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## Concept Note on Regional Lending Operations

### Note to Transition Framework Working Group members

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Working Group on the Transition Framework — First 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 operations
SIDS	small island developing states

# Concept Note on Regional Lending Operations

## 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, 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. 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 IFAD11, IFAD is proposing to leverage on existing legal and financial instruments and on current allocation mechanisms as further explained in paragraphs 13, and 29-32. This will provide sufficient time and experience to evaluate a separate allocation mechanism or set aside as available in all other IFIs. These considerations will be analysed in conjunction with the review of the PBAS ahead of IFAD12.

## Next steps

7. The following steps are foreseen as a lead up to the introduction of regional operations at IFAD:
  - Further review of IFI experience with regional operations will be conducted.
  - Approach to design and legal framework for regional operations will be defined.
  - Expanded concept note 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.
  - Pilots are expected to be launched during 2019 or 2020.

## I. Background

8. IFAD is increasing its engagement at the regional level, recognizing 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.
9. Many development challenges, such as pollution of cross-border rivers or sharing of transboundary aquifers, span country borders. And many goods and services – such as transport, disease prevention and natural resource and water basin management – are best provided at the regional level to tap economies of scale. Efforts to tackle these challenges and harness the opportunities can only be achieved through coordination and cooperation at the regional level. 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.
10. 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.
11. 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:
 

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.
12. 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.
13. As IFAD intends to pilot regional operations in IFAD11, these pilots will be designed leveraging the currently available financial instruments, i.e. loans through the performance-based allocation system (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 PBAS and finance policies to support regional lending operations for IFAD12 and beyond.

## II. Overview of regional lending operations

14. Regional lending operations (RLOs) 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 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.

15. 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 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.
  - (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.
16. 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.<sup>1</sup>
17. 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 alignment with the national priorities of participating countries. Ownership and alignment need to continue past the design stage and accompany 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

18. 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 ROs, including the World Bank (2003), Inter-

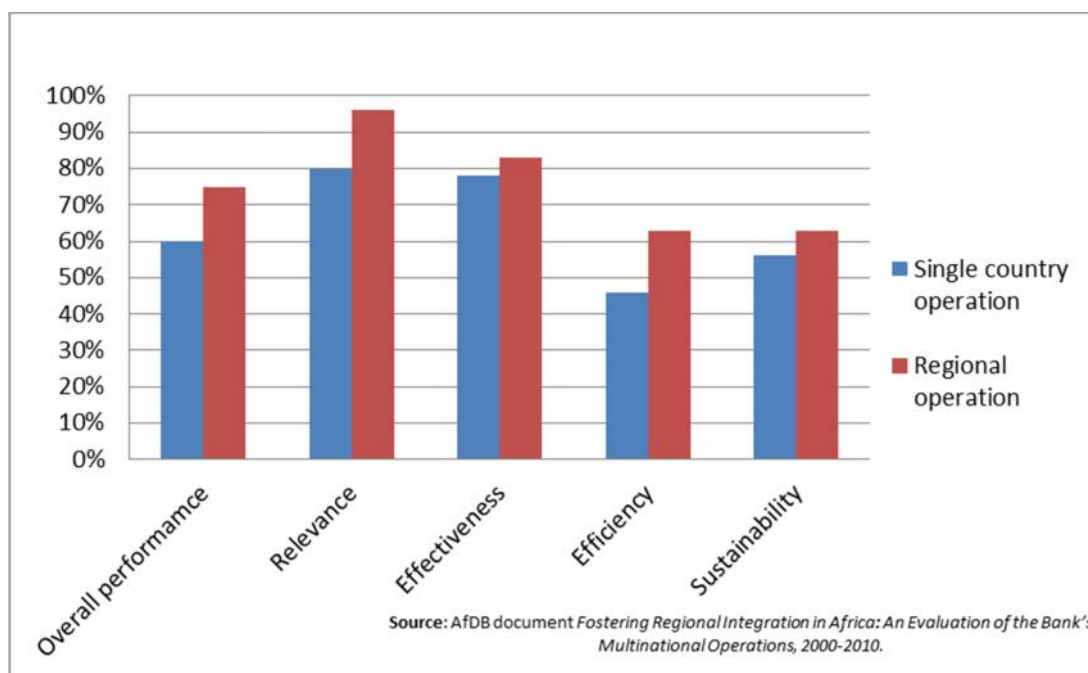
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<sup>1</sup> Sandler, T., "Regional public goods and international organizations", in *The Review of International Organizations*, March 2006, Volume 1, Issue 1, p. 5-25. <https://link.springer.com/article/10.1007/s11558-006-6604-2>.

American Development Bank (2004), Asian Development Bank (2006) and African Development Bank (2014).

19. 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.
20. 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.
21. Evaluations of the RLOs in other IFIs show that while requiring more coordination and attention during design and implementation, regional operations are often more successful and generate more plentiful benefits than single-country projects. Evidence to this effect can be found in independent evaluations conducted by the African Development Bank, among others.

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



22. 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. Additionally, an overview will be undertaken of the impact of the operations and how this impact is measured.

#### IV. Implementing regional operations in IFAD

23. Given IFAD's mandate and focus on agriculture and rural development, the regional lending operations undertaken by IFAD will have a similar focus. There are several examples of regional rural development projects in other IFIs, mainly the World Bank and AfDB,<sup>2</sup> though the majority of regional operations are in other sectors, such as finance and transport.
24. There are plenty of entry points for rural development projects with a regional scope. 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. 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, farmland biodiversity, air and water quality, water availability, soil functionality, climate stability (greenhouse gas emissions, carbon storage), food security, food safety, rural viability and farm animal welfare.
25. 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

<sup>2</sup> Around 7 per cent of the regional lending in the African Development Bank in 2000-2010 was to agricultural and rural development projects.

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.

26. Regional lending operations will enable IFAD to extend the reach of these regional activities, and to draw on experience. There are numerous activities within IFAD's areas of focus and its comparative advantage that could benefit from regional operations (see below).

#### Examples of areas for IFAD regional lending operations

IFAD will undertake an extensive consultation process to identify possible candidates for IFAD pilot RLOs. Examples of the type of activity that could potentially benefit from support include:

- 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 responses to extreme weather events 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.

27. RLOs will be of particular relevance for countries with low PBAS allocations, as shared project management and coordination would lead to lower administrative costs for the individual participating country. From an IFAD perspective there would also be efficiency gains, as shared design processes and subsequent supervision would entail lower costs than for single country projects.
28. 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.

## V. Work programme to be undertaken

29. 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.<sup>3</sup> 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.

30. 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.
31. For IFAD11 the regional pilots will be a learning instrument to assess the viability to develop regional/multi-country strategies in IFAD12.
32. 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.
33. 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.
34. 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.

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<sup>3</sup> This is why most IFIs have a separate window to finance RLOs, as a top-up of PBAS allocations to serve as a financial incentive. The amount financed can cover the whole RLO or cofinance a portion (e.g. two thirds) of a country's share of a regional project, with the remaining portion (e.g. one third) to be financed through the country allocation.

35. 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.

## VI. Issues for discussion with the Working Group

36. 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.<sup>4</sup>
  - (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 2

### 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.

<sup>4</sup> 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 3  
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.<sup>5</sup>

#### 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).<sup>6</sup>

<sup>5</sup> Pingali, P. and Evenson, R., *Handbook of Agricultural Economics*, Vol. 4, North Holland, Elsevier 2010, p. 3582-3583.

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