-borrowing) regional organizations that act in multiple roles such as cofinanciers, facilitators or implementers. Coordination is an integral part of RLOs; it can be provided by one of the borrowing countries, or by an organization or other structure that can bring together individual national interests and foster a broader, collective effort for the provision of multi-country activities and regional public goods.
17. RLOs finance cross-border or multi-country interventions that impact a number of countries. Critical issues that can best, or only, be addressed through RLOs include:
 - (a) Promoting regional connectivity: Support for transportation networks and other infrastructure that crosses borders or benefits multiple countries. Individual countries often lack incentives, regulations and planning processes, and sometimes the financial capacity (especially small countries) for these investments, which can be critical for better access to markets for groups such as smallholder farmers or nomadic pastoralists living in border regions.
 - (b) Expanding regional trade in agriculture and food products. Improved trade positively impacts growth, farmers' incomes and regional food security. Larger cross-border markets increase intraregional trade and help to drive innovation and growth.
 - (c) Protecting common goods and shared natural resources. Managing threatened natural resources (e.g. forestry and fishery resources) that cross national borders requires joint action by regional stakeholders. These operations can also help reverse land degradation and preserve biodiversity, as well as support multi-country disaster risk management.

³ A review of the PBAS formula for IFAD12 is already planned as requested by the Executive Board at its 121st session in September 2017.

- (d) Developing common standards supports harmonization in countries across a region, for example of financial regulations or sanitary and phytosanitary measures.
 - (e) Promoting security and reducing vulnerability: supporting regional labour markets and migration-related challenges.
18. A regional approach to operations has several advantages. RLOs provide a broad strategic framework to tackle development challenges that are shared by different countries in the same area, thus optimizing both planning and operational efforts and costs. They allow a pooling of resources, which is particularly important for smaller and fiscally constrained countries. They also promote South-South and Triangular Cooperation, and they may lead to best practice innovations that can be scaled up in other regions and regional institutions.⁴
 19. One major challenge of RLOs is the need for political alignment, a degree of integration, and joint ownership across all countries benefiting from the operation. To address this requires policy dialogue to pave the way for regional solutions and to ensure their alignment with the national priorities of participating countries. Ownership and alignment need to continue past the design stage, accompany becoming an integral part of implementation and beyond. In structuring a regional lending operation, another critical issue is how to assess the share of benefits, and thus the contributions, for each country participating in the operation.

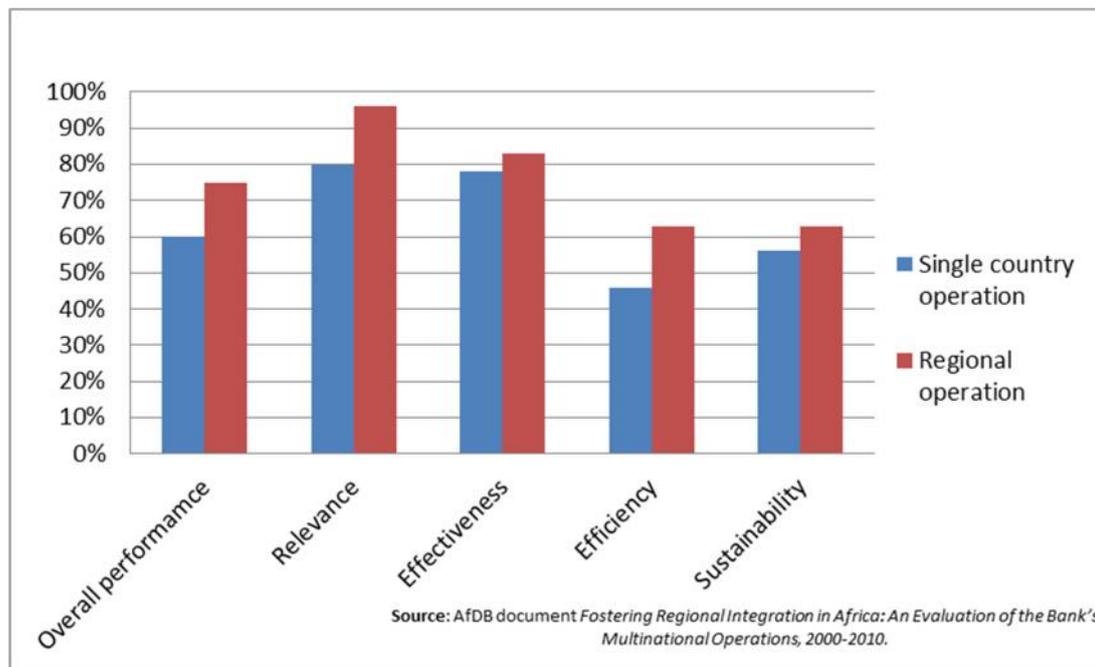
III. Regional lending operations in other IFIs

20. Regional and multilateral organizations, such as the regional development banks and the World Bank, can act as catalysts in the provision of multi-country activities and cross-border public goods through their ability to convene, generate and transfer knowledge, assist negotiations and provide funding. Several IFIs have introduced mechanisms for financing RLOs, including the World Bank (2003), Inter-American Development Bank (2004), Asian Development Bank (AsDB) (2006) and African Development Bank (2014).
21. There are commonalities across IFIs in how they define RLOs. These include: (i) projects that span multiple countries, require multi-country planning and coordination and generate benefits across countries; (ii) a national project with significant cross-border impact; (iii) projects that are part of a subregional investment programme or regional strategy; (iv) projects that create public goods that cannot be created cost-effectively by one country; or (v) projects that provide a platform for a high level of policy harmonization. Eligible sectors are very broad and range from infrastructure and agriculture to trade, investment, monetary and financial cooperation. Eligible entities for IFI RLOs appear to be restricted to member countries for loans, but include a multiplicity of organizations (e.g. regional, national and subnational) that can receive grants in conjunction with these operations.
22. One common feature across the IFI programmes for regional operations is the evolution of these mechanisms. They have generally been structured at the outset as “learning by doing” exercises, which have required considerable adaptation over time. Key elements that have been revised as the programmes mature include: creating dedicated windows for regional loans, which provide a financial incentive to individual countries to participate and increase loan amounts beyond each country’s PBAS; creating a grant programme to accompany the regional operations either to subsidize country participation or to finance the coordination of the operations; prioritizing the selection of RLO projects; and providing extra support during implementation to facilitate difficulties with disbursements.

⁴ Sandler, T., “Regional public goods and international organizations”, in *The Review of International Organizations*, March 2006, Volume 1, Issue 1, p. 5-25. <https://link.springer.com/article/10.1007/s11558-006-6604-2>.

23. Evaluations of the RLOs in other IFIs show that while requiring more coordination and attention during design and implementation, regional operations ~~are often~~ can be more successful and generate ~~more plentiful~~ greater benefits than single-country projects. Evidence to this effect can be found in independent evaluations conducted by the AfDB, among others.

Figure 1
Percentage of satisfactory operations financed by AfDB (2000-2010).



24. As part of the work programme to develop IFAD's RLO mechanism, the experiences of other IFIs will be further assessed. In order to build on best practice and leverage this extensive experience, the main features and lessons learned from RLOs in other IFIs – particularly those in the agricultural and rural development sector – will be examined for their relevance to IFAD. Additionally, an overview will be undertaken of the impact of the operations and how this impact is measured.

IV. Implementing IFAD's comparative advantage for regional operations in

25. With its focus on single-country sovereign loans, IFAD is currently unable to sufficiently support countries in addressing development issues that are cross-border, multi-country or regional in nature. IFAD already supports a number of regional activities through its regional grant programme⁵ and other regional initiatives are funded through Global Environment Facility (GEF) supplementary funds.⁶ However, these financing mechanisms are insufficient for many regions, subregions and countries to fully realize their development potential. As a result, there is considerable unmet demand for IFAD's services.
26. IFAD has a comparative advantage in filling gaps left by other IFIs. Given IFAD's mandate and focus on agriculture and rural development, the RLOs undertaken by IFAD will have a similar focus. There are focus on agriculture and rural development. These areas do not receive substantial support from other IFIs'

⁵ Examples include support to the Farmers' Organizations in Africa Programme, the Alliance for a Green Revolution in Africa and the African Green Revolution Forum.

⁶ Examples include the hub project aimed at providing regional services to the pilot programme on Fostering Sustainability and Resilience for Food Security in Sub-Saharan Africa – An Integrated Approach.

regional programmes, which focus on infrastructure.⁷

27. A number of challenges faced by smallholders require trans-boundary and regional approaches. For example, water resource management and agricultural pests and diseases know no boundaries. These issues are exacerbated by climate change, which is increasing the reach and severity of water scarcity and floods, and the spread of invasive species and pests. These are just some of several examples of regional entry points for designing and implementing cross-border rural development projects in other IFIs, mainly the World Bank and AfDB, though the majority of regional operations are in other sectors, such as finance and transport. There are plenty of entry points for rural development aligned with a regional scope. Successful agriculture depends on the availability of IFAD's mandate.
28. Environment and natural resource issues, including water, which often require regional management approaches. The same applies to pest and disease management. Likewise, the agriculture sector produces a variety of tradable commodities — such as food, fibre and fuel — and the production and trade of these commodities could in some cases benefit from regional efforts. Agriculture also implies environmental and social externalities, which include agricultural landscapes, such as biodiversity, air and water quality, water availability, soil functionality, climate stability (greenhouse gas emissions, carbon storage), food and climate stability have important impacts on the sustainable development of agriculture and related value chains. This in turn impacts socioeconomic objectives such as food security, food safety, rural viability and farm animal welfare. IFAD currently supports a number of regional activities through its regional grant programme. Examples are the Support to Farmers' Organizations in Africa Programme, and the support provided to the Alliance for a Green Revolution in Africa and the African Green Revolution Forum. Other initiatives are funded through Global Environment Facility supplementary funds, such as the Hub project that will provide regional services to the programme on Fostering Sustainability and Resilience for Food Security in Sub-Saharan Africa, using the integrated approach pilot. These financing mechanisms are however insufficient to fully realize the development potential of many regions.
29. IFAD already has experience in addressing challenges related to climate change with a regional approach. The GEF-financed programme on food security (see footnote 6), which IFAD leads, aims to increase the adoption of resilient, improved production systems for sustainable food security and nutrition through integrated landscape management and sustainable food value chains in 12 African countries. IFAD has integrated a regional component into the programme, which promotes regional collaboration and South-South learning. This programme is a replicable example of how IFAD could work at the regional level.

V. Demand for IFAD support for regional operations

30. There are numerous activities within IFAD's areas of focus. Regional lending operations will enable IFAD to extend the reach of these regional activities, and to draw on experience, and its comparative advantage that could benefit from regional operations (see below). In each area, IFAD's comparative advantages in providing solutions will need to be compared with those of other institutions.

⁷ Around 7 per cent of the regional lending in AfDB in 2000-2010 was to agricultural and rural development projects. Approximately 68 per cent of World Bank Group support (including loans, credits, equity, guarantees and grants) for regional activities is geared towards transport, information and communications technology, and energy, with less than 10 per cent for agriculture. The World Bank regional programme geared toward International Development Association (IDA) countries has supported only 11 operations in the past 14 years.

Examples of areas for IFAD regional lending operations

IFAD will undertake an extensive consultation process to identify possible candidates for IFAD pilot RLOs. Example of the type of activity that could potentially benefit from support include: Based on past demand for single-country operations and the identification of cross-border development challenges that could be addressed with its support. IFAD expects demand for RLOs in the following areas:

- Managing issues around pests and diseases related to crops and livestock, the incidence of which is expected to shift as an effect of climate change particularly in trade corridors.
- Managing natural resources and disasters such as drought in countries that share common landscapes with fluid borders and communities.
- Strengthening resilience and coordinating emergency response to extreme weather events disaster risk management through preventative measures and establishing early warning systems in a cost-efficient way between countries, e.g. among SIDS.
- Managing significant cross-border livestock trade (e.g. Southeast Asia, East Africa, Western African pastoral systems), and the transhumance across various parts of East Africa, the Horn of Africa and the Sahel.
- Managing fisheries resources that are shared across political boundaries, e.g. major inland African lakes.
- Multi-country investments in commodity chains (e.g. dairy products) and harmonization of trading policies for these commodities, e.g. in South Asia.

31. Early indications relative to IFAD pilot areas include the following:

- (a) Significant opportunities exist for a cross-border project involving several countries in South Asia. IFAD's main areas of investment would comprise cross-border trade of agricultural products and support to agricultural logistics. A regional operation could be used to strengthen the marketing focus of IFAD-supported operations in this region, especially to facilitate transport from one South Asian Association for Regional Cooperation (SAARC) country to another. This would not only reduce waiting time at borders, but would also harmonize quality criteria, facilitate the development of agri-logistics facilities and enable the processing of higher-value products based on regional market demand.
- (b) In the Caribbean, SIDS are particularly vulnerable to climate and economic shocks. Even those that have idle agricultural lands and high youth unemployment and migration rates are not exploiting their potential for production of fresh fruits and vegetables, and fisheries. As a result, most food is imported, resulting in low-quality diets and malnutrition. A programme focused on climate-smart agriculture and youth entrepreneurship in agricultural and fisheries value chains could: improve the attractiveness of rural jobs for youth using innovative technologies; retain youth in rural areas; improve the quality of local diets; and reduce food imports.
- (c) In addition, there are opportunities to strengthen the management of fishery resources in Africa's large inland lakes such as Lake Victoria and Lake Tanganyika. Proposals for regional operations, though grant-financed, have already been requested by the Lake Victoria Fisheries Management Organization, a specialized body of the East African Community.

32. From an efficiency perspective, RLOs will be particular especially relevant for countries with low PBAS allocations, as pooled resources and possible shared project management and coordination would could lead to lower administrative costs for the individual participating country. From an IFAD perspective there There would also be efficiency gains for IFAD since shared design processes and subsequent supervision would entail lower costs than for single country projects. Based on the above, the most likely countries to request regional operations in IFAD are countries vulnerable to depletion of natural resources and extreme

~~weather events that face regional challenges to ensure the productivity of smallholder farmers. Other groups are SIDS vulnerable to extreme weather events that have low PBAS allocations or middle-income countries with an interest to strengthen value chains across borders.~~

33. Management proposes to undertake an extensive consultation in order to identify possible candidates for the pilot RLO. This consultation will be facilitated by IFAD's enhanced field presence and undertaken in conjunction with discussions on PBAS programming, with a view to identifying one or more pilot operations by the end of 2018. Other IFIs have already created incentives – such as dedicated windows and funding in addition to PBAS allocations – for countries to tackle regional issues. This has eliminated the dilemma many countries face in choosing between regional and national priorities, and will need to be addressed by IFAD after the pilot phase.

VI. Work programme to be undertaken

34. Other IFIs such as the World Bank have developed approaches to regional operations over time, evolving their institution-specific approaches based on lessons learned. IFAD Management proposes a similar approach, with experiences gained through the pilot (based on provisional procedures) assessed to inform future operational guidelines. The proposed way forward is outlined below.
35. Pilot and learning phase. The IFAD11 period (2019-2021) would constitute a learning phase in which IFAD's current financial instruments are used to pilot a small number of regional operations (likely two). This number could expand depending on demand in subsequent years. The pilot RLO would be governed by interim procedures.
36. The current thinking on the interim procedures for regional lending operations is as follows:
- (a) Identification of pilot operations: In order to identify operations for the pilot phase, IFAD regional divisions would promote the RLO concept among borrowing countries as the programme of loans and grants for IFAD11 is being developed.
 - (b) Financing of RLOs: RLO pilots in IFAD11 would be financed through IFAD's current financial instruments, particularly the following:
 - (i) The PBAS allocation to each participating country in the RLO: participating countries could choose to include their full country allocation or a partial allocation in the RLO.⁸ According to the financing terms of each country, PBAS allocations could consist of loan funds (for "green" and "yellow" countries), country-specific grants (for "green" countries only) or Debt Sustainability Framework grants (for "yellow" and "red" countries).⁹ For "green" countries, country-specific grants¹⁰ could be used to finance RLO-related activities such as incremental

⁸ Other IFIs offering RLOs operate with ceilings on the share of performance-based allocations that countries can use for regional operations. The shares range from 10 per cent at the AfDB to 20 per cent at the AsDB and World Bank. One rationale for these ceilings is to ensure that funds are also available for national priorities, especially in countries with small allocations. However, other IFIs have larger performance-based allocations and usually finance several projects in one country. In this case, it is reasonable to set a ceiling since a diversified project portfolio is a good risk-management measure. Since IFAD offers smaller PBAS allocations, it would not be efficient to set ceilings for IFAD11 RLO pilots as they might become too small. This issue may be reconsidered if a window with additional financing for RLOs is introduced in IFAD12.

⁹ Financing terms of each country are governed by the Policies and Criteria for IFAD Financing, and Proposed Arrangements for Implementation of a Debt Sustainability Framework at IFAD (EB/2007/90/R.2).

¹⁰ Country-specific grants are included in countries' PBAS allocations and are equivalent to 1.5 per cent of IFAD's programme of loans and grants. Only "green" countries (countries not eligible for Debt Sustainability Framework grant financing terms) are eligible to receive this grant financing. Country-specific grants comprise: (i) loan-component grants (i.e. part of an investment project); or (ii) stand-alone grants. Both types of country-specific grants could be used to finance RLOs.

- regional coordination, South-South and Triangular Cooperation, cross-border knowledge management and other activities supporting countries' efforts towards regional integration.
- (ii) Regional grants: According to IFAD's Policy for Grant Financing, IFAD grants should: (i) make a significant contribution to a global, regional or national public good related to IFAD's mandate; (ii) focus on interventions in which grant financing has clear added value and a comparative advantage over regular loans; and (iii) not be used as a substitute for resources from IFAD's administrative budget. IFAD regional grants are subject to competitive approval processes and are implemented by third parties (i.e. non-governmental entities). It is proposed that regional grants be used to finance regional public goods that complement ongoing stand-alone IFAD loans to one or more countries. The grants would seek to explicitly address issues that the stand-alone national loans cannot and would be linked to IFAD's lending programme.
 - (iii) Additional cofinancing and partnerships: In line with IFAD's proposed cofinancing strategy, Management proposes to identify and seek out additional sources of financing to complement core resources in financing RLO pilot operations. This includes mobilizing additional resources to the second phase of its Adaptation for Smallholder Agriculture Programme and IFAD's partnerships with GEF and the Green Climate Fund. Management will learn from the approaches taken with GEF in order to address regional and trans-boundary environmental challenges, and achieve results.
- (c) Legal establishment: It is proposed that each participating country have a separate financing agreement with IFAD drawing on its PBAS allocation. Schedule 1 of the financing agreement – project description and implementation arrangements – would stipulate how the country-specific activities would fit into the larger regional project. Agreements for regional grants would include clear language detailing how regional activities will be coordinated with national actors during RLO implementation.
 - (d) Lending terms: The applicable lending terms would be those of each borrowing country.
 - (e) Eligibility criteria: Clear criteria would be developed for regional operation eligibility. These criteria would tentatively include the following:
 - (i) Proposed regional operations must include details on how they will deliver specific development results in a more effective way than through a single-country operation.
 - (ii) IFAD11 RLO pilot operations would usually include two or more countries, with some flexibility for single-country operations with regional impact. This practice is in line with comparator organizations such as the AsDB and the AfDB, which require two or more countries (or one country with regional impact) to participate in a regional operation. The World Bank requires at least three countries to participate unless one of them is experiencing a fragile situation, in which case only two countries are required.
 - (iii) The focus of RLO pilot operations would be aligned with the strategic objectives of participating countries' country strategic opportunities programmes (COSOPs).

- (f) Synergies with IFAD's decentralized structure would be sought, taking advantage of the regional approach to country programme delivery embedded in that model.
- (g) Learning module: In pilot operations, attention would be paid to monitoring and evaluation, and learning, including adequate funding to learn from experience. Management will continue to learn from other IFIs as their structures and delivery mechanisms for regional operations evolve.
- (h) Approval: RLOs would be presented to the Executive Board for approval regardless of the amount to be financed. Ideally, all financing agreements would be presented to the Executive Board at the same time, although this is not a legal requirement. IFAD would coordinate with borrowing countries and grantees to ensure appropriate timing of loan and grant approvals.
37. In late 2019 or early 2020 (once some RLO pilot operations have been designed and implementation started), IFAD will assess the benefits and challenges of this approach in order to estimate further demand for RLOs among borrowing countries. Based on the findings of this assessment, Management will decide whether to pursue the development of an enhanced approach to RLOs and mainstream this approach into IFAD's service offerings.
38. Enhanced approach to regional lending operations. Subject to the findings of the assessment mentioned above, an enhanced approach to RLOs would be included in the Consultation on the Twelfth Replenishment of IFAD's Resources, which will begin in early 2020.
39. As with other IFIs, an enhanced approach would likely include a specific window for countries to access funds in addition to PBAS allocations for RLOs. IFAD's grant programme would be revisited at that time to assess whether regional grants should be enhanced or other grant sources mobilized to support RLOs. This enhanced approach would also identify the need for: specific policies or strategies related to RLOs; and legal and procedural changes for RLOs beyond the pilot phase.¹¹ COSOP guidelines may also be adjusted to capture the agenda for regional integration, which RLOs could help to further.
40. Work plan on RLOs in the context of the Transition Framework. Working Group members can expect the following information related to the Transition Framework at their next meetings:
- (a) Informal seminar on 11 September 2018: On this occasion, Management will present:
- (i) A summary of Management's current assessment of other IFIs' approaches to RLOs (apart from the issues mentioned above, which are mainly related to RLO design, the assessment will include information on implementation mechanisms); and
- (ii) An updated version of the approach for piloting RLOs in IFAD11.
- (b) Fifth Working Group meeting on the 29 October: Management will present the final Transition Framework for endorsement by the Working Group, including the approach for piloting RLOs in IFAD11 and next steps.
- (c) If members agree on the proposed approach to piloting RLOs in IFAD11, interim operational procedures will be finalized by early 2019 and pilot operations will be designed and launched during 2019 and 2020.

¹¹ According to the Agreement Establishing IFAD, the Fund can also provide loans to inter-governmental organizations in which IFAD Members participate. In this case, IFAD may require governmental or other guarantees. Financing through inter-governmental organizations is another approach for regional operations that will be explored in IFAD12, although this approach does not seem feasible for IFAD11 since the PBAS currently allocates funds to countries and not regional entities.

- (d) ~~As part of the work programme to develop its RLO mechanism, IFAD will need to tackle a number of design and financial issues. The institution will develop specific criteria for RLOs and explore how best to deploy a combination of loans and grants to support RLOs, as well as identify the sources of funding for these loans and grants. During the IFAD11 pilot phase, it is assumed that IFAD Member States will draw on their PBAS allocation to finance the loan portion of regional operations. This may mean that borrower countries will need to prioritize their available financing between a country and a regional programme. PBAS allocations may however be complemented with funding from established IFAD supplementary sources, such as GEF, and could potentially be combined with funding from other institutions (e.g. IFIs) as cofinancing to increase the scale of IFAD impact.~~
- (e) ~~In addition to loan financing, IFAD could use of a part of the global/regional grants window to support regional operations, particularly to finance regional public goods. IFAD currently finances a relatively small amount of regional activities, and does so through grants only, specifically through the 5 per cent of the overall programme of loans and grants allocated to global and regional grants. It is assumed that this level of financing available for regional grants will not be revised during IFAD11. Additionally, loan component grants could be used to finance the coordinating mechanism to implement the RLO.~~
- (f) ~~For IFAD11 the regional pilots will be a learning instrument to assess the viability to develop regional/multi-country strategies in IFAD12.~~
- (g) ~~As part of the work programme to develop IFAD's RLO mechanism, a number of legal issues will need to be addressed. The structuring of legal agreements will be key — e.g. whether they will take the form of individual financing agreements for each participating borrower, a common financing agreement for all participating borrowers, or a single financing agreement to a "lead borrower" with subsidiary agreements to other participants and with associated repercussions for debt servicing and coordination of the timing of disbursements. IFAD will need to review all relevant policies/procedures to determine how legal agreements for RLOs can be structured, and what will need to be amended in the current legal and/or policy framework to facilitate their introduction. Lending terms across multiple countries and of other potential borrowers would also need to be examined, as would flow of funds arrangements and financial reporting/audits. Once the policy framework for RLOs is complete, IFAD will develop a road map for any special supporting structures such as loan administration, billing, reporting or disclosure needed for RLOs.~~
- (h) ~~As part of the work programme to develop IFAD's RLO mechanism, pilots will be identified. IFAD will undertake a series of internal consultations, as well as discussions with Member State governments, to identify specific areas of activity and potential candidates for the RLO pilots to be launched during IFAD11. This could include region-by-region mapping of specific challenges and areas of intervention. A review of recipients of IFAD regional grants could be undertaken to draw lessons from past and current activities and identify potential areas for future support.~~
- (i) ~~Some implementation issues can be identified ex-ante, while others will likely emerge as the pilot phase progresses. IFAD will need to gear up to developing the capacity to carry out the policy dialogue needed to pave the way for RLOs, and deepen relationships with RLOs to facilitate coordination or even support the design and implementation of regional operations. Based on the experience of the pilots in IFAD11, guidelines and processes will be developed to be able to design and implement regional lending operations in a more structured manner in IFAD12 and beyond.~~

- (j) ~~The steps required to develop RLO pilots will include the work programme outlined above, including further review of IFI experience with RLOs; information gathering on relevant activities and countries for potential IFAD pilots; and design and legal issues as outlined above. It will also include consultations with the Board. Management will revert with an expanded concept note to be discussed at an informal seminar, scheduled for 11 September 2018. This will be followed by finalization of a draft concept note, including any needed policy revisions, in early 2019 for discussion with the Executive Board later that year. Pilots are expected to be launched during 2019 or 2020.~~

~~VII. Issues for discussion with the Working Group~~

~~The Working Group is invited to provide their views on the following aspects: Elements of the work programme to be undertaken by IFAD to design the RLO mechanism, including further review of IFI experience with RLOs; information gathering on relevant activities and countries for potential IFAD pilots; and design and legal issues as outlined above.~~

Key Parameters of Regional Lending Operations across IFIs

	Asian Development Bank	African Development Bank	World Bank	Inter-American Development Bank
Eligible entities	Developing Member Countries	Regional member countries	IDA member countries	<p>IDB member states can access additional lending for projects promoting regional integration</p> <p>Regional Public Goods Initiative finance grants to regional, national and private entities</p>
Eligible sectors	(i) cross-border infrastructure (hard and soft); (ii) trade and investment; (iii) monetary and financial cooperation and (iv) regional public goods	(i) regional infrastructure development; (ii) enhancement of industrialization and trade and (iii) strengthening country and regional mechanisms and institutional capacities	All sectors in which the Bank is active	Any area in which the Bank is active with specific requirements to promote regional integration or regional public goods
Financing instruments	Loans and grants under specific set-asides from both the ordinary (OCR) and the concessional (ADF) windows	African Development Fund country and multinational resources (concessional), African Development Bank resources (ordinary), Fragile States Facility, Private sector window	Grants, credits, loans under a Regional window and within the Scale-Up Facility	<p>Specific loan funds are set aside for regional integration</p> <p>Grants under a Regional window for regional public goods</p>

The Concept of Regional Public Goods

1. A good or service is defined as "public" when it satisfies the two criteria of being non-rival and non-excludable.¹²
 - (a) Benefits are non-rival when each individual's consumption of such a good leads to no subtraction from any other individual's consumption;
 - (b) Benefits are non-excludable when they are available to all would-be consumers once the good is supplied and it is infeasible to price units of a good in a way that prevents those who do not pay from enjoying its benefits.
2. These two properties of pure public goods give rise to market failures that may require either government provision or some form of cooperation among the benefit recipients. Non-exclusion results in a market failure because a provider cannot keep non-contributors from consuming the good's benefit (the free rider problem). Once the public good is provided, consumers have no incentive to contribute because their money can purchase other goods whose benefits are not freely available. Thus, the public good will be either undersupplied or not supplied. Benefit non-rivalry means that extending consumption to additional users results in a zero marginal cost. Exclusion based fees are inefficient because some potential users, who derive a positive gain, are denied access even though it costs society nothing to include them.

Figure 1
The nature of Public Goods



3. Pure regional public goods are those services or resources whose benefits are shared by countries in a region and that satisfy the two above-mentioned conditions (non-rivalry and non-excludability). For purely public regional public goods, intervention by a global institution, regional organization, or other collective is required for provision.

¹² The theory of public goods was first postulated by Paul Samuelson in "The Pure Theory of Public Expenditure", *The Review of Economics and Statistics*, Vol. 36, No. 4, November 1954.

Figure 2
Public Goods and their provision level



4. Regional efforts produce regional public goods (RPGs), and therefore are subject to the free-rider problem of financing public goods (and to market failures). Except for the largest countries, which have an incentive to supply themselves with these regional public goods, countries may seek to benefit from the investment of others.
5. The under provision of RPGs is related to the reluctance of countries to devote their national resources to supranational projects whose spill-overs are often not clearly identifiable, nor quantifiable. In many cases, in fact, the RPG itself does not generate direct revenues, but it only has an indirect positive influence. It is precisely here that a Regional or a Multilateral Development Bank (MDB) has a major opportunity to step in, since it can both coordinate as well as contribute to the financing of these essential regional capacities. To effectively exercise a leadership role, MDBs need to develop mechanisms for financing RPGs that do not depend solely on individual country borrowing decisions.¹³

Regional Public Goods in Agriculture

6. Apart from tradable commodities, such as food, fibre and fuel, agriculture also provides non-commodity outputs. The former production outputs are usually defined as the agricultural economic function. In contrast, the latter are referred to as environmental and social externalities of agriculture, which include agricultural landscapes, farmland biodiversity, water quality, water availability, soil functionality, climate stability (greenhouse gas emissions, carbon storage), food security, food safety, rural viability and farm animal welfare. Agricultural activities impact upon environmental functions, such as soil function, water purity, air quality, landscapes and biodiversity, resulting in either positive externalities (public goods) or negative externalities (public bad).¹⁴

¹³ Pingali, P. and Evenson, R., *Handbook of Agricultural Economics*, Vol. 4, North Holland, Elsevier 2010, p. 3582-3583.

¹⁴ Chen, Q., Sipiläinen, T. and Sumelius, J., "Assessment of Agri-Environmental Externalities at Regional Levels in Finland", *Sustainability*, n. 6, 2014.