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THE WORLD BANK

World Bank Lending for Lines of Credit

An IEG Evaluation

INDEPENDENT EVALUATION GROUP

ENHANCING DEVELOPMENT EFFECTIVENESS THROUGH EXCELLENCE AND INDEPENDENCE IN EVALUATION

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Preface

This evaluation provides an independent assessment of lines of credit (LOC) financed by the World Bank during the period FY93–FY03. It is the first of a two-part evaluation looking at Bank support to the financial sector. The second part focuses on Bank support for financial sector reform.

This volume presents data on trends in lending for LOC and examines whether the design, supervision, and reporting on LOC followed the Bank's policies. The evaluation examines outcomes, analyzes factors associated with satisfactory outcomes, and draws conclusions based on the analysis; the evaluation also presents recommendations for the future.

The basis for this evaluation consists of a database developed by IEG on all LOC, a survey of the characteristics of a large sample of the projects at entry, during supervision, and at completion, plus information on cancellations and IEG project assessments. The methodology for the sample selection and survey instrument is described in appendix A. The evaluation also draws on a similar exercise carried out by the Consultative Group to Assist the Poor (CGAP) on microfinance LOC, the full results of which are in a separate report.

IEG's report was circulated to Regional Bank managers involved in LOC, the Financial Sector Board of the Bank, and the Financial Sector Operations & Policy Department (OPD). The Management Response is attached as appendix E. This evaluation was discussed at the Committee of Development Effectiveness (CODE) meeting held on October 13, 2004, and the Chairman's Summary is attached as appendix F.

Executive Summary

During the FY93–FY03 period, $13.4 billion were approved for lines of credit (LOC), representing 8.4 percent of total Bank commitments for investment lending. The trend in commitments has been sharply downward, however, continuing the trend that started in the mid-1980s.

Lending for LOC has decreased from about 10 percent of total Bank commitments in the early 1990s to well under 2 percent in FY02–FY03. Although LOC are embedded in projects in most sectors, the bulk of the LOC are in the rural and financial sectors and in municipal lending, and involve a wide range of designs, objectives, and arrangements.

Main Findings

Implementation of Bank guidelines for LOC has been poor:

- One-quarter of the LOC were approved in highly unstable macroeconomic conditions, but as macroeconomic stability has improved in recent years (since 1997), this is now less of an issue.
- Fewer than one-half of the projects used clear eligibility criteria to select the participating financial intermediaries for channeling Bank funds, and for a number of those that did, the criteria used were quite weak (75 to 85 percent loan repayment rates, for example).
- At appraisal, fewer than 40 percent of the LOC reported on the quality of the loan portfolio or other salient information about participating financial intermediaries, and the percentage drops further in supervision and completion reports.
- At completion, almost 40 percent of the LOC had no information on repayment rates of Bank-funded subloans.
- Of those LOC that could have an environmental impact, roughly one-third had no mention at appraisal of requiring environmental assessments on subprojects and of the closed LOC; only about one-half made any mention of environmental impact.
- Financial sector LOC did somewhat better than LOC in other sectors in implementing Bank guidelines.
- There was no difference between the earlier or later years in quality of the design of LOC.

Outcomes are poor. At 52 percent satisfactory by number of loans and 45 percent by net commitments, outcome ratings are unacceptably low. The best outcomes are for LOC under the rural sector (67 percent by number of loans), and the worst are for LOC under Private Sector

Development (10 percent by number of loans), although the availability of supporting evidence for these outcomes varies widely among the LOC.

Cancellation rates have been high, over 40 percent of original commitments, more than double the cancellation rates of other investment loans during this period. Smaller LOC tend to have lower cancellation rates. Information in completion reports and reports from Bank managers suggest that lending by other multilateral and bilateral donors may influence Bank disbursements on LOC, as other donors may have fewer conditions and requirements, and lower financial and transaction costs. Further analysis of this is needed.

Better outcomes for LOC are associated with: (i) stable macroeconomic conditions; (ii) stronger financial sectors, including satisfactory competition policies and good legal and regulatory regimes governing financial institutions, and mostly market determined interest rates, few distortionary credit and tax policies, and limited state ownership of financial institutions; (iii) use of clear eligibility criteria in the selection of participating financial institutions, and (iv) use of only private sector financial intermediaries. In addition, smaller LOC are associated with lower cancellation rates.

In spite of the downward trend in Bank lending for LOC, they are unlikely to disappear. Demand from client governments remains strong (even if their financial institutions do not always want to make timely use of them), and a recent internal Bank report on enhancing support to middle-income countries recommends making greater use of lending for infrastructure through LOC to subnational level governments (mainly municipalities). LOC are likely to continue to be used as a lending instrument. The findings from IEG's review can be used to improve the quality of design and outcomes.

Recommendations

- Guidelines for LOC should be updated to ensure that all LOC components and projects, as defined in this review, regardless of type or purpose, follow the guidelines and reflect recent developments in financial instruments and risk management techniques (particularly with respect to foreign exchange risk). Mechanisms should be established to ensure that the updated guidelines are followed. In addition, now that the Private Sector Development Strategy proposes to give the International Finance Corporation (IFC) the right of first refusal for LOC, there is an inconsistency between the operational policy regarding LOC and the new proposal, which should be addressed.
- All LOC components should be systematically identified in all Bank-funded projects as part of the basic information on the project, and the LOC guidelines should apply to all LOC components and projects, as this analysis has shown that LOC that do follow current guidelines have better outcomes. If the costs of applying the guidelines appear to outweigh the benefits, given the scope of the LOC, then the LOC is not the appropriate instrument for meeting the objectives of the component. In particular, conditions for better LOC outcomes include: (i) a stable macroeconomic framework (inflation at less than 30 percent and declining); (ii) strong financial sectors (stable, competitive, well-regulated); (iii) use of quantified eligibility criteria for selecting financial intermediaries (preferably private sector, if possible), accompanied by (iv) sound analysis by the Bank, as well as reasonably reliable data on financial performance and portfolio quality from the intermediaries and an external audit to verify the data; (v) better efforts to measure subsidies and to discuss their magnitude and the policies underlying them with the government; (vi) a minimum set of key indicators established during appraisal and monitored during supervision, including a measure of the quality of the loan portfolio, with clear definitions, and other key ratios (such as capital adequacy) established by the prudential norms in the country.
- Conservative estimates of the demand for funds and sizing the LOC to be a modest fraction of that demand can help reduce the probability of poor disbursements and the need for large cancellations.

- Bank management needs to engage with other multilateral development banks and major donors to assess the extent to which there are differences in guidelines and to work toward harmonizing them, to the extent practical. Internal country aid should focus on better coordination in practice.
- The Quality Assurance Group should use Bank guidelines in its quality-at-entry reviews and its ratings should reflect the extent to which the guidelines are observed.
- The Financial Sector Network should ensure better quality enhancement than in the past during the appraisal process. All Regions should adopt a practice of having their financial sector staff review LOC components.
- For projects that have significant LOC (at least 30 percent of the loan/credit amount), information on basic key indicators such as repayment rates, portfolio quality, and some measure of the subsidies involved should be provided in Implementation Completion Reports (ICRs). In the absence of such indicators, the outcomes of these loans cannot be adequately evaluated and would be considered unsatisfactory.
- Given that the IFC has largely taken over the role within the World Bank Group of investing in financial intermediaries, an evaluation of the IFC's portfolio of LOC that are not covered under the ongoing review of IFC Assistance to Small and Medium Enterprises would be beneficial.

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Director-General
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ACRONYMS AND ABBREVIATIONS

AFR	Africa Region
BP	Bank Procedure
CGAP	Consultative Group to Assist the Poor
EAP	East Asia and Pacific Region
ECA	Europe and Central Asia Region
FI	Financial institution
FIL	Financial Intermediary Loan
FSB	Financial Sector Board
ICR	Implementation Completion Report
IDP	Institutional Development Plan
IEG	Independent Evaluation Group (formerly OED)
IFC	International Finance Corporation
LAC	Latin America and Caribbean Region
LOC	Lines of credit
MDB	Multilateral development bank
MNA	Middle East and North Africa Region
OD	Operational Directive
OED	Operations Evaluation Department (changed to IEG)
OP	Operational Policy
PFI	Participating financial intermediary
PSD	Private Sector Development
QAG	Quality Assurance Group
QER	Quality Enhancement Review
OPD	Financial Sector Operations and Policy Department
SAR	South Asia Region
SDI	Subsidy Dependence Index
SME	Small and medium-size enterprise
TA	Technical assistance

Introduction

Lines of credit (LOC) are funds that are passed through financial intermediaries and require repayment by the ultimate users of the funds. They have a long and contentious history within the World Bank.

Although they have been used since the 1950s, mention LOC within the Bank and immediately a debate ensues about whether they are good instruments for overcoming market failures, reaching the underserved private sector, and promoting growth and employment, or whether they are terrible instruments that introduce distortions, are unsustainable, and crowd out private sector intermediaries. The debate has been driven partly by ideology, partly by selective reviews, and by anecdotes and experience. Although the Bank and IEG have looked at sector-specific lines of credit or selected aspects of lines of credit,[1] to date, no comprehensive evaluation has been done of the Bank's experience with LOC in all sectors and for all types of projects. During the FY93–FY03 period, about $13.4 billion were committed by the Bank for LOC, representing over 8 percent of total Bank commitments for investment lending.

This review is the first comprehensive evaluation of all Bank-funded LOC. It is the first of a two-part IEG evaluation that also examines Bank support for financial sector reform, published as a separate report. The evaluation was motivated not only by the ongoing debate within the Bank on the usefulness of LOC, but also by perceptions within the Bank that demand by clients for LOC remains strong. Combined with renewed emphasis on using LOC in the context of support to middle-income countries, there may be a new surge of lending for LOC, making it thus both timely and relevant.

This LOC review has several objectives. The first is to show trends in Bank lending for LOC during the past decade. The conventional wisdom in the Bank has been that the strict guidelines for LOC issued in 1992 drove the LOC "underground"; that is, the Bank was continuing to lend for LOC, but they were "hidden" in other projects and were, therefore, invisible. This review presents Bank lending for all LOC since FY93, including LOC that are formally labeled as Financial Intermediary Loans (FILs) as well as *all other* LOC: in Private Sector Development (PSD) projects, rural sector, social funds, energy projects, water supply and sanitation, housing, other municipal infrastructure, environment, education, and health projects. Because of the absence of a reliable database or clear identification of LOC in Bank documents, this was not an easy task.

LOC have a long and contentious history within the World Bank.

The second objective is to establish the extent to which Bank guidelines and strategy on lending for LOC are consistent with the literature on access to credit, and the extent to which the lending has been consistent with the guidelines. The third objective is to examine outcomes related to the original objectives of LOC, and to review the evidence supporting the outcome ratings. The review also looks for factors associated with satisfactory outcomes in order to draw lessons for the future.

The review is organized as follows: chapter 2 reviews the theoretical and empirical literature regarding the existence of constraints on access to credit, particularly for smaller enterprises. Bank guidelines for LOC from 1992 and the policy statement that replaced them in 1998 are presented, and the extent to which the guidelines are consistent with the literature is examined. The literature and Bank guidelines, together, serve as the benchmarks against which to the Bank's LOC are compared. Chapter 3 presents trends since FY93 in Bank lending for "regular" LOC and microfinance LOC, by sector and by Region, and compares these trends to those of other multilateral development banks (MDBs). Chapter 4 examines the quality-at-entry of the LOC, the extent to which their designs met Bank guidelines and whether they were designed with a view to sustainability; conclusions are drawn about how the LOC compare with the benchmarks established in chapter 2. Chapter 5 analyzes outcomes of closed projects and factors related to satisfactory outcomes. Chapter 6 summarizes the findings and presents recommendations for the future.

Literature Review and Bank Guidelines

Theoretical and Empirical Literature

For financial markets, there is a wealth of both theoretical and empirical literature that establishes the importance of economic stability for financial sector development; the preeminence of competitive market forces to establish interest rates and allocate credit; the critical role of supporting infrastructure (regulatory, supervisory, legal, accounting, and auditing systems); and the need for well-governed and well-managed financial institutions.[1]

Beginning with the seminal article by Stiglitz and Weiss (1981), another body of theoretical literature has established the existence of market imperfections and credit shortages, even when all of the above elements are in place.[2]The empirical literature on developing countries, summarized in an IEG background paper (Gine 2003), finds some evidence of credit constraints, particularly for small and medium enterprises (SME) and microenterprises. As noted below, the Bank has often justified its support for LOC, either explicitly or implicitly, by the existence of these market imperfections and credit constraints, which the Bank support is designed to try to overcome. Whether LOC are the appropriate response to these credit shortages (a rational response to market imperfections) is open to debate.

Many articles have established links between financial sector development and growth rates. In terms of the economic benefits of targeting credit to SME firms, the literature is more ambiguous. There is evidence of an association between the size of the SME sector and economic growth, but it is not clear if it is a causal one (Beck, Dermirguc-Kunt, and Levine 2003). Other writings assert that increasing access to *microfinance* is welfare enhancing, but attempts to measure the impact on the beneficiaries of access to microfinance are fraught with difficulties; most studies suffer from selection biases (i.e., the absence of a well-defined control group) and thus a possible overestimation of results (IEG, Gine 2003).

Bank Approaches

As early as the 1950s, the Bank based its support for LOC on the presumption that market imperfections existed, and that Bank lending could help overcome constraints on access to credit, in particular, to foreign exchange. It was only in the 1980s that the Bank began to question whether the instrument was being used under the right circumstances and to good

effect.[3] By the late 1980s, consensus was building among the Bank's specialists that LOC should be put in place only in countries that met certain preconditions—such as macroeconomic stability and sound financial sector prudential regulation and strong supervision—and only at unsubsidized interest rates, to financial intermediaries that met minimum eligibility criteria. These views were formalized in 1992 in Operational Directive (OD) 8.30, which covered investment as well as adjustment lending in finance.

OD 8.30 detailed stringent minimum conditions for allowing financial intermediaries to participate in LOC.

Guidelines

OD 8.30 provided, for the first time, a formal set of guidelines, instructions, and prerequisites for LOC. It covered country, sectoral, and institutional preconditions, and specified the kind of analysis, and the source of the information for the analysis, that Bank staff should carry out. The directive was long (50 pages) and detailed, and included nine appendixes, with sample formats for analyzing capital adequacy, arrears, collection ratios, and debt service and interest cover ratios. It was (and remains) unusual among Bank directives in its scope and detail.[4]

The extensive detail in OD 8.30 on stringent minimum conditions for allowing financial intermediaries to participate in LOC was based on more than two decades of poor experiences with badly governed, managed, and performing financial intermediaries. With respect to market failures, the OD acknowledged that directed credit and subsidies could try to overcome them, but argued that these measures might, instead, add to market distortions. The directive stipulated that the Bank was to analyze and document the importance of the LOC, and wherever they were important, the Bank should try to have them phased out.

The 1998 OP retains the spirit of the 1992 OD, without the detail, but with additional focus on safeguards, particularly environmental.

Although OD 8.30 has been criticized for its emphasis on interest rate issues and lack of guidance on sequencing reforms, it adhered closely to theoretical and empirical literature. Many Bank staff criticized the directive at the time for adhering too closely to classical theory, not taking into account the pervasiveness of market failures or the realities of working in client countries, and requiring analysis that was far too onerous for both Bank staff and borrowers.

In an effort to simplify Bank guidelines in general and OD 8.30 in particular, the directive was replaced in July 1998 by a four-page Operational Policy (OP) 8.30 (appendix D), including a one-page appendix on Bank Procedure (BP), which applies only to financial intermediary lending or LOC. Adjustment and technical assistance (TA) are no longer addressed.

The 1998 OP retains the spirit of the 1992 OD, without the detail, but with additional focus on safeguards, particularly environmental. The OP also requires that the incidence of subsidies by participating financial institutions be measured. Audited financial statements of the participating financial institutions were to be reviewed by the Bank at least once a year and their findings recorded in supervision reports. OP 8.30 established five stringent conditions under which the Bank could support subsidies. BP 8.30 indicated that another note would be forthcoming to provide guidance on many of the elements in the OP, but to date no such note has been produced.

The 1998 OP lists operations which are *not* subject to the policy: LOC where the intermediary does not assume credit risk; emergency recovery operations; pilot programs; and operations in social sectors that do not aim to support sustainable institutions or programs. Given that supporting sustainable development is at the heart of the Bank's work, these exclusions are somewhat surprising. At the same time, however, the BP recommends that for nonfinancial LOC, the Region should consult with the Financial Sector Board (FSB) and says on the basis of that consultation, the project concept review meeting should decide whether the OP/BP will apply to the LOC component. It is unclear on what basis a decision would be

taken to exempt a credit component from the Bank's policies on LOC. In any case, there is no evidence that any such process involving the FSB has been used systematically.

In sum, both the Bank's guidelines and more recent policy are consistent with the literature. This review explores the extent to which LOC have followed these guidelines in chapter 4.

Are Lines of Credit an Instrument of the Past?

Overview

For the purposes of identifying trends and patterns in Bank lending for LOC, IEG defined a line of credit as funds that are passed through an intermediary bearing the credit risk for demand-driven purposes, and where the final end user has to repay the loan, usually with interest.[1] Because no system exists for systematically identifying LOC in Bank projects, IEG developed a database by examining Bank documents of loans and credits approved in FY93–FY03 (box 3.1).

In most projects, LOC comprised at least 75 percent of the original commitment.[2] In this chapter, trends in lending for all types of LOC are explored, including microfinance.[3]

During the period FY93–FY03, a total of $13.4 billion were committed for LOC (representing 8.4 percent of total Bank investment lending), of which $11.7 billion were for regular LOC and $1.7 billion were for microfinance LOC. The number of LOC in the financial sector comprised only about one-fifth of total LOC (table 3.1). The rural sector accounted for the largest share of all LOC, at 31 percent. The dominance of LOC in sectors other than finance persists in the analysis across time and for all Regions. In terms of commitments, the picture changes slightly, although the rural sector remains dominant. (For details, see appendix B and the IEG background paper by Jacob Yaron, 2003).

Box 3.1: Identifying LOC

In the absence of a reliable database for all LOC, OED examined appraisal and completion reports for over 2,000 loans and credits (and found over 200 LOC). Other than projects specifically classified as financial intermediation loans, it was not always clear whether LOC were embedded in project designs. Some appraisal reports mentioned that a component would be passed on to beneficiaries as subloans to be repaid, but provided no other detail. In other cases, it was difficult to know if the subloans were being financed by the Bank loan or credit and if so, the amount. For example, China presented special challenges, as virtually all Bank lending is passed on to provinces, municipalities, state agencies, and other institutions in the form of subloans. IEG also compared its database with other databases on LOC within the Bank and IFC to ensure completeness.

Table 3.1: LOC Sectoral Distribution, by Number of Operations, FY93–FY03

Sector	Percent of all LOC	Percent of regular LOC	Percent of microfinance LOC
Rural	31.4	26.4	42.5
Finance	16.9	20.2	9.6
Urban	14.0	19.0	2.7
Private Sector Development	9.7	11.7	5.5
Social Protection	9.7	3.1	24.7
Energy	4.7	4.3	5.5
Environment	3.8	4.3	2.7
Water and Sanitation	3.0	3.7	1.4
Other[a]	6.8	7.4	5.5
Total	100	100	100

a. Includes the public sector; transportation; economic policy;education; and health, nutrition, and population sectors.

Trends in Lending

Bank-wide Patterns

The total number of loans and amount of funding for all LOC, taken together, decreased markedly between FY93 and FY03 (figure 3.1); during the last five years of the review period there were very few LOC operations approved by the Bank. As a percentage of total Bank commitments, the drop was equally dramatic: from a peak of 12 percent of total commitments in FY95, LOC accounted for under 2 percent of annual commitments in FY02–FY03 (appendix B, figure B.1). This pattern was not the result of a switch to adjustment or TA lending to the financial sector, which increased during this period, but not by as much as LOC decreased. In addition, this declining pattern is seen across all sectors and all Regions (appendix B, figures B.1–B.3). As noted in chapter 1, the rationale for evaluating the LOC instrument, in spite of the sharp decline in its use, is the likelihood that LOC will reemerge in terms of numbers and commitments in the future. In addition, there are several relatively large LOC in the queue for approval. In fact, in FY04 and FY05, more LOC in both number and amount were approved. An internal Bank paper on actions to enhance Bank support to middle-income countries suggests greater use of LOC, particularly for municipal infrastructure lending.

During the last five years of the review period there were very few LOC operations approved by the Bank.

During this same period, microfinance LOC were more or less steady in terms of overall commitments and increased slightly in number. As a result, microfinance lending has become a substantial part of both the number and amounts of Bank lending for LOC. This may be partly the result of the increased focus on poverty alleviation and the growing perception that microfinance might be an effective and efficient tool for fighting poverty.

The sharp drop in lending for LOC (excluding microfinance) is due to both a decline in their number as well as a large decrease in their average size, as shown in figure 3.2. This trend may be due in part to an attempt to avoid slow disbursements and cancellations, which characterized earlier experiences with LOC. The data show that cancellations of LOC commitment amounts have indeed been problematic during the past decade (discussed in chapter 5), and Bank staff and managers may have sought to reduce the risks of slow disbursements, which show up in portfolio performance measures, by reducing the average LOC commitments over time. This is an appropriate response: it not only helps portfolio performance but, more importantly, it helps the client country avoid unnecessary commitment fees.

Figure 3.1: LOC Commitments and Number of Projects

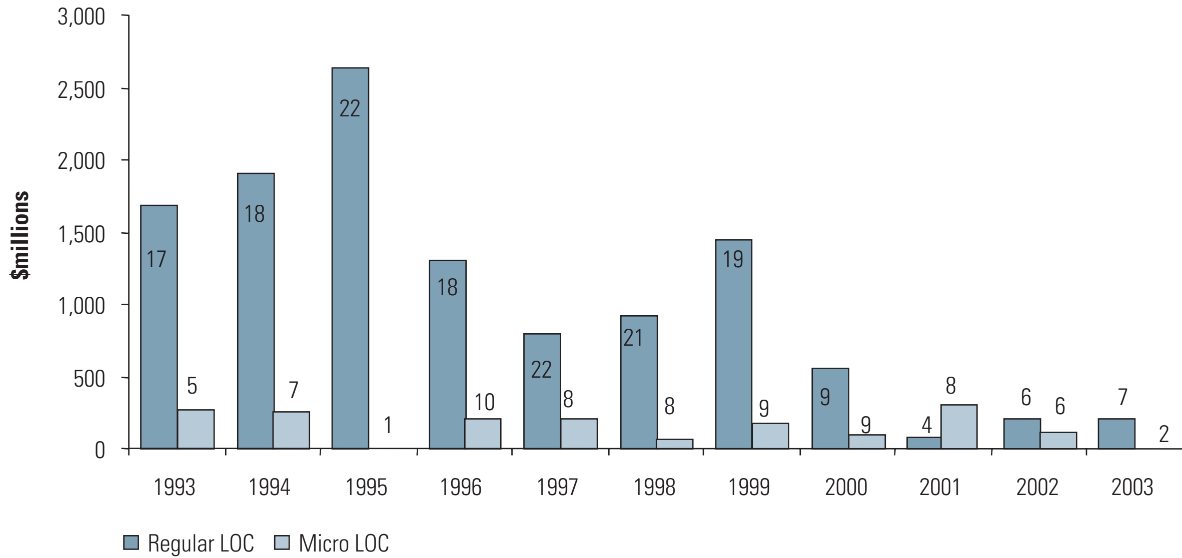
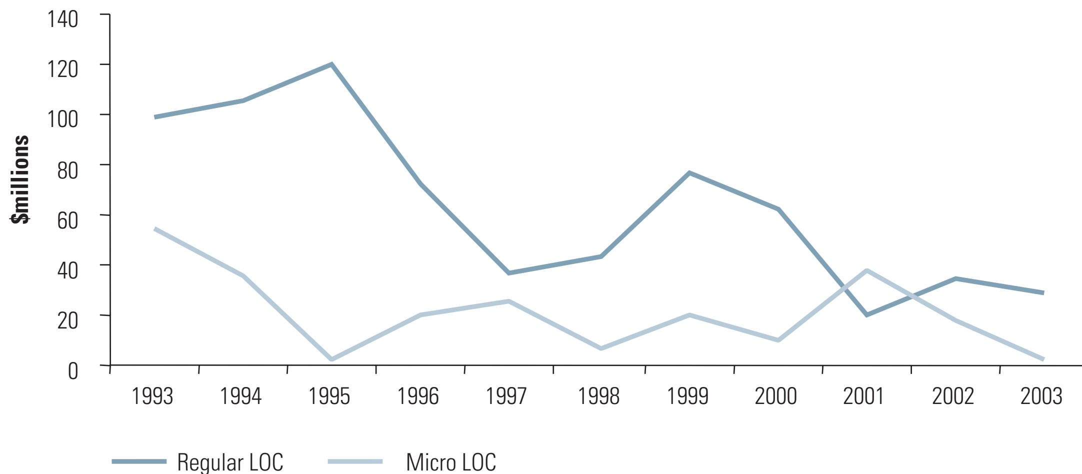


Figure 3.2: Average Size of LOC, FY93–FY03



Regional and Sectoral Patterns

Between FY93 and FY03, most Regions showed sharp decreases in commitments for regular LOC (not including microfinance LOC), except for the Africa Region (AFR), which had a low level of LOC lending throughout the period (see table 3.2 and appendix B for details). In contrast, commitments in East Asia and Pacific (EAP) averaged over $500 million per year in FY93–FY95, dropping to under $60 million per year in FY01–FY03. The Europe and Central Asia (ECA) Region led the Bank with the highest number of operations during the period, while cumulative commitments were highest for the Middle East and North Africa (MNA) Region, driven by several large LOC. In all Regions

Table 3.2: Commitments for Regular LOC, by Region, FY93–FY03

	Number of LOC operations	Cumulative amount committed US$ million	As percent of Region's lending
Africa	14	229.4	1
East Asia and Pacific	38	3,193.7	6
Europe and Central Asia	55	2,339.8	5
Latin America and the Caribbean	24	2,718.6	5
Middle East and North Africa	17	1,198.0	10
South Asia	15	2,064.0	6
Total	**163**	**11,743.5**	

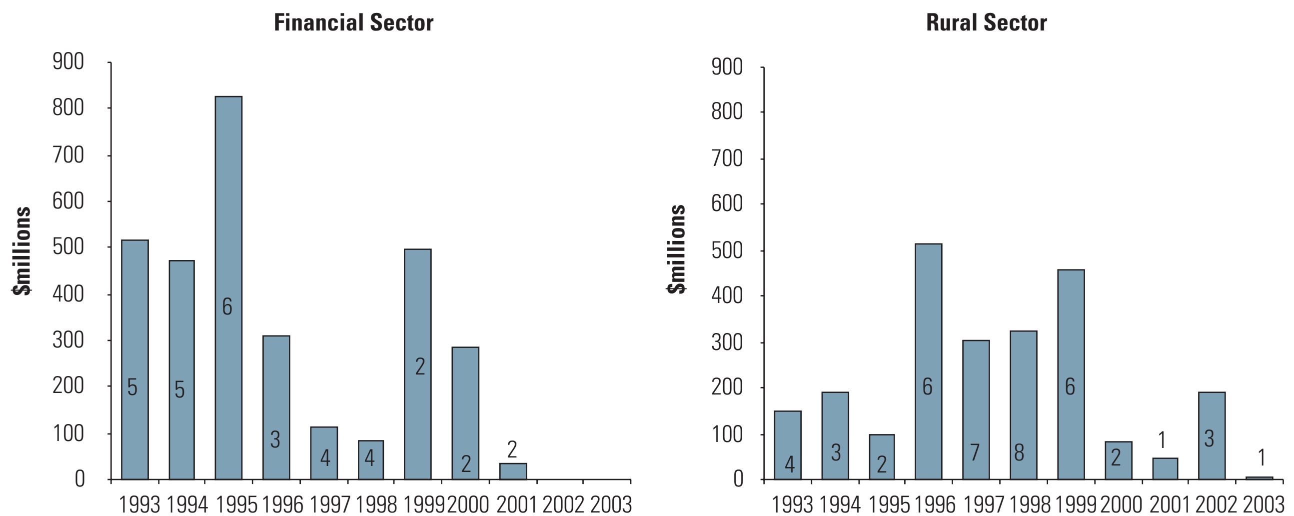
combined, LOCs account for a modest proportion of total lending commitments, between 5 and 10 percent, except AFR, at 1 percent.

Among the sectors accounting for the bulk (three-quarters) of the regular, nonmicrofinance LOC—rural, financial, Private Sector Development, and urban—the trends are similar (figure 3.3 and appendix B, figure B.3).[4] The occasional spikes in commitments were due to one or two large loans in a given year. Contrary to a perception in the Bank that the sharp drop in financial sector LOC started with the issuance in 1992 of OD 8.30, the trend had started in the 1980s, owing to widespread dissatisfaction with LOC and the realization that they were not performing as expected. In the FY84–FY88 period, for example, the Bank lent an average $2.6 billion per year in financial sector LOC; in FY89–FY93, that average had already dropped to $1.6 billion, before the 1992 directive became effective. In the five-year period, FY99–FY03, the annual average commitment for financial sector LOC was below $0.2 billion. Rural LOC followed a similar pattern, peaking in FY83–FY89 at about $1 billion per year and dropping thereafter, also well before the 1992 directive.

Lending to Financial Institutions by Other Agencies

Is the decrease in Bank lending for LOC a reflec-

Figure 3.3: Trends in Regular LOC, by Number of Operations and Amounts



tion of the trend in overall World Bank Group support to financial intermediaries, or has the IFC maintained or increased its presence in this area through net investments to banks and other lending institutions? Is the downward trend of the Bank's lending mirrored in the trends of other MDBs?

The IFC's lending for credit lines grew during FY93–FY03, as shown in figure 3.4.[5] Combined with the decrease in Bank lending, the IFC's credit lines in FY03 were more than twice the level of the Bank's, in contrast to the beginning of the period, when the IFC's were a small fraction of the Bank's commitments. This may partly be a result of the 1997 Strategic Compact, when the Bank emphasized a better division of responsibilities between the Bank and the IFC with respect to financial sector development work, a division formalized further in 1998 in OP/BP 8.30.

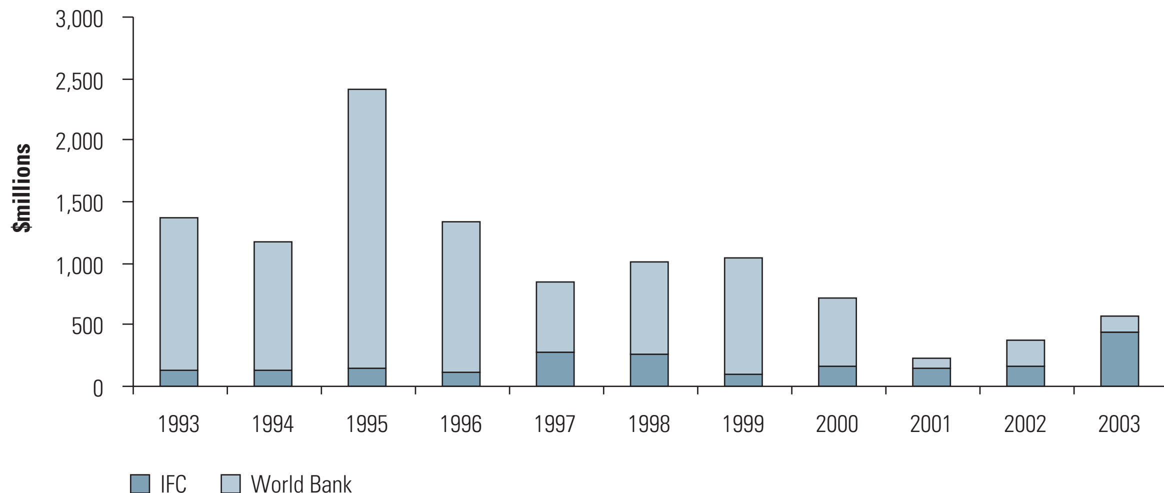
In 2001, a financial sector strategy proposed that the IFC take the lead role in developing viable financial institutions. In 2002, a PSD strategy was even more explicit in proposing that the IFC have the right of first refusal of any LOC, and that the FSB should amend the OP and monitor its implementation. Although the trend here would suggest that the IFC has de facto taken on a larger role in LOC, the Bank's 1998 OP has not been updated to reflect the more explicit role for the IFC, and no formal mechanism has been set up to make sure that its role is recognized across all sectors.

Figure 3.5 presents lending for LOC from other MDBs.[6] Because other MDBs may also have "hidden" LOC, however, these figures may understate total funding. Nevertheless, it is clear that other MDBs have slightly increased their LOC lending during the review period. As a result, they have become increasingly important sources of funding for LOC, particularly in the AFR, LAC, and MNA Regions (appendix B, figure B.5). These figures do not include funding from bilateral sources, which in some countries is also quite significant.

Most of the Regions suggested that other MDB lending for LOC is more attractive than the Bank's LOC lending, by virtue of having fewer conditions, lower fiduciary requirements, fewer safeguard issues, less prior review of subloans, lower financial costs, and allowing onlending at below-market interest rates. In light of the evidence presented later in this review on cancellations and outcomes of Bank-funded LOC, it is important to understand whether

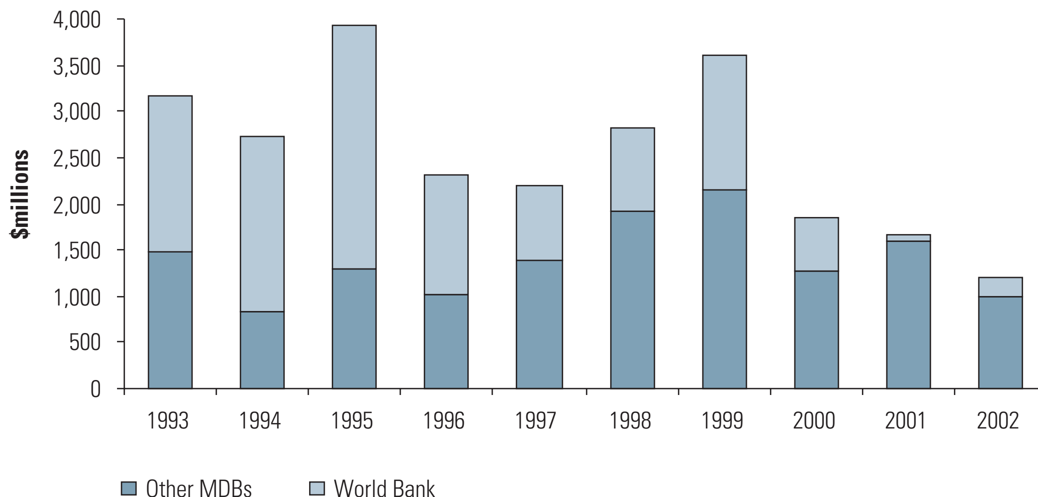
Most of the Regions suggested that other MDB lending for LOC is more attractive than the Bank's LOC lending.

Figure 3.4: World Bank and IFC-Lending for LOC



Source: Operations Evaluation Group, IFC.

Figure 3.5: World Bank and Other MDBs, Lending for LOC



other MDBs have similar guidelines to those of the Bank for LOC lending, whether the guidelines are followed in fact, and how the overall transaction costs for the borrowers of other MDB lending for LOC compare with those for Bank-financed LOC. Further research by the Bank on this issue is warranted.

Conclusions on Trends

With the exception of microfinance LOC, the Bank's use of LOC declined sharply during the FY93–FY03 period to become virtually negligible in FY02 and FY03. This pattern holds, in varying degrees, for all Regions and all sectors. An explicit proposal in the 1997 World Bank Group's Strategic Compact to cede the use of this instrument to the IFC cannot fully account for the virtual disappearance of an instrument that accounted for more than 10 percent of total Bank commitments only a decade earlier. The decline cannot be explained by increased use of other instruments to address financial sector issues because neither financial sector adjustment loans nor TA operations increased dramatically during this period. According to Bank staff, the demand for LOC from client countries, or at least the governments, if not financial institutions, remains strong. The availability of resources from the private sector as well as other MDBs and bilateral donors may be influencing the Bank's move away from LOC. Moreover, Bank staff and managers may be shunning this instrument because of perceptions of the difficulties associated with using them—adhering to Bank guidelines, responding to critics within the Bank, competing with other donors—and the mediocre to poor outcomes achieved (discussed in chapter 5).

Bank staff and managers may be shunning this instrument because of perceptions of the difficulties associated with using them and the mediocre to poor outcomes achieved.

In contrast to the trend in regular LOC, lending for microfinance LOC remained fairly steady in terms of commitments, possibly owing to the emphasis on targeting poverty and more participatory approaches to poverty alleviation. The reasons why the trend did not increase more sharply during FY93–FY03 may be related to perceived difficulties in implementing microfinance LOC well.

LOC: Are Bank Guidelines Being Followed?

Methodology and Hypotheses

This chapter presents an assessment of the quality of LOC designs and the extent to which the Bank has followed its guidelines for appraisal, supervision, and completion.[1] The next chapter examines whether adherence to the specific guidelines reviewed here is associated with better outcomes.

IEG carried out a desk review of a large sample of LOCs approved during the period.[2] The review covered all closed projects at the time of the review and a randomly selected sample of active projects, for a total sample of 121 LOC, representing about three-quarters of the number of LOC and 81 percent of total commitments (table 4.1).[3] As explained in box 4.1, the Consultative Group to Assist the Poor (CGAP) carried out a similar exercise on microfinance LOCs, and the preliminary results of their review are presented below.

Table 4.1: LOC Approved and Sample Coverage, FY93–FY02[a]

	Number of LOC	Commitments (US$m)	Percent of commitments
Total LOC	156	11,538	100
Closed	68	5,260	46
Active	88	6,278	54
Sample	121	9,312	81 of total
Closed	68	5,260	100 of closed
Active	53	4,052	65 of active

a. Excludes microfinance; information from FY03, at the time of the IEG review.

IEG used a structured set of questions to develop a database on the sample. The set of questions and the LOC included in the desk review are shown in appendix A, tables A.1 and A.2, respectively. The questions covered the issues incorporated in the Bank's 1992 guidelines and 1998 policy and were designed to test two hypotheses, that

(i) results were different for financial sector LOC than for LOC in other sectors,[4] and
(ii) results were different (better) for LOC approved during the more recent five-year period.

The first hypothesis was based on the assumption that financial sector LOC were formally subject to the Bank's guidelines in a way the nonfinancial sector LOC were not and, therefore, may have gone through more rigorous reviews. Moreover, reliance on eligibility criteria would have been less relevant, to the extent that LOC in other sectors were narrowly targeted to specific end uses (e.g., irrigation equipment, low-income housing), and given that only one specialized

Box 4.1: CGAP Analysis of Microfinance LOC

CGAP is a global program, which was established to support microfinance. Although it cannot be considered altogether unbiased, CGAP conducted a separate analysis of microfinance LOC. Using IEG's questionnaire, CGAP added two elements relevant for microfinance—outreach (number of clients) and the poverty levels of clients—and coordinated with IEG during its analysis. Although its findings are reported in a somewhat different format (e.g., using an information index and combining subjects which are presented separately here), its approach in evaluating the quality of design is closely aligned with the method used in IEG. CGAP supplemented the document reviews with interviews of task managers, field visits on a subsample of projects, and an additional review by a panel of experts on the overall quality of project design. The results of CGAP's assessments were consistent across projects and similar to IEG's findings on regular LOC.

financial institution may have been available to serve as the financial intermediary.

The second hypothesis was based on the idea that Bank processes—Network and Regional quality control mechanisms and the influence of the Quality Assurance Group (QAG)—would improve quality in LOC over time. An alternative hypothesis would be that the stricter OD that governed LOCs in the first five years of the review might have resulted in better quality designs.

One important caveat is that, with the exception of the subsample discussed below, the findings in this chapter are based on a desk review of Bank documents, including appraisal, supervision, and implementation completion reports (ICRs). Additional analysis and information may exist in files or offices of Bank staff, and the quality-at-entry and supervision of the projects could be higher than what is suggested by IEG's desk review. Nevertheless, both experience and the guidelines point unambiguously to the need to apply financial analysis and to use independent audits to select participating financial intermediaries (PFIs). Significantly, CGAP did an identical analysis on the availability of information for microfinance LOC and their findings are remarkably similar to those of IEG.

Virtually all LOC aimed to fund investments

Sample Characteristics

Objectives. Virtually all LOC aimed to fund investments—that is the basic reason they were put in place—while some LOC also contained financial sector objectives (table 4.2). Three LOC were put in place with *only* financial sector objectives,[5] and within the financial and PSD sectors most projects had sectoral objectives such as increasing competition or improving efficiency. In the rural sector, over half had either sectorwide and/or PFI-related objectives; and in the municipal and other sectors, strengthening PFI or support for financial sector reforms was mentioned in fewer than half the projects. *Only three projects in the sample mentioned promotion of savings mobilization as an objective* or as an activity to be supported under the project, despite the recognized importance of resource mobilization as a way to expand financial intermediation in client countries.

Targeting. Although Bank guidelines discouraged support for directed credit, 80 percent of LOC involved some degree of targeting (table 4.3). Among these, some were only loosely targeted but others had narrowly defined sets of borrowers (see box 4.2 for examples). Targeting can introduce or worsen distortions in the credit allocation process but relatively untargeted lending can also have unexpected results, such as lending going to otherwise highly creditworthy clients, who likely would have been able to obtain credit another way. The justification for such LOC has to be focused on institutional development, rather than expanding overall lending, or as in the case of the Philippines project, reducing poverty.[6]

Public versus private intermediaries. At appraisal, most LOC (94 out of 121 total) specified the number of participating intermediaries, and about half of these LOC specified that public sector intermediaries (banks, finance bureaus, or funds) were to channel the Bank funds. Municipal LOC, as noted above, are almost always channeled through public sector entities. PSD had the fewest LOC (10 out of 18)

Table 4.2: Operations by Sector and Objective

Sector	Total number of LOC	Real sector objectives	Financial sector objectives: General sector	Financial sector objectives: PFI strengthening
Rural	32	32	17	18
Financial	28	25	25	24
PSD	18	18	15	14
Municipal	22	22	6	8
Other	21	21	8	9
Total	**121**	**118**	**71**	**73**

Table 4.3: LOC by End Users

Beneficiaries/Investments	Number of LOC	Percent	Commitment (US$m)
Not targeted	25	20	1,519
Small and medium enterprises	7	6	789
Export-oriented enterprises	7	6	593
Farmers and agro-industries	33	27	1,788
Infrastructure entities	8	7	1,091
Homeowners	10	8	873
Municipalities, provinces	18	15	1,538
Other targeted end users	13	11	1,122
Total	**121**	**100**	**9,313**

that specified the number of intermediaries at appraisal; and, consistent with its focus on private sector activities, mostly private intermediaries were identified to participate. Of the closed LOC (excluding municipal and canceled LOC), for which information is available on the nature of the PFI, about 83 percent used either only public sector PFI or a combination of public and private sector PFI. Thus, *although the OD and OP requires Bank assurance regarding managerial autonomy and commercial orientation of PFI, particularly when publicly owned or controlled banks are involved, the Bank has continued to rely mostly on public sector banks.* This most likely reflects the reality that there is little alternative to public banks when lending to sectors, subsectors, or beneficiaries that are not attractive to private banks.[7]

Findings

Macroeconomic Framework at Entry

Both the 1992 Bank OD and the 1998 OP recommended considerable caution when approving LOC in an unsound macroeconomic framework characterized by high inflation, major distortions in goods and factor markets, and/or an overvalued exchange rate. While LOC are not ruled out in such situations, they are clearly discouraged. Well over half of the appraisal reports mention inflation rates, and almost half mention the extent of protection for the targeted sector (table 4.4).

Box 4.2: Diversity of LOC Objectives

Most untargeted LOC are in the financial and PSD sectors. Examples include the **Bangladesh** *Financial Institutions Development Project* (FY00); **Mozambique** *Enterprise Development Project* (FY00); **Lithuania** *Enterprise and Financial Sector Development Project* (FY95); and **Tunisia** *Private Investment Credit Project* (FY94). In the rural sector, some LOCs were also fairly widely targeted, for example, the **Philippines** *Rural Finance 2* (FY96) included financing for all enterprises beyond a 30-km radius outside of Manila, and a number of LOC in the ECA Region, such as the **Latvia** *Rural Development Project* (FY99), and the **Azerbaijan** *Agricultural Development and Credit Project* (FY99), as well as LOC in other Regions had a broad potential audience, including rural enterprises and farmers.

In contrast, many LOC were used as a means of reaching a specific objective; the end users were defined to help meet that objective. Examples include most **China** LOCs, each financing one of the following: seed suppliers; animal feed enterprises, aquaculture farmers and seafood processors, state farms, and technology research centers. Urban LOC in **Egypt** (FY93) and **Uzbekistan** (FY00) funded tourism infrastructure developers and bus operators, respectively. Environmental projects in **Slovenia** (FY96) and **Egypt** (FY98), and a transport LOC in **Mexico** (FY93), financed equipment to reduce pollution.

Municipal LOC are conceptually distinct: the targeted intermediary (usually municipal governments, sometimes specialized municipal financial intermediaries), end users (municipal agencies), and end uses (infrastructure, water supply and sanitation) are almost always in the public sector (although sometimes agencies that use the credit are private). Cost recovery to the municipality relies on tariffs and charges, collected by the municipal entities, from the consumers. These LOC are mostly in the urban sector, but can also be in the environment, energy, and water supply and sanitation sectors. All Regions have such projects.

Table 4.4: Macroeconomic Framework at Appraisal

Sector	Number of LOC	Of which the LOC information on Inflation	Fiscal deficit	Over- or undervalued exchange rate	Protection of targeted sector
Financial	28	24	13	6	4
PSD	18	10	8	4	5
Rural	32	18	11	3	22
Municipal	22	13	7	4	13
Other	21	12	7	4	11
Total	**121**	**77**	**46**	**21**	**55**

While most LOC were approved in relatively stable macroeconomic conditions (though not necessarily with small fiscal deficits), *almost one-quarter of them* (29 out of 121) *were approved in countries characterized by very high inflation* (i.e., over 30 percent per year for three years prior to approval), mostly in ECA countries (20 of the 29 LOC), and mostly in the earlier part of the period under review, FY93–FY97. In the FY98–FY03 period, inflation was brought under control in almost all countries receiving LOC, and only five LOC were approved under high inflation conditions, all in the ECA Region (Romania, Turkey, and Uzbekistan).

Conditions of LOC Onlending

Interest rate. Both OD 8.30 and OP 8.30 state that interest rates should, in general, be market determined and that the Bank's LOC, in particular, be onlent at unsubsidized, market-determined rates of interest. On this point, over 70 percent of LOC appraisal documents had

some discussion of onlending interest rates to the PFI, and 79 percent mentioned onlending rates to the final beneficiaries, although these were mostly in terms of a specific interest rate or a mark-up rate over "cost," which would be appropriate for single currency subloans. Only 8 percent of the LOC mentioned onlending to PFIs at market rates and about one-third mentioned onlending at market rates to the final beneficiary, which would be relevant for subloans denominated in local currency. In several LOC, particularly in high-inflation countries, interest rates were strongly negative in real terms. These included one LOC in Zimbabwe, where interest rates were negotiated between the PFI and the final borrower, but were negative throughout the project and as low as minus 80 percent in real terms; and in the Kyrgyz Republic, funds were to be onlent in dollars at the prevailing market rate, but after little demand for dollar-denominated subloans, the project was modified to onlend in local currency at below-average lending rates, to remain in line with other donor-funded programs in the country. Fewer than half of the closed LOC (excluding those that were mostly canceled) reported on interest rates during supervision or at completion.

Foreign exchange risk. The guidelines have been consistent in stating that any foreign exchange risk of subloan repayment be borne by either the end user or the government; in no case should it be the PFI. At appraisal, information on foreign exchange risk was available in about 85 percent of the LOC, so this is clearly an area of focus for the Bank, the borrower, and/or the PFI. In about one-quarter of these cases, however, the foreign exchange risk was borne by the PFI; the rest were pretty evenly split between the government and the end users. It was difficult to know, however, whether the pricing of subloans provided adequate insurance for the PFI or for the government from likely foreign exchange losses. This has been an issue in the past in some countries where devaluation occurred between the time of approval of the subloan and repayment.[8] Without such information, it is not possible to know the full extent to which the LOC are being subsidized.

PFI Eligibility Requirements and Financial Performance

In the 1980s poor LOC results were attributed in large measure to poor performance of the PFI. As a result, both the 1992 OD and the successor OP gave considerable guidance on minimum acceptable criteria, including profitability, capital adequacy, portfolio quality (little rescheduling), loan collection rates, and adequate loan loss provisions. The motivation for these guidelines was to ensure that PFI were capable of making sound lending decisions and could achieve a certain degree of efficiency in intermediation; this principle should apply whether LOC are aimed primarily at real or financial sector objectives.

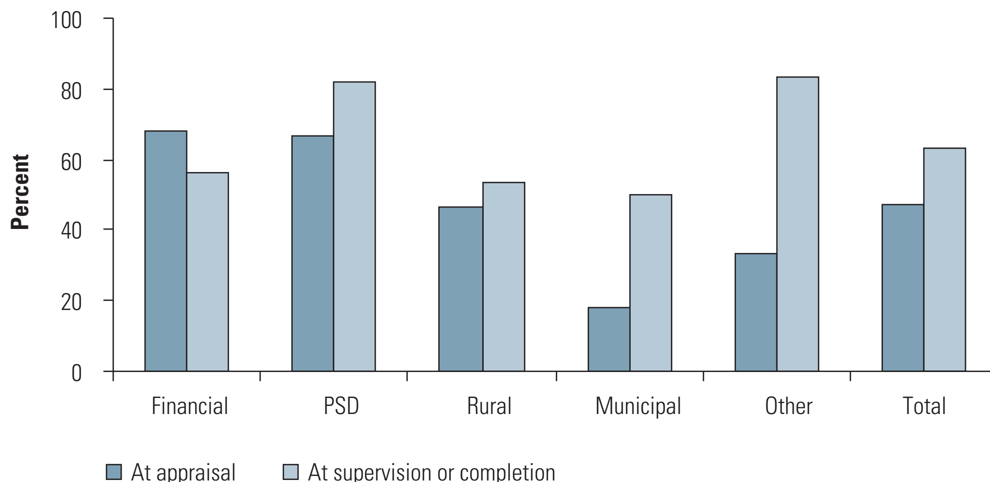
One-quarter of LOC were approved in highly unstable macroeconomic conditions.

These guidelines have been largely ignored. Out of a total of 121 LOC, fewer than half contained quantified eligibility criteria at appraisal for *even one of these variables*.[9] There was no LOC whose eligibility criteria included all of the variables mentioned in Bank directives. Furthermore, the use of such criteria was no assurance that the minimum standard was acceptable: in several ECA LOC, and in one South Asia Region (SAR) LOC, the minimum acceptable loan repayment rate varied from 75 to 85 percent.[10] Regardless of the definition used for repayment rate, these figures are exceptionally low. Finally, of the LOC that had quantified eligibility criteria and were not subsequently canceled, only about two-thirds had evidence that the criteria were monitored during supervision to ensure that the PFI continued to meet the minimum levels established at appraisal (figure 4.1).

Given past concerns with the poor quality of lending portfolios of PFIs, it was particularly noteworthy that out of the sample PFIs that had a financial history (that is, excluding government agencies or PFIs set up

The guidelines for LOC eligibility have been largely ignored.

Figure 4.1: Eligibility Criteria at Appraisal and Monitoring during Implementation



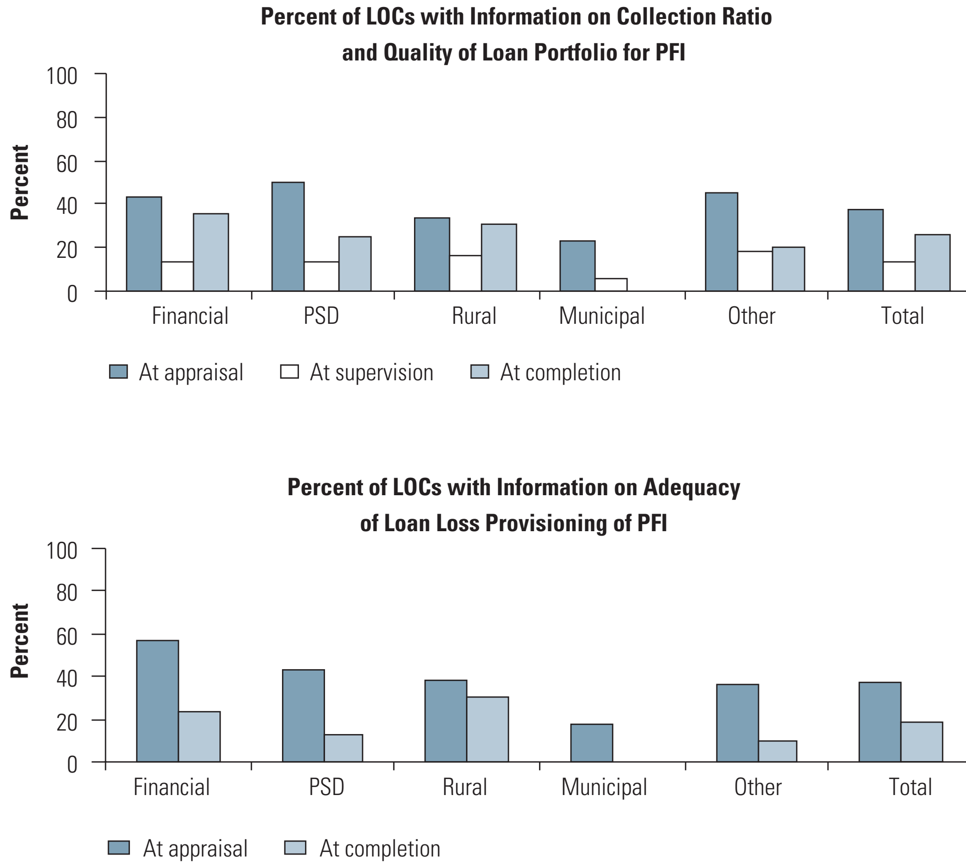
for onlending under the project), where information on the quality of the loan portfolio would be a relevant indicator of the quality of credit operations, only 38 percent had any information at appraisal on loan repayments (collection rates) or portfolio quality (arrears, rescheduling). During supervision, 14 percent of the LOC contained any mention of this critical aspect of PFI performance. This percentage improves only slightly at completion: about one-fourth of all completion reports of closed and uncanceled LOC had any information at all on the quality of loan portfolios or collection rates of the PFI. One LOC stipulated at appraisal that the PFI was to have a debt to equity ratio no greater than 6 to 1; there was no information in the status reports on its financial situation. At completion, it was found to have had a debt to equity ratio of over 26 to 1 during the course of the project, as well as nonperforming loans in the Bank-funded portfolio at 67 percent. Information on the adequacy of loan loss provisioning is equally poor (figure 4.2).

To examine the consistency of the analysis and use of financial indicators throughout the project cycle, IEG looked in more detail at all LOC in the three major sectors (financial, PSD, and rural) that used both quantified eligibility criteria and had any information on arrears, loan collection rates, and/or adequacy of loan loss provisioning at appraisal. These were considered the most promising in terms of quantity and quality of information. Only 15 LOC, out of a total of 78 LOC in the three sectors, qualified for this "deeper look."[11] The financial information varies greatly in both quantity and quality across the 15 LOC. The only ratio that was consistently analyzed at appraisal was capital adequacy, where the criterion for PFIs was usually at or above 8 percent (in a few LOC, the minimum was set higher, in recognition of the relatively risky environment). For the two LOC where PFIs did not meet the criterion, action plans were identified to overcome the capital deficiency. The definition of capital adequacy was not consistent across projects, however; in five of the selected projects, shortfalls in provisioning for loan losses were not taken into account in the calculation of capital ratios. As in the larger sample of LOC, reporting during supervision and at completion on financial indicators was considerably poorer than at appraisal.

Reporting on financial indicators for PFIs has been uniformly poor.

Subsidy dependence. Over 10 years ago, the Bank developed a methodology for measuring the extent of subsidies involved in LOC.[12] A 1996 IEG review of agricultural credit suggested that subsidies could be appropriate under certain conditions and Bank management responded by

Figure 4.2: Project Cycle Information on PFI Financial Health, by Sector



agreeing that a subsidy dependence index (SDI) would be systematically calculated for all rural LOC.[13] The 1998 policy explicitly required that such a calculation be done for any LOC where there was evidence of subsidies. The review found that subsidies were calculated in five LOC, or under 5 percent. Of these, four were in the rural sector (representing about 13 percent of sample rural LOC) and one in the financial sector. These findings may reflect the difficulty of getting adequate information in order to do the subsidy calculations, but they also point out the extent to which the Bank is inconsistent in its approach toward analyzing and ensuring transparency with respect to subsidies.

Institutional development plans. In recognition of the fact that client countries may not have strong financial intermediaries that meet eligibility criteria, the Bank's guidelines suggest that such institutions can participate in an LOC, provided they agree to an institutional development plan (IDP) with monitorable performance indicators. In the absence of eligibility criteria, it is difficult to know how many LOC should have had such plans; IDPs were mentioned in only five LOC.

Reporting on Portfolio of Bank-Financed Funds

The situation on financial reporting is somewhat better on monitoring the use of Bank funds (distinct from financial analysis of the overall loan portfolio of the PFI), although it is still not satisfactory. During supervision, only a little over one-third of the LOC had information on repayment rates or arrears. At completion, a little more than

During supervision, only a little over one-third of the LOC had information on repayment rates or arrears.

Box 4.3: Good Practices Do Not Necessarily Yield Good Outcomes

Despite finding poor or inconsistent implementation of Bank guidelines or good practices, there are examples of LOC that are well designed; use eligibility criteria and monitor them during implementation; pay attention to loan portfolio quality and monitor repayment rates; and report on these features at the beginning, during implementation, and at completion of a project. These practices do not, of course, guarantee good outcomes.

For example, the **Russia** Enterprise Support Project involved thorough appraisal procedures for PFIs, close supervision during implementation, and good reporting on nonperforming loans and repayment rates. The project was fraught with problems, however, including inadequate and unreliable data used in the audits and subsequent monitoring.The eligibility of financial institutions was withdrawn (related in part to the financial crisis), and the project was restructured. As of end-March 2004, the project was still on-going.

In contrast, the **Philippines** Rural Finance II Project, which also calculated the subsidy dependence index, and the **Sri Lanka** Private Financial Development Project both reported on eligibility criteria and financial performance during appraisal and supervision, and at completion. (Although in the Philippines project, reporting related to the apex institution rather than the retail-level PFI). The outcomes of both projects were rated satisfactory.

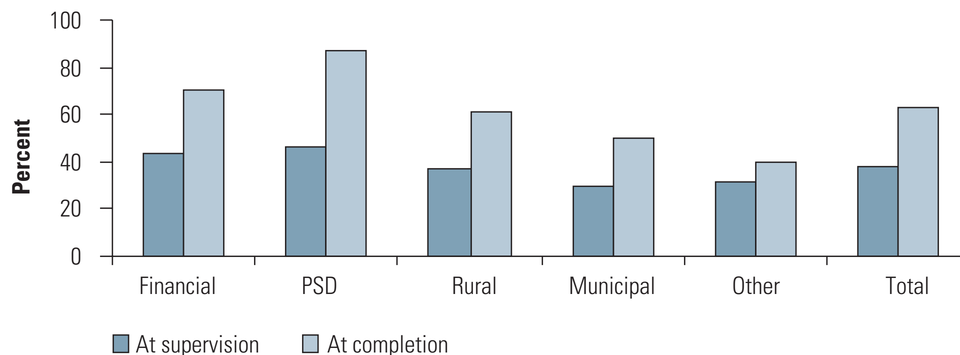
In the **Armenia** Enterprise Development Credit Project and the **Tunisia** *Private* Investment Credit Project, compliance with eligibility criteria was monitored during supervision, and at least one bank was suspended from the project for failure to comply. Both projects reported on qualified opinions of auditors. The Tunisia project outcome was rated satisfactory; the Armenia project, moderately unsatisfactory.

60 percent of the projects reported the same type of information (figure 4.3). Even in LOC with only term lending and long grace periods, there should have been interest payments on the subloans, so it is reasonable to expect that all projects have some information on repayments. A further analysis of LOC with project status information found that much of the information was qualitative, rather than quantitative. The absence of *any* information in almost 40 percent of LOC at completion, and the poor quality of the information that did exist, is a strong indicator that in a substantial proportion of these operations, there is inadequate attention to the issue of financial sustainability, particularly in the rural, municipal, and other sectors.

Use of Independent External Audits

Analyzing the financial performance and soundness of banks and other financial intermediaries is extremely difficult because of problems inherent in evaluating the loan portfolio, which depends, in turn, on a realistic assessment of loan losses and the value of guarantees and other collateral backing the loans. Unless the financial intermediary adheres to appropriate prudential norms for loan classi-

Figure 4.3: Percent of LOC with Information on Repayment of Bank Funds



fication, provisioning, valuation of collateral, income recognition and capital adequacy, and it uses generally acceptable accounting principles, financial statements will not be reliable indicators of its situation. At a minimum, the Bank needs to base its analysis of financial institutions on externally audited accounts, prepared in accordance with sound auditing principles. Prudential norms and general accounting principles require use of external audits of the PFI (not to be confused with the legal requirement of audited statements of the use of Bank funds). The 1998 OP also required reporting on a review of the annual audit in supervision/status reports.

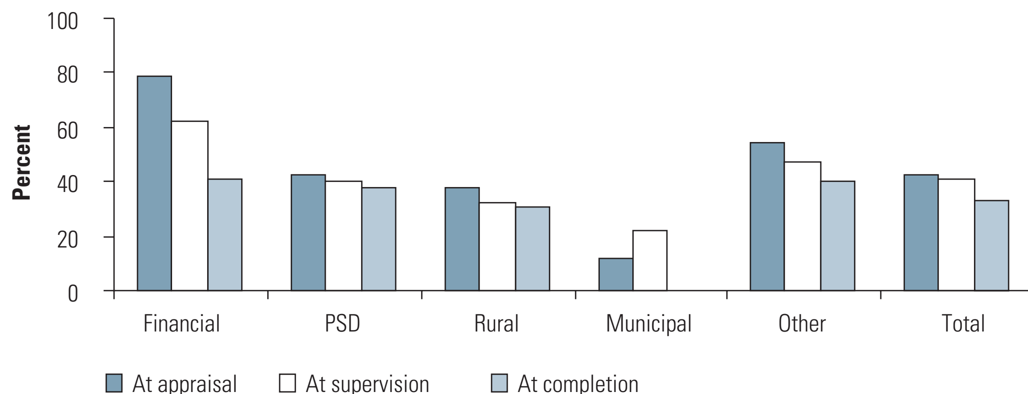
As shown in figure 4.4, Bank appraisal documents make reference to external audits in less than half of total relevant cases (i.e., all PFI excluding government nonfinancial agencies or newly created PFI). The proportion drops over the course of project cycle: project status reports mention audits explicitly in just over 40 percent of LOCs,[14] and completion reports in only 30 percent. This finding does not mean that audited accounts were not available and used by the Bank task team, or that Bank staff did not apply sound eligibility criteria with regard to the selection and monitoring of PFIs. Given that the use of and reporting on audits are explicit Bank requirements, however, it is reasonable to expect that evidence should be readily available that appropriate sources of information had been used, at least at the time of project appraisal and completion.

At a minimum, the Bank needs to base its analysis of financial institutions on externally audited accounts, prepared in accordance with sound auditing principles.

Testing the Hypotheses

The first hypothesis was that the findings on implementation of Bank guidelines and policy would be better for financial LOC than for those from other sectors. For most of the elements examined in appraisal documents, *financial sector results were about the same as for PSD*, which was, in any case, part of the same network for most of the period under review, and together, *they were better than the findings for rural and other sectors*. During supervision and at completion, however, the financial sector LOC performed no better than the other sectors in terms of the extent to which: (i) eligibility criteria, if they existed at the outset, were monitored; (ii) collection ratios or other elements of loan portfolio quality were examined; (iii) collection rates on the use of Bank funds were monitored during supervision; (iv) adequacy of loan loss provisioning was monitored; or (v) audits were used at completion. Two exceptions to these findings are: during supervision, the financial sector LOC did better in providing information on external audits and at completion, LOC in both the financial sector and PSD did better than other sectors did at reporting on

Figure 4.4: Evidence on the Use of External Audits



repayment rates for the use of Bank funds. On average, financial and PSD LOC did somewhat better, but not consistently so, than LOC from other sectors.

The second hypothesis is that the results were different (better) for the LOC approved in the more recent five years than in the earlier five-year period. For variables examined at appraisal, there were no significant differences in any dimension, except for evidence of quantified eligibility criteria: the more recently approved LOC perform better (56 percent for more recent LOC versus 43 percent, see figure 4.5).[15] With this exception, the data show no significant trend in the quality-at-entry of LOC.

Environmental Safeguards

Although all Bank projects are subject to all safeguard policies, for LOC, the most relevant is likely to be the environmental policy. IEG, accordingly, focused its review on the extent to which LOC implemented the Bank's environmental guidelines and policies. IEG examined all LOC that were at least 30 percent of the total loan commitment; of these, 85 percent were categorized as having relevant environmental issues.[16] Of the latter, only 65 percent required an environmental assessment for relevant subprojects to be financed by the LOC. At completion, only 55 percent of the relevant sample of LOC mentioned environmental aspects of subprojects (table 4.5). At entry, about one-fifth of the LOC mentioned improving the capacity of either the PFI or other agencies to carry out environmental screening of subprojects. Given the importance that the Bank places on doing no harm to the environment, these figures suggest that further improvement is needed in making the Bank's actions consistent with its environmental guidelines.

Information on Real Sector Outcomes

IEG also analyzed the availability of evidence for 54 closed LOC on real sector outcomes (excluding 14 closed projects where most of the funds were canceled). About 90 percent of LOC had at least some information on these outcomes, although the quantity and quality of the data varied widely. Most projects had multiple real sector objectives, and only about one-quarter of the closed LOC presented evidence on all objectives. The more complete and better quality data usually resulted from household or enterprise surveys, control groups, other ex post beneficiary assessments of a range of stakeholders, and/or field visits to beneficiaries. Examples of these projects include the India *Private Sector Infrastructure Finance*; Kazakhstan *Agriculture Post Privatization*

Figure 4.5: Quality of Financial Information, by Period

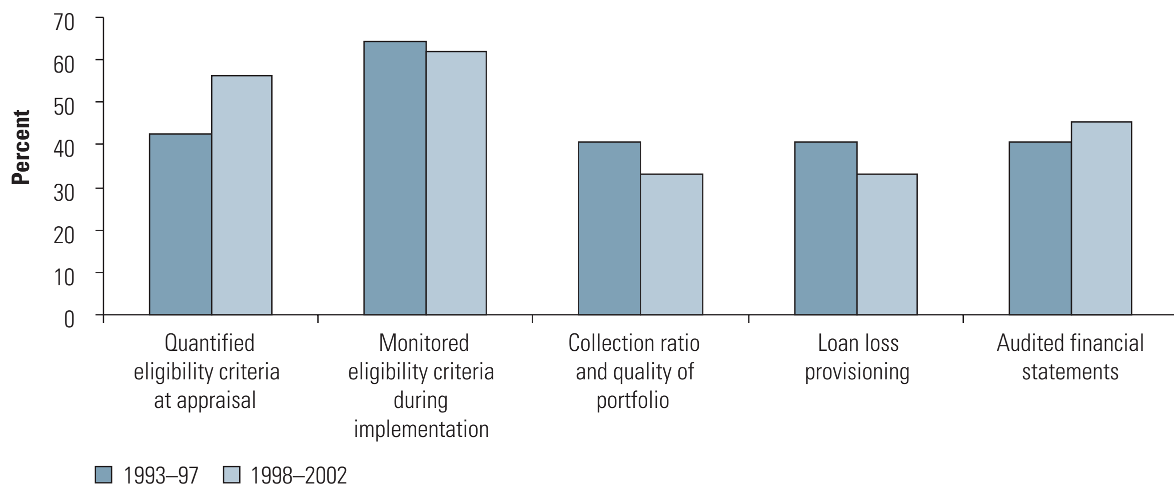


Table 4.5: Adherence of LOC to Environmental Policies

	Number of projects	Relevant sample
LOC is >30 percent of loan commitment	105	100%
LOC categorized as A, B, FI	89	85%
Evidence at appraisal that environmental assessment was required for subprojects	58	65%
Environmental capacity building included at appraisal	19	21%
Closed LOC categorized as A, B, FI	40	100%
Environmental impact at exit	22	55%

a. Categories that require environmental assessments prior to investment.

Assistance; and China *Red Soils Area Development*. LOC whose objectives included increasing infrastructure did better than average at presenting detailed evidence on outcomes. By comparison, LOC that aimed to promote PSD or to improve the profitability, production, or efficiency of firms had less evidence than average. The quality of the information also varied enormously, from reports that compared yields, farm outputs, livestock holdings, and income levels in situations with and without projects, to reports that made general assertions that the LOC had contributed to output/exports/employment with no supporting data or sources of information.[17]

Findings on Microfinance LOC

The results of CGAP's analysis on microfinance LOC are strikingly similar to those of regular LOC.[18] An index of performance information was developed, with a possible score from 1 to 100. The average score for all microfinance LOC was 48, with the financial sector scoring considerably higher (74 out of 100) than the average. The indicators on outreach and poverty targeting were usually present while other financial information was much more scarce. For information on arrears, and quality of the loan portfolio, only 17 percent of the relevant sample had information available at the time of appraisal. The supplemental exercise on the quality of microfinance LOC scored the projects on an index from 1 (exceptionally bad) to 5 (exceptionally good), with 3 indicating a "weak but acceptable" quality and 2 as unacceptable. The average score for 64 microfinance LOC was 2.77, or toward the low end of weak. Only 16 of the 64 were rated 4 (good) or better.

Quality Assurance Group's Role in Quality-at-Entry

IEG examined the 18 LOC that were subject to a quality-at-entry assessment by the QAG. None of the 18 assessments mentioned the OD or OP 8.30 explicitly, although in 7 of the 18, there was reference to some of the specific requirements of the guidelines, such as the use of eligibility criteria for selection of the PFI and the requirement that the PFI have unqualified audits (meaning the auditors expressed no significant concerns about the quality of the PFI's financial statements). But in over half of the LOC reviewed by QAG, there was no mention of any of the formal Bank requirements for LOC. The extent to which QAG ratings were consistent with IEG's findings on the designs of LOC was mixed. In about five of the 18 cases, QAG rated the overall quality-at-entry and the technical and economic aspects of the project as satisfactory, where there was no evidence that any quantified eligibility criteria had been used, no attempt to measure subsidies, and no evidence of the use of audits. On the environment, QAG rated environmental aspects as satisfactory, where there was no evidence that environmental assessments were required for subprojects (in projects where such assessments were

The average score for all microfinance LOC was 48, with the financial sector scoring considerably higher.

relevant). Otherwise, there was general agreement between QAG and IEG on the quality of the LOC designs. Given the impact that QAG's standards for their assessments of quality-at-entry can have on staff behavior, it would be useful if QAG could refer explicitly to the requirements of the OP when reviewing LOC and consider the extent of adherence to these guidelines as relevant for rating the project's quality-at-entry.

Conclusions on LOC Design

The evidence from this review finds that the Bank has used LOC with little concern for the soundness or viability of the financial intermediaries. Information is available in only a minority of LOC on the quality of the PFIs, on monitoring their overall performance throughout the disbursement of the LOC, and on reporting these findings. Evidence on the use of external audits to verify the financial performance of PFI, attention to repayment rates, and, ultimately, to the sustainability of the intermediation, have been relatively unimportant aspects of LOC. A number of reasons may explain these findings, including budget constraints and a lack of awareness by nonfinancial sector specialists, but the fact remains that the implementation of the Bank's guidelines has been poor.

These findings go well beyond implementation of Bank guidelines and policies. They raise questions about whether LOC are the appropriate instrument in situations where the objectives are focused only on achieving narrowly defined, real sector objectives. In projects where the objective is to support investments in pollution control for industries, for example, or on-farm irrigation equipment to accompany public investments in large-scale irrigation, it may be preferable to seek alternative means of accomplishing the objective. The challenge for the Bank is to ensure that when LOC are used, the financial intermediation is carried out in an efficient and, ultimately, sustainable way.

LOC Outcomes

The review in this chapter covers all lines of credit approved during FY93–FY03 and that were closed as of February 28, 2004. LOC fitting these criteria numbered 82 and totaled an original commitment amount of $6,194 million, roughly one-half of the total number and amounts of LOC approved during the period.

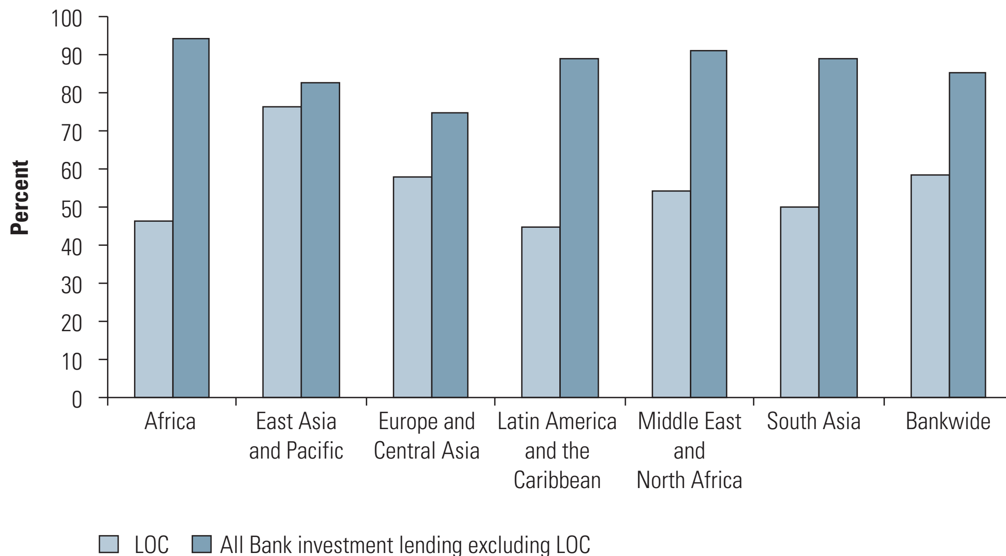
Low Disbursements

One of the salient features of these closed LOC is the relatively high proportion of unused funds originally committed for them. Figure 5.1 shows disbursements as a percentage of commitments, by Region and for the Bank as a whole. Disbursements for LOC have been less than 60 percent of original commitments, compared with 86 percent disbursement level for all other investment loans. Of course, estimating, ex ante, amounts for LOC is inherently more difficult than estimating costs of other investments because prior amounts are based on an estimate of the demand for funds, rather than on an estimate of the costs of construction, equipment, vehicle, and consultants. Nevertheless, precisely because there is uncertainty and because the borrower pays a fee on unused Bank funds, it is all the more important to have in place LOC funding that represents a small proportion of a conservative estimate of the demand.

These results occurred despite efforts to spur lagging disbursements. Roughly 40 percent of the sample had revisions in project design, mostly to facilitate disbursements. The most frequent design changes concerned eligibility criteria for ultimate borrowers and interest rates.

In 14 out of 68 closed LOC, at least 90 percent of the original LOC amount was canceled. In some the cases, there were external reasons, such as a macroeconomic shock (Indonesia, Russia); in other cases, according to ICRs, legislative or government delays and subsequent changes in conditions reduced the attractiveness of the LOC (Colombia, Slovenia), or alternative funds were identified shortly after approval or during implementation (Philippines, Uruguay). But in many cases, project design issues surfaced during implementation: overestimation of demand (India), weak PFIs (Bulgaria, Pakistan), and lending terms and conditionalities that proved too difficult to meet (Egypt, Zimbabwe)—although it may be difficult to distinguish between difficulty and overestimation of demand. In at least six cases, new LOC were put in place despite very weak performance in preceding LOC (box 5.1).

Figure 5.1: Disbursements as a Percentage of Commitments, by Region



Box 5.1: Cancellation Preceded by Poor Performance

In **Morocco**, it became apparent during the implementation of the *National Agricultural Credit Project* (FY89) that the main PFI was in serious financial distress and the follow-up project, *National Rural Finance*, approved in FY94, was later substantially canceled ($21 million out of $99 million canceled). In **Mexico**, the *First Solid Waste Management Project* (FY86) suffered from weak borrower performance and poor cost-recovery systems. These problems carried over into the *Second Solid Waste Management Project* (FY94), which was substantially canceled ($177.9 million out of $178.9 million canceled). The *Fifth **Caribbean** Development Bank Project* (FY90) was characterized by poor quality of subprojects; high nonperforming loans should have prevented the approval of the *Sixth Caribbean Development Bank Project* (FY94), which ended up being canceled in its entirety.

For a fuller discussion of substantial cancellations, see the IEG background paper by Barbara Yale (2003).

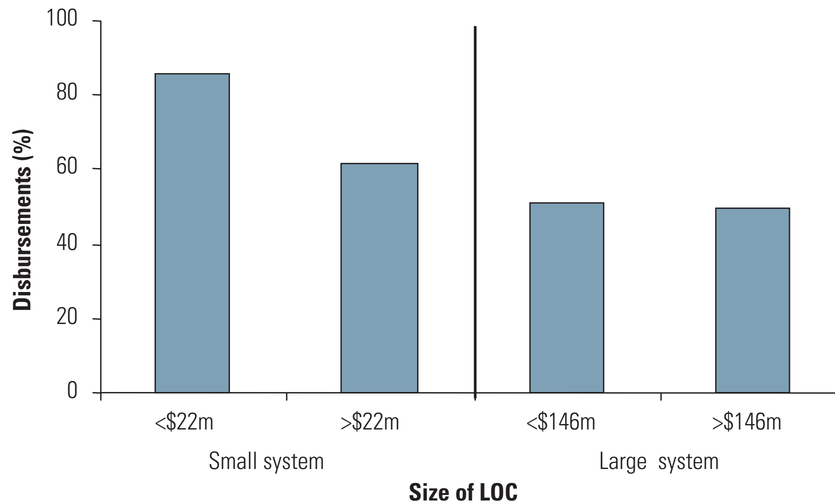
The average disbursement rate for 30 closed microfinance LOC during this period was slightly lower than for regular LOC, at 56 percent, although when two exceptionally large, canceled microfinance LOC are excluded, the average disbursement of the remaining 28 microfinance LOC goes up to 86 percent, well above that of the regular LOC. One reason for the higher disbursement rate, excluding the two large LOC, may be the generally smaller size of these microfinance LOC, as discussed in the next section.

Factors in Cancellation Rates

Other MDB lending. One factor that could explain high cancellation rates is the introduction of other MDB and bilateral lending for LOC, which may be more attractive than Bank loans. Although there is no statistical relationship, on a country basis, between disbursement rates and lending through public sector windows by other MDBs, ICRs and Bank staff and managers report that the presence of other MDBs and bilaterals has affected the demand from financial intermediaries for Bank funds. More work is needed to examine actual MDB conditions and to harmonize them with those of the Bank.

Size does matter. The impact of the presence of other MDB lending for LOC may interact with the Bank's LOC design. In particular, the size of the LOC is related to disbursement rates in smaller financial systems: smaller LOC disburse better in smaller systems and, on average, LOC

Figure 5.2: Disbursements as a Percentage of Commitments, by LOC and Financial System Size



do better in smaller than in larger financial systems (figure 5.2); these results are statistically significant.[1] Although it is difficult to clearly determine what constitutes an appropriate size for LOC, these findings point to the importance of using conservative demand estimates for subloans and ensuring that the LOC is a small proportion of total estimated demand.

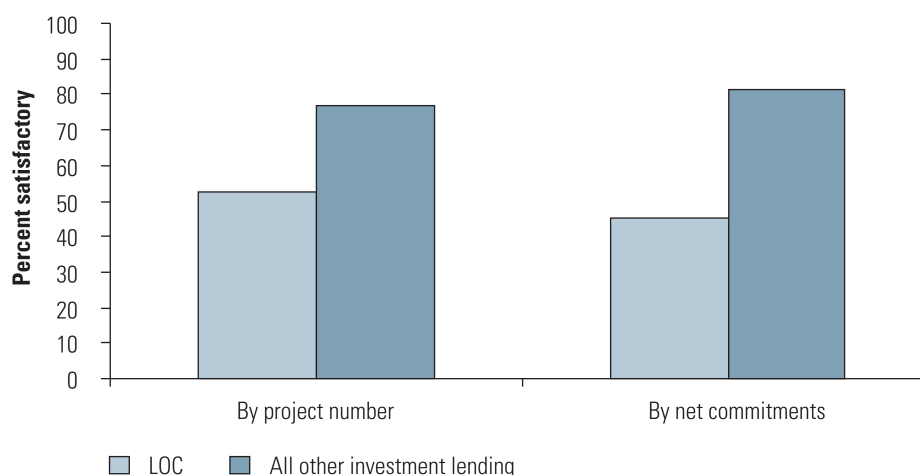
IEG also examined other factors that could affect disbursement rates. If Bank staff incorporated the lessons of earlier, poorly disbursing LOC into the designs of later LOC, then disbursement rates of later LOC show a decrease. An analysis of disbursement rates by fiscal year of approval shows no clear pattern (appendix B, figure B.8).

Given anecdotal evidence that eligibility criteria for PFIs established under several LOC was such that no PFI could qualify for intermediate Bank funds, IEG examined whether this was a systematic issue, and found *virtually identical disbursement rates in closed LOC, with and without eligibility criteria for PFI*. It is, of course, possible that the cumulative effect of *all* of the requirements of Bank-funded LOC—eligibility criteria for PFI and ultimate borrowers, interest rates, foreign exchange risk, environmental requirements, and audited accounts—is such that the transaction costs of LOC have made them much less attractive than alternative funding. The evidence here suggests that smaller LOC have a better chance of being used than larger ones, all else being equal.

Outcomes

The outcomes of LOC are poor. Ratings are presented for all closed LOC[2] approved during FY93–FY03, where the LOC were at least 50 percent of the respective commitment amount of the loan/credit.[3] Figure 5.3 presents outcome ratings for 63 closed and rated LOC, representing $3.5 billion in net commitments, and shows that by both numbers of projects and commitment amounts, the percentage of satisfactory outcomes of LOC is well below the Bank average for other investment lending. At 52 percent by count and 45 percent by net commitment, LOC are well below what can be

Figure 5.3: Satisfactory Ratings by Number of Projects and Net Commitments



considered acceptable.[4] Regional outcomes vary: none of the four closed and rated LOC in AFR was satisfactory, while ECA and MNA were somewhat above average (table 5.1). By sector, the rural sector had the best outcomes and PSD had the worst, with only one out of 10 closed LOC rated as satisfactory (table 5.1).

These poor outcomes turn out to be closely related to cancellation rates, which were quite high, as discussed above. For LOC that had cancellations of 25 percent or less of the original commitment amount, satisfactory outcomes approach the average for other investment loans; when cancellation rates are

Table 5.1: Satisfactory Ratings, by Sector and Region

	Number of closed LOCs, where LOC>50% of loan amount	Total net disbursements of closed LOC	Percent of number satisfactory	Percent of net amount satisfactory
Region				
Africa	4	55.8	0	0
East Asia and Pacific	12	1,315.0	50	46
Europe and Central Asia	22	446.8	68	67
Latin America and the Caribbean	7	392.0	29	39
Middle East and North Africa	10	542.8	60	77
South Asia	8	713.2	50	14
Total	**63**	**3,465.6**	**52**	**45**
Sector				
Financial	20	1,038.6	60	41
PSD	10	259.6	10	9
Rural	12	507.1	67	83
Municipal	9	642.8	56	42
Other	12	1,017.5	58	44
Total	**63**	**3,465.6**	**52**	**45**

higher than 25 percent, the satisfactory outcome rating plummets to 30 percent (table 5.2). Of course, there were LOC that were substantially canceled that also had a (moderately) successful outcome (box 5.2) and vice versa. However, these are the exceptions. In practice, channeling funds to the target (or untargeted) group dominates

Table 5.2: LOC Characteristics and Outcome Ratings

	Number of LOC	Percent satisfactory outcome
Macroeconomic stability[a]		
With normal inflation levels at entry	50	54
With high inflation:		
Greater than 30 percent per year, for 3 years prior to entry	13	46
And greater than 30 percent per year during implementation	8	0
Financial sector characteristics		
Financial stability (competition, legal & regulatory regimes)		
Satisfactory (scale: 1–5, with rating above 3)	31	68
Unsatisfactory (with rating 3 or below)	29	41
Financial sector depth, efficiency and resource mobilization (monetary and credit policies; tax and ownership policies)		
Satisfactory (scale: 1–5, with rating above 3)	42	62
Unsatisfactory (with rating 3 or below)	18	39
Eligibility criteria for PFI		
With criteria	30	57
Without criteria	25	32
Nature of PFI		
All or most funds through public sector PFI	21	52
All or most funds through private sector PFI	14	71
Cancellation rate of original commitment		
Less than or equal to 25 percent	33	73
Greater than 25 percent	30	30
Information on quality of loan portfolio of PFI		
Information in supervision or completion reports	14	50
Information *not* available in Bank documents	33	48
Information on quality of Bank-funded loan portfolio		
Information in supervision or completion reports	34	50
Information *not* available in Bank documents	13	46
Information on loan loss provisioning		
Information in completion reports	9	67
Information *not* available in Bank documents	38	45
Information on real sector objectives		
No information	5	20
Partial information (on some objectives)	33	59
Information on all objectives	13	67

Note: As of end-February 2004, outcome ratings were available for 63 LOC, which were at least 50 percent of the gross loan commitment. Not all of these LOC were included in the sample, and not all LOC in the sample had information on all variables, so the number of observations differs, depending on the variable.

a. Analysis was also done with 20 percent per year inflation, with similar results.

Box 5.2: Exceptions to the Rule: High Cancellation, Satisfactory Outcome

The **Pakistan** *Financial Sector Deepening and Intermediation Project* (FY95) was originally a loan for $216 million to support reforms begun under an earlier financial adjustment loan. It consisted of a $200 million LOC to support private firms and $16 million for TA to strengthen the State Bank of Pakistan and support privatization of banks. The LOC was canceled in its entirety because few PFIs met the eligibility criteria and subborrowers were unwilling to bear the foreign exchange risk of the subloans. The loan was restructured as a TA operation only and was considered moderately satisfactory in achieving its revised objectives of strengthening the State Bank of Pakistan, supporting bank privatization, and improving the regulation of securities and insurance markets.

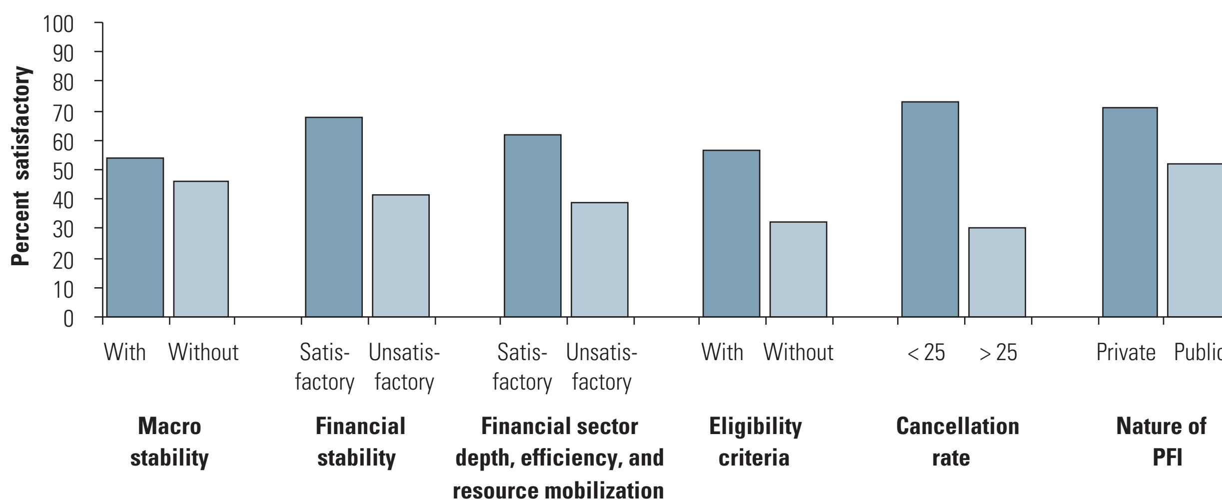
Other examples of high cancellation rates with (moderately) satisfactory outcomes include the: **China** *Animal Feed Project*, where only $22 million of the original $150 million was disbursed, and was considered to have met its qualitative objective of modernizing and expanding the animal feed industry, although Bank performance and quality-at-entry were judged unsatisfactory; and **Estonia** *Financial Institutions Development*, where only $2.3 million of the original $10 million was disbursed because of delays in effectiveness and the availability of more attractive financing (particularly from EBRD). Nevertheless, the project served as a catalyst for restructuring a large state-owned bank and, through the provision of TA, achieved its institutional development goals. Its outcome was rated marginally satisfactory.

the focus of reporting on the achievement of objectives; if funds do not flow, the main objective of the LOC is usually considered unmet.

The guidelines turn out to be sound. Characteristics of the country, the financial sector, and LOC were examined to identify those associated with success (table 5.2 and figure 5.4 below). Many of the elements recommended in the Bank's OD and OP 8.30 turn out to be associated with better LOC outcomes:

- The inflationary environment, for example, makes a difference: for eight LOC implemented in countries that either continued or developed very high inflation (Bulgaria - with two LOC, Ghana, Romania, Russia, Uruguay, Zambia, and Zimbabwe), none had satisfactory outcomes. The presence of high inflation is, therefore, strongly associated with unsatisfactory outcomes.[5]
- The nature of the financial sector also matters: in countries that had good performance

Figure 5.4: Factors Associated with Differences in LOC Outcomes



indicators for the financial sector, satisfactory LOC outcomes were 23 to 27 percentage points higher than LOC in countries whose financial systems had unsatisfactory indicators.[6] Therefore, financial systems that have satisfactory competition policies (limited barriers to entry and low segmentation between foreign and domestic financial institutions), and good legal and regulatory regimes governing financial institutions have better LOC outcomes that those that have less than satisfactory policies and legal and regulatory regimes. And financial sectors that have primarily market-determined interest rates and few distortionary credit schemes, moderate tax policies on financial transactions, and limited state ownership of financial institutions also have higher satisfactory LOC than systems that do not have these characteristics.

- Consistent with the guidelines that stipulate using PFI that have managerial autonomy and commercial orientation, LOC that used only or predominantly private sector PFI had better outcomes than LOC where only or mainly public sector PFI were used.
- Use of eligibility criteria for selecting the PFI also made a difference in outcomes: where evidence exists that criteria were used, outcomes were 25 percentage points better than where evidence shows that criteria were not used.

Poor information and satisfactory outcomes? Except for information on loan loss provisioning, outcome ratings are no higher where there is little hard evidence on the financial situation of the PFI than where there is some evidence, and for real sector objectives, outcome ratings are not much different between cases where there is only partial information and those where the information is more complete. More significant, *in roughly half of the projects with inadequate information on key indicators of financial performance, IEG rated the outcomes of these LOC as satisfactory.* This finding holds as well for microfinance LOC. It could be that the absence of information masks poor performance on repayment, which should affect outcome rating. These outcome ratings may, therefore, be an upper bound of what they would be if better information were available. This raises an important issue for the basis of IEG ratings for LOC.

A Deeper Look at Outcomes

Of the 36 closed LOC that included funding for TA, only about half of it was used.

PFI and sectorwide changes. Beyond official IEG outcome ratings on LOC, which may be driven by whether funds were disbursed, this review examined other objectives pursued in LOC. For example, some LOC used technical assistance and training and/or loan conditionality to achieve financial sector objectives, such as improvements in specific institutions (better internal controls; better-trained staff; use of manuals) and sectorwide improvements (greater competition, lower interest spreads, less directed credit). The impact of such achievements would not necessarily be reflected (yet) in data on disbursements, repayments, and other financial information of the PFI.

As discussed above, over half of the sample (of 121) LOC had financial sector objectives. These included strengthening individual PFIs, or subsector objectives, such as improving rural or municipal finance, or general sector objectives, such as increasing efficiency and competition, improving the soundness of the financial sector, or accelerating deregulation. The most frequent measure included in the projects to help meet these objectives was the provision of TA under the project (or arranging for TA from other donors) to strengthen capacity, or to help restructure and/or privatize state-owned banks; improve banking laws and prudential regulations; strengthen banking supervision; dismantle directed credit; and make capital market improvements.

A little over half of the LOC included funding for TA, on average, about 6 percent of the LOC commitment. Even this modest amount went largely unused. Of the 36 closed LOC that included funding for TA, only about half of it was used. Thus, on the input

LOC can be a useful instrument when used well, and despite generally poor designs and outcomes.

side, relatively little use was made of Bank resources. It is, of course, possible that borrowers arranged for alternative funding for TA.

Changes in banking laws, the introduction of new or stricter prudential regulations, and reforms aimed at deregulation tended to have been accomplished, but information on implementation or impact of the changes was hardly ever presented. Legal changes were addressed in 13 LOC, including for banking, collateral, and judicial changes, but there was virtually no information on the implementation of the changed laws. Dismantling directed credit was an objective in seven projects, but only two reported on outcomes, with mixed results. In all nine LOC in which reforming prudential regulations was an objective, the regulations were strengthened. But of the six that mentioned enforcement of the stricter regulations, only three reported that it had helped improve the soundness of the banking system—the other three noted the lack of will to enforce them. (Three did not report on whether or not the regulations were enforced, but in two of these three, the financial health of the system deteriorated during the implementation period.)

A review of the evidence in the completion reports as well as other evidence on the financial sectors of the client countries concerned showed that of 39 closed LOC with financial sector objectives, 22 of them can be considered to have had satisfactory outcomes, accounting for 46 percent of commitments.[7] Therefore, in terms of other financial sector objectives of the LOC—that would not be captured by financial performance indicators of individual PFI—the LOC were about as (un)successful in achieving them as they were in meeting their other real sector objectives.

Conclusions on LOC Outcomes

LOC do not follow Bank guidelines to any significant extent and LOC outcomes have been poor. Nevertheless, the analysis here shows that when the guidelines are followed, outcomes tend to be much better than when they are ignored. LOC can be a useful instrument when

Box 5.3: Good LOC Are Well Prepared, Timely, and Useful

The outcomes of LOC, by virtually any measure, are not good. This does not mean, however, that there are no good LOC. Some LOC are carefully prepared, well designed, follow good practice, disburse well, and meet their objectives. In addition, some LOC were useful for meeting specific needs at important points in time.

Moldova's *First Private Sector Development Project* (FY96) had a $28 million LOC, plus funding for improving the payments system; TA was cofinanced by the Netherlands government on a grant basis. The project design was based on detailed background work for both the enterprise and financial sectors. Eligibility criteria were established at appraisal, based in part on audits of formerly state-owned banks. The project met its main objectives for both enterprises and commercial banks; eight private banks met eligibility criteria, benefited from TA, and, by the end of the project, had several good performance indicators (high capital adequacy and low nonperforming loans; returns on assets and equity were more mixed). In addition, overall term lending to enterprises increased from negligible levels prior to the project, and repayment of onlent Bank funds was close to 98 percent. The outcome is considered satisfactory.

In **Bosnia and Herzegovina**, an *Emergency Pilot Credit* for Republika Srpska (FY98) was approved in a postconflict situation, for a modest amount, and cofinanced by six bilateral donors. The subloans were channeled through four state-owned banks, which benefited from TA on credit analysis and risk management; repayment rates were high and the quality of the portfolio of subloans good. A survey of enterprises pointed to both incremental employment and increased exports resulting from investments financed by the LOC.

The *Second Municipal Development Project* in **Morocco** (FY98), cofinanced with France, successfully met its objectives of increasing the provision of basic infrastructure in small- and medium-size cities and strengthening the financial institution specializing in providing financial services to the municipal sector. Because the borrower did not agree to TA, however, institutional development was less than expected (rated modest).

used well, and despite generally poor designs and outcomes, should not be entirely discarded from the Bank's lending toolkit.

Outcome ratings are closely related to the disbursement of funds. This may reflect a Bank-wide focus on disbursements rather than on achieving results. Although high disbursement rates are hardly sufficient for achieving objectives, they can be a signal that the demand for funds has not been overestimated, that the eligibility criteria have been realistically established, and that crowding out is not a problem.[8] In the smaller financial systems (defined by deposit size), which characterize most Bank clients, better disbursement rates turned out to be associated with the initial size of the LOC (and, in general, LOC disbursement do somewhat better in smaller systems than in larger ones). Therefore, although it is difficult to develop a formula for selecting LOC amounts, these findings point to the need to make conservative estimates of demand for funds and to ensure that the LOC represent a modest proportion of that estimate.

Use of LOC to bring about financial sectorwide improvements does not have a good track record; TA was seldom used, and where legal and regulatory changes were made under the project, little information was available on enforcement and outcome of the changes. Outcomes on financial sector objectives were considered to be satisfactory in about half the projects.

Conclusions and Recommendations

Findings

LOC can play a useful role when used well. They can achieve a variety of objectives, such as expanding access to credit for sectors and groups of borrowers that would otherwise be excluded from borrowing. They can also enable new technologies, expand access to infrastructure, help create employment, strengthen financial intermediaries, and develop a market in lending to subsectors.

In practice, however, many, if not most, Bank-funded LOC during the last decade failed to achieve good results. Bank guidelines on LOC were followed in the minority of projects; and in a high proportion of LOC, funds were not used as planned, financial sector objectives and real sector objectives were generally not met, and the rate of satisfactory outcomes was unacceptably low.

LOC are unlikely to disappear. According to Bank operational staff and managers, demand from governments remains strong and the queue of upcoming projects contains a number of relatively large LOC scheduled for approval in the next fiscal year. Furthermore, a recent internal Bank paper on enhancing Bank support to middle-income countries suggests the use of LOC for funding infrastructure at a subnational (mainly municipal) level. The Bank could be at the bottom of a U-curve in terms of commitments for LOC.

This review has shown that LOC can be useful instruments under the right circumstances and has pointed to a number of salient features of LOC that are associated with better outcomes. If Management continues to approve LOC, it must ensure that these features are present in the design and supervision of LOC and LOC components.

Recommendations

The recommendations regarding the guidelines are for Bank Management's attention; recommendations regarding other MDBs and donors are for the Bank Management, QAG, and IEG.

Operational Policy 8.30 should be updated to ensure that it applies to all types of LOC.[1] Second, it should be updated to reflect changes in Bank strategy as well as developments in financial instruments. The relatively wide use of single-currency Bank loans, for example, and the increased availability of risk mitigation mechanisms in some borrowing countries make the issue of who carries the foreign exchange

risk less important, and these developments should be reflected in revised guidelines. In addition, because the World Bank Group adopted the Private Sector Development Strategy, which proposed giving the IFC the right of first refusal for LOC, there is an inconsistency between the existing OP for LOC and the PSD Strategy, and the inconsistency should be addressed.[2] Coordination between the IFC and the Bank on LOC should be systematically implemented at a project level.

Management should ensure that the guidelines are followed. First, all LOC components in Bank-funded projects should be identified as part of the basic information on the loan/credit and the guidelines should apply to all LOC components. This review has shown that following the Bank's guidelines for LOC leads to better results. If the costs of establishing sound eligibility requirements, reviewing and monitoring eligible PFIs, making use of audits and reporting on their findings, and estimating the incidence of subsidies on financial intermediaries outweigh the benefits of the LOC, then the LOC is not the appropriate instrument for meeting the objectives of the component. In particular,

- Macroeconomic stability is important; few LOC succeed in a highly inflationary environment. Although high inflation rates no longer characterize most client countries, the Bank should not approve LOC or LOC components in countries with a history of high inflation in the years prior to approval year, even if the rates have been declining, nor should it approve LOC in countries with high and accelerating inflation (over 20 percent per year) in the years prior to approval.
- LOC implemented in financial sectors that are relatively stable and efficient, dominated by private financial institutions, tend to have much higher satisfactory outcomes than LOC implemented in very weak financial systems. The Bank should avoid approving LOC in systems that have unstable, uncompetitive, or poorly regulated financial systems.
- Using sound financial intermediaries leads to better outcomes. Selecting good intermediaries requires sound analysis by the Bank, as well as reasonably reliable data on financial performance and portfolio quality from the intermediaries and an external audit to verify the data. Better efforts should be made to measure subsidies and to discuss their magnitude and the policies underlying them with the government. A minimum set of key indicators should be reported on and analyzed for every LOC, including a measure of the quality of the loan portfolio, clear definitions, and other key ratios (such as capital adequacy) established by the prudential norms in the country.
- Using conservative estimates of the demand for funds and sizing the LOC to be a modest fraction of that demand can help reduce the probability of poor disbursements and the need for large cancellations.

Bank management should take the initiative to engage with MDBs and other major donors to assess the extent to which there are differences in guidelines governing LOC and to work toward-coordinating them, to the extent possible. At the country level, where there may already exist systems for aid coordination, agreeing with MDBs and bilateral donors may be less of a challenge, but anecdotal evidence suggests that the Bank has been taken by surprise by other donors undercutting Bank-funded LOC. Greater efforts are also needed at a country level to reach agreements with other donors on conditions for LOC.

Quality enhancement within the Bank for LOC should be improved. QAG should make explicit use of internal Bank guidelines for LOC in their quality-at-entry reviews and its ratings should reflect the extent to which the guidelines are followed. The Network also has responsibility for taking the lead in organizing quality control during the appraisal process. Some Regions have started a system of peer review of all LOC components and projects by financial sector staff. The extent to which this will improve quality will vary by Region and over time, but should be done in all Regions, even if the LOC are modest components of larger projects. This obviously makes the process of approving LOC

components in larger projects more time consuming and goes counter to the current efforts under way to simplify and streamline loan processing. But, the additional transaction costs to improve LOC quality-at-entry should pay off in terms of lower cancellation rates and better outcomes.

Improving supervision is more difficult. It has been shown here to be the weakest area examined. Again, key performance indicators should be included at appraisal, which will be reported on during supervision on a regular basis, and these should include the overall quality of the portfolio of the financial intermediaries as well as any available information on loan repayment rates for the Bank-funded subloans.

Basic indicators and quantitative financial information should be evident. For LOC components that represent a significant part of the project under review (e.g., over 30 percent of the loan or credit amount), ICRs should *not* be considered satisfactory if basic key indicators on loan repayments on Bank funds, portfolio quality of the PFI, and some measure of the amounts of subsidies involved are absent. In addition, evidence should be provided on these performance indicators in support of outcome ratings; in the absence of quantitative financial evidence on outcomes, the outcomes of these loans cannot be adequately evaluated and would be considered unsatisfactory.

Finally, with respect to the IFC's activities in this area, the evaluation group within the IFC is currently carrying out a study in selected countries on the institution's support for small and medium enterprises through banks. LOC comprise most of the operations covered by the study. Based on its findings, the evaluation group should consider whether to examine LOC not covered by the study.[3]

APPENDIXES

APPENDIX A: DEFINITIONS AND METHODOLOGY

Definitions

Lines of credit were defined to include funding onlent through financial intermediaries, where the intermediary took the credit risk, to final borrowers in a demand driven manner, and that required repayment. The decision on what constituted a LOC was based on the documentation at appraisal and, if available, at completion.

Even applying this definition did not always result in clear cut decisions and in any case resulted in an very heterogeneous set of LOC in terms of intermediary, final beneficiaries, and terms and conditions of the onlending. Although IEG believes that the identified LOC in this evaluation is as complete as possible, there may be some projects not in the IEG database containing LOC that could not be identified from appraisal or, if available, completion documents (too little information). The database may also include LOC that are in a somewhat gray zone. For example, several credits to China were to be onlent to a number of state owned enterprises (seed producers in one project and agro-industrial enterprises in another) preselected by World Bank missions for investments whose scope and objectives were predefined by the Government and the Bank. These two projects were included in the universe of LOC, because there was some degree of freedom in deciding on the exact scope of the final investments to be financed, although it was not clear from the documents who bears the credit risk.

Methodology of LOC Analysis

The questionnaire was designed to capture basic information on the LOC as well as the characteristics that would permit testing hypotheses related to fiscal year of approval, region, sector, and nature of financial intermediaries. It used the contents of the OD and OP as a guide for selecting the characteristics to examine. Thus, information on macroeconomic stability, sector distortions, onlending terms, eligibility criteria for selection of the PFI, use of audits, and attention to safeguards (mainly environment) was captured. The questionnaire with the questions and categories of information is attached as appendix table A.1 to this appendix.

Within the available resources, IEG selected as large a sample as possible to analyze the characteristics of the LOC. Because it wanted to maximize the information on completed LOC, it took the entire set of closed projects and a random sample of the active LOC. The resulting list of LOC analysed by the questionnaire is in table A.2 to this appendix.

Table A.1: Questionnaire for LOC

Topics	Variables/questions	Type of answer
General project information	Region	
	Country	
	Project id	
	Name of project	
	IBRD/IDA	
	Gross commitment (entire loan/credit size)	US$million
	Net disbursement (for loan/credit)	US$million
	Sector	
	Subsector	
	Lending instrument type	Inv/Adj
	Approval FY	
	Exit FY	
	Project status	Active/Closed
	Latest Development Objective from last PSR	
	Latest Implementation Progress from latest PSR	
	Latest risk rating - active projects	
	Was the project categorized as finance?	Yes/No
	Gross commitment for the FIL onlending component (no TA) – at appraisal?	Number
	Net disbursement for the FIL onlending component – at exit?	Number
What were main objectives of finance component? (check all that apply)	Financial sector reforms, increasing competition, transparency, efficiency, resource mobilization for the sector	Yes/No
	Promoting PSD, financing needs of subborrowers	Yes/No
	Strengthening financial intermediaries	Yes/No
	Specify other objectives	Explanation
Financial Intermediaries	At appraisal, number of PFIs	Number
	At appraisal, number of private PFIs	Number
	At completion, number of PFIs	Number
	At completion, number of private PFIs	Number
Macro framework at appraisal	Specify inflation range: <10%, 10–20%, 20–30%, >30%	Range
	Fiscal deficit as % of GDP	Number
	Indication of over or under valued exchange rate?	Yes/No
	Information available on protection/subsidy of targeted sector?	Yes/No
Eligibility requirements for participating intermediaries	Is there any evidence at appraisal that eligibility criteria were applied to select PFI?	Yes/No
	If yes, were eligibility criteria quantified?	Yes/No
	Was eligibility of a PFI continuously monitored by the Bank during implementation?	Yes/No
	How many new FIs became eligible during implementation?	Number
IDP	If FI did not meet eligibility requirements, were they allowed to participate subject to having an acceptable Institutional development plan (IDP)?	Yes/No
	If FIs did have an IDP, was it monitored during supervision?	Yes/No

Table A.1: Questionnaire for LOC (continued)

Topics	Variables/questions	Type of answer
	Was an FI ever dropped from the project for failing to show adequate progress on its IDP?	Yes/No
Onlending interest rates to ultimate clients and lending volume	Is information on onlending interest rates to PFIs available?	Yes/No
	Average nominal annual lending rate to PFIs at appraisal	Number/range
	Is information on onlending interest rates to the ultimate borrower available?	Yes/No
	Average nominal annual lending rate to ultimate borrower at appraisal	Number or range
	Was there a bonus for prompt loan repayment?	Yes/No
	Average nominal annual lending rate to PFIs during supervision OR at completion	Number/range
	Number of subloans estimated at appraisal	Number
	Number of subloans at completion, or latest supervision report	Number
	Average value of subloans estimated at appraisal	Number
	Actual average value of subloans at completion OR latest supervision	Number
	Actual average subloan amount/GDP per capita	
Arrears and loan collection	Is information on loan arrears/collection available for PFIs in appraisal report?	Yes/No
	Is information on loan arrears/collection available for the PFI in supervision reports?	Yes/No
	Is information available in supervision reports on loan arrears/collection for project funds?	Yes/No
	Is information on loan arrears/collection for PFIs available in completion reports?	Yes/No
	Is information on loan arrears/collection for project funds available in completion reports?	Yes/No
Adequacy of provisioning and reserves	Did appraisal report evaluate adequacy of loan loss provisioning/loan loss reserve for PFIs?	Yes/No
	Did completion report document adequacy of the annual provisioning for loan losses and/or loan loss reserve for PFIs?	Yes/No
	At appraisal, was there a plan to improve the adequacy of loan loss provisioning/loan loss reserve for PFIs?	Yes/No
The subsidy dependence of the PFI	Was the subsidy dependence index (SDI) or other tool to assess the subsidy dependence used at appraisal?	Yes/No
	If Yes, what was the SDI estimated value ?	<0%, 0–20%, 20– 50%, 50–100%, >100
	Did PSRs evaluate the SDI of the PFIs?	Yes/No
	If Yes, what was value of the SDI at beginning of project period?	<0%, 0–20%, 20– 50%, 50–100%, >100
	Did the completion report evaluate the SDI of the PFIs?	Yes/No
	If Yes, what was value of the SDI at the end of project?	<0%, 0–20%, 20– 50%, 50–100%, >100

(*Table continues on the following page.*)

Table A.1: Questionnaire for LOC (continued)

Topics	Variables/questions	Type of answer
Saving mobilization	Did the project promote saving mobilization among PFIs?	Yes/No
	Were the borrowers required to invest in obligatory savings?	Yes/No
Targeting	Did the FIL target subborrowers?	Yes/No
	If Yes, define the target group.	Explanation
Technical Assistance to PFIs	Did the loan include a component of technical assistance focused on improving lending operations?	Yes/No
	Total estimated loan/credit amount for TA component aimed at FIL at appraisal.	Number
	Actual net disbursement for TA component aimed at FIL at completion.	Number
	The main objective of the technical assistance	Explanation
	Were output indicators related to TA included in the appraisal report?	Yes/No
	Were the target output indicators achieved?	Yes/No
Assumption of foreign exchange risk	Is the FX risk assumed by the ultimate client?	Yes/No/Maybe
	Is the FX risk assumed by the PFI?	Yes/No
	Is the FX risk assumed by government?	Yes/No/Maybe
	Were fees for the assumption of FX risk paid by the client to PFI/state	Yes/No
	Were fees for the assumption of FX risk paid by the PFI to state	Yes/No
	Were the fees designed to fully cover the FX risk at appraisal?	Yes/No
Audited financial statements of the main PFIs	Were audited financial statements available for main PFIs at appraisal?	Yes/No
	Were audited financial statements available for main PFIs during supervision?	Yes/No
	Were audited financial statements available for main PFIs at completion?	Yes/No
	Did the Bank make a written response to annual audited financial statements of the main PFIs at any time during project implementation ?	Yes/No
Project restructuring	Was the project restructured/revised?	Yes/No
	If yes, what was changed?	
Project ratings for completed projects	How is project outcome rated?	
	What is the Institutional Development Impact rated?	
	How is sustainability rated?	
Environmental Assessment	How is the project EA categorized?	A, B, C, FI , if FIL is < 30 % of Project Cost, NA
	Were the subborrowers required to carry out EA?	Yes/No
	Is there evidence that the project planned to strengthen country's capacity to monitor environmental impact of subprojects?	Yes/No
	At completion, was there an indication of environmental impact?	Yes/No

Table A.2: List of Projects Included in Desk Reviews

Region	Country	Project ID	Name of project
Closed Projects			
Africa	Ghana	P000920	Private Enterprise and Export Development
	Rwanda	P002262	Private Sector
	Zambia	P003210	Social Recovery II
	Zambia	P003221	Agricultural Marketing and Processing
	Zimbabwe	P035628	Enterprise Development
East Asia and Pacific	China	P003595	Red Soils II Development
	China	P003563	Animal Feed
	China	P003561	Sichuan Agricultural Development
	China	P003533	Tianjin Industrial Development
	China	P003580	Southern Jiangsu Environmental Protection
	Indonesia	P003970	Financial Sector Development
	Korea, Rep. of	P004172	Financial Intermediation
	Philippines	P004614	Rural Finance 2
Europe and Central Asia	Armenia	P008279	Enterprise Development
	Bosnia-Herzegovina	P050892	Emergency Pilot Credit for Republika Srpska
	Bosnia-Herzegovina	P044389	Emergency Recovery
	Bulgaria	P008312	Private Investment & Export Finance
	Croatia	P008328	Emergency Reconstruction
	Croatia	P040139	Investment Recovery
	Estonia	P008401	Financial Institutions Development
	Hungary	P008482	Product Market Development
	Kazakhstan	P008503	Agricultural Postprivatization Assistance
	Kyrgyz Republic	P008520	Rural Finance Project
	Latvia	P034584	Municiple Services Development
	Latvia	P008527	Agricultural Development Project
	Latvia	P008529	Enterprise & Financial Sector Restructuring
	Latvia	P044804	Rural Development Project
	Lithuania	P035163	Energy Efficiency/Housing
	Lithuania	P008536	Enterprise & Financial Sector
	Lithuania	P008538	Private Agriculture Development
	Macedonia, FYR	P043447	Private Sector Development
	Moldova	P008561	First Private Sector Development
	Poland	P035082	Municipal Finance
	Romania	P008774	Industrial Development
	Slovenia	P008853	Environment
Latin America and the Caribbean	Bolivia	P006190	Municipal Development
	Ecuador	P007098	Private Sector Development
	Jamaica	P007485	Private Investment & Export Development
	Mexico	P007694	Transport Air Quality Management

(*Table continues on the following page.*)

Table A.2: List of Projects Included in Desk Reviews (continued)

Region	Country	Project ID	Name of project
Latin America and the Caribbean	Mexico	P007707	Second Water Supply & Sanitation
	Paraguay	P007917	Private Sector Devt/EL NINO
Middle East and North Africa	Egypt, Arab Rep. of	P005168	Private Sector Tourism Infrastructure and Environmental Management
	Jordan	P035995	Export Development
	Jordan	P005323	Housing Finance and Urban Sector Reform
	Morocco	P005486	National Rural Finance
	Morroco	P005514	Land Development Project for Low Income families
	Tunisia	P005748	Private Investment Credit
	Tunisia	P005720	Rural Finance
	West Bank and Gaza	P047065	Microenterprise
South Asia	India	P010563	Financial Sector Development
	India	P039935	Private Infrastructure Finance
	Pakistan	P010450	Second Private Sector Energy
	Sri Lanka	P010419	Private Financial Development
	Sri Lanka	P063472	Year 2000 Emergency Assistance
Active Projects			
Africa	Cote d'Ivoire	P037575	Municipal Support
	Mozambique	P049874	Enterprise Development
	Zambia	P044324	Enterprise Development
East Asia and Pacific	China	P040185	Shandong Environment
	China	P046952	Forestry Development in Poor Areas
	China	P003539	Sustainable Coastal Resource Development
	China	P003649	Shanxi Poverty Alleviation
	China	P046564	Gansu & Inner Mongolia Poverty Reduction
	China	P038988	Heilongjiang Agricultural Development
	China	P003639	Southwest Poverty Reduction
	China	P003600	Technology Development
	China	P003638	Seeds Sector Comm.
	China	P003591	State Farms Commercialization
	East Timor	P070283	Small Enterprises Project Phase I
	East Timor	P072654	Small Enterprises Project II
	Mongolia	P049789	Private Sector Development Credit
	Philippines	P048588	Local Government Finance and Development
	Philippines	P004595	Community Based Resources Management
	Philippines	P069491	Second Local Government Unit Urban Water and Sanitation
	Thailand	P056269	Social Investment
Europe and Central Asia	Armenia	P035806	Agricultural Reform Support
	Azerbaijan	P040544	Farm Privatization
	Azerbaijan	P035813	Agricultural Development and Credit
	Bosnia-Herzegovina	P062936	Export Enterprise Facility

Table A.2: List of Projects Included in Desk Reviews (continued)

Region	Country	Project ID	Name of project
Europe and Central Asia	Georgia	P050910	Municipal Development
	Kyrgyz Republic	P008524	Private Enterprise Support
	Moldova	P060434	Rural Investment and Services
	Romania	P056891	Rural Finance Development
	Russian Federat	P042622	Capital Market Development
	Russian Federat	P008839	Enterprise Support
	Russian Federat	P036973	Enterprise Housing Divestiture
	Russian Federat	P008827	Housing
	Turkey	P065188	Export Finance Intermediation Loan
	Turkey	P009073	Industrial Technology
	Ukraine	P044851	Export Development
	Uzbekistan	P046043	Rural Enterprise Support
	Uzbekistan	P050508	Urban Transport
Latin America and the Caribbean	Argentina	P006010	Provincial Agricultural Development
	Brazil	P037828	Parana Rural Poverty Alleviation and Natural Resources Management
	Brazil	P006562	Bahia Municiple Development
	Brazil	P006436	Ceara Urban Development & Water Resource
	Mexico	P007648	Medium Size Cities Urban Transport
	Mexico	P007710	Northern Border Environment
	Mexico	P007610	FOVI Restructuring
	Peru	P008037	Irrigation Subsector
Middle East and North Africa	Egypt, Arab Rep. of	P054958	Pollution Abatement
	Morocco	P005523	Municipal Finance II
	West Bank and Gaza	P043338	Housing Finance
South Asia	Bangladesh	P041887	Municipal Services
	Bangladesh	P044811	Financial Institutions Development
	India	P049770	Second Renewable Energy Project
	India	P050637	Second Tamil Nadu Urban Development
	Sri Lanka	P010517	Private Sector Infrastructure Development

APPENDIX B: DATA ON LINES OF CREDIT

Figure B.1: Lending by Region and Fiscal Year

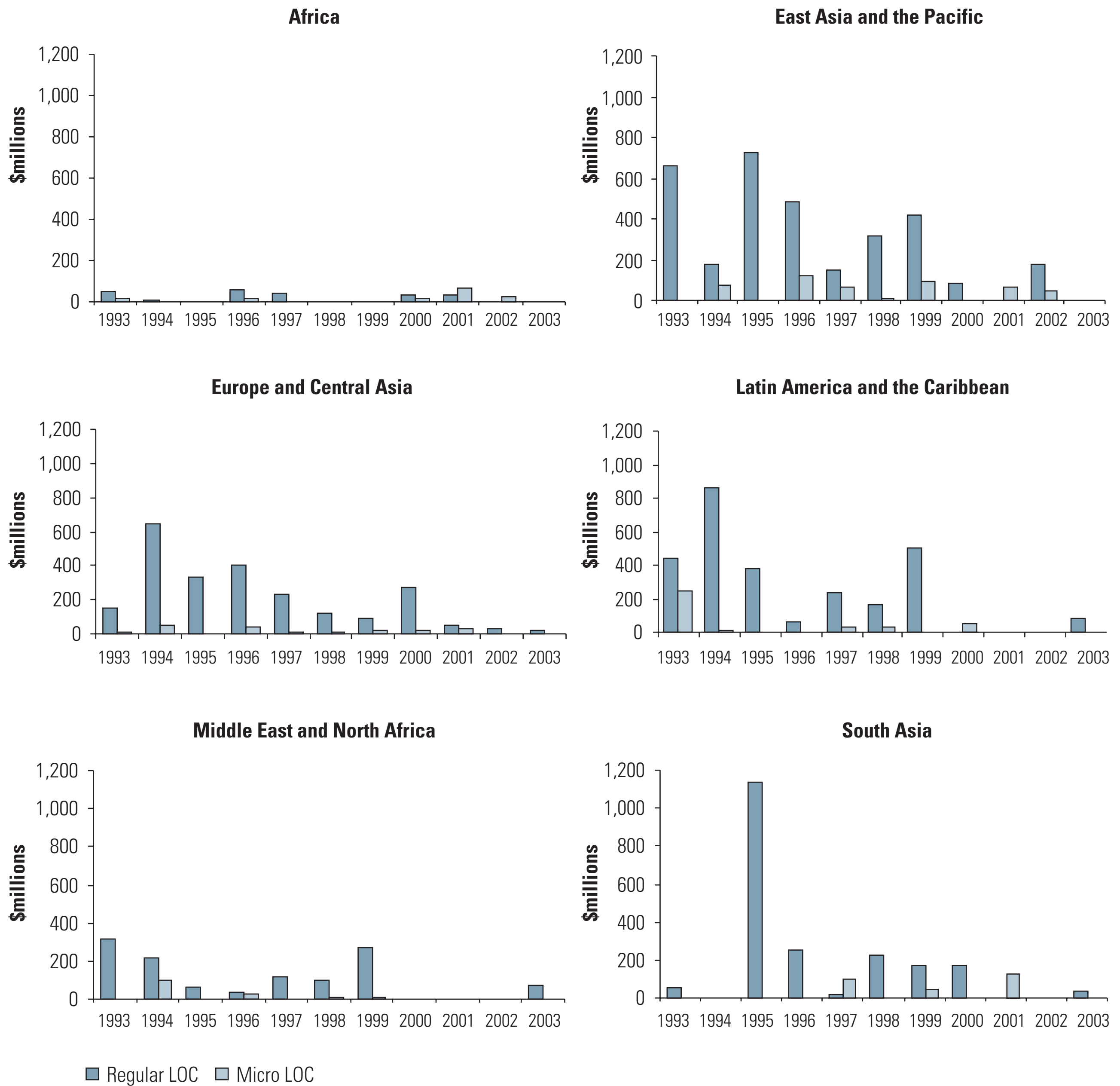


Figure B.2a: Total LOC Lending (Including Microfinance) as Percent of Total Bank Commitments, by Year

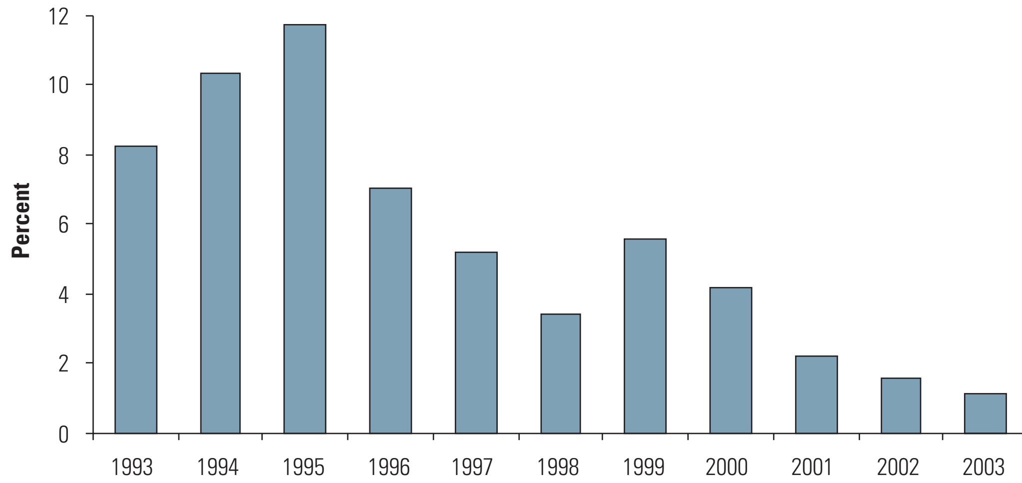


Figure B.2b: Total LOC Lending as Percent of Region's Commitments

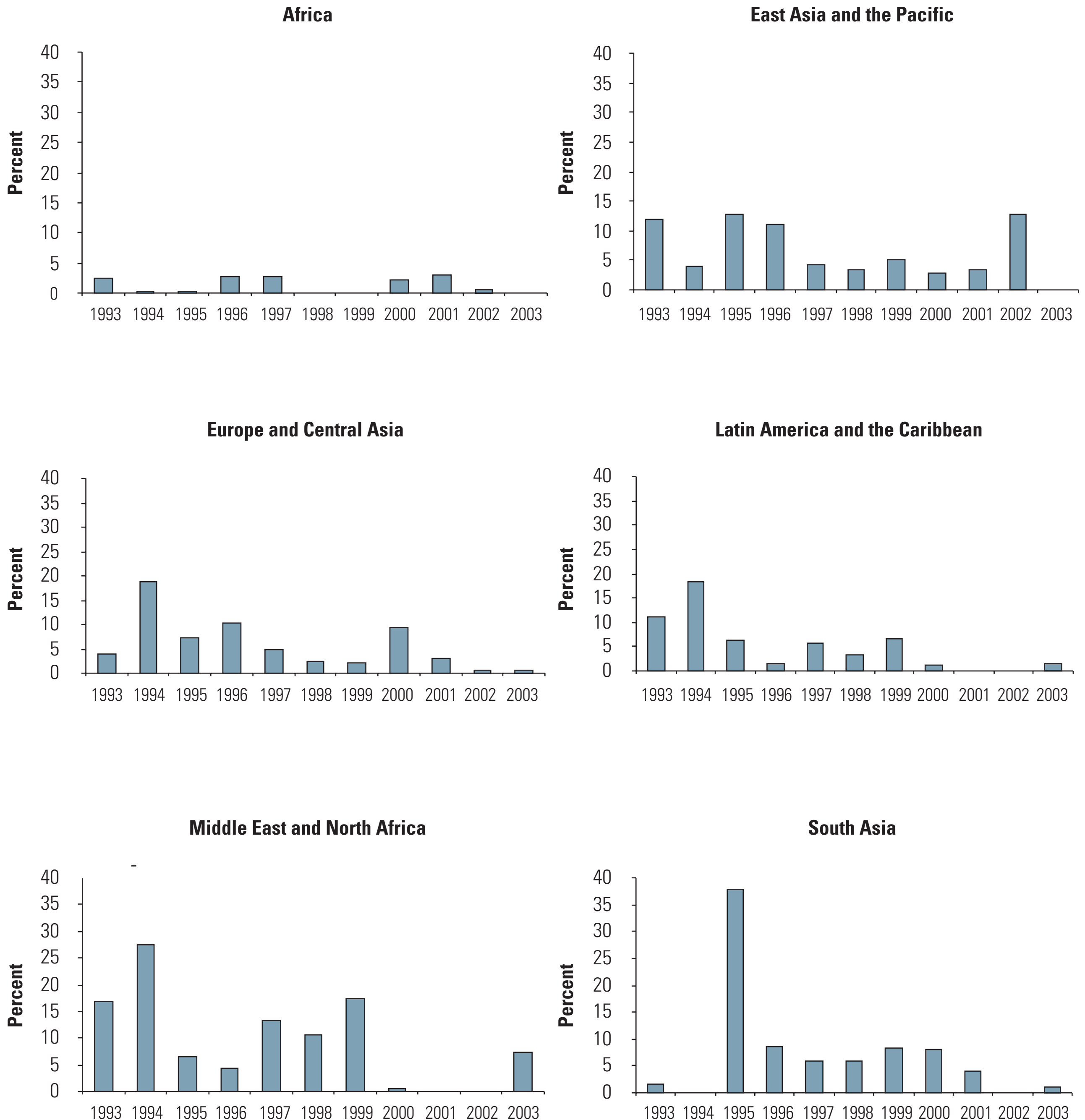
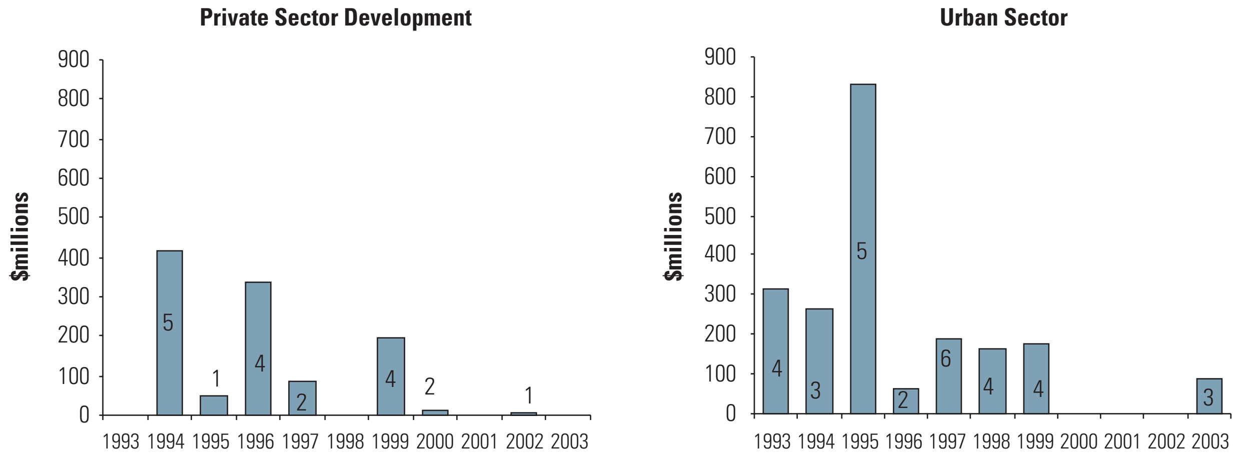
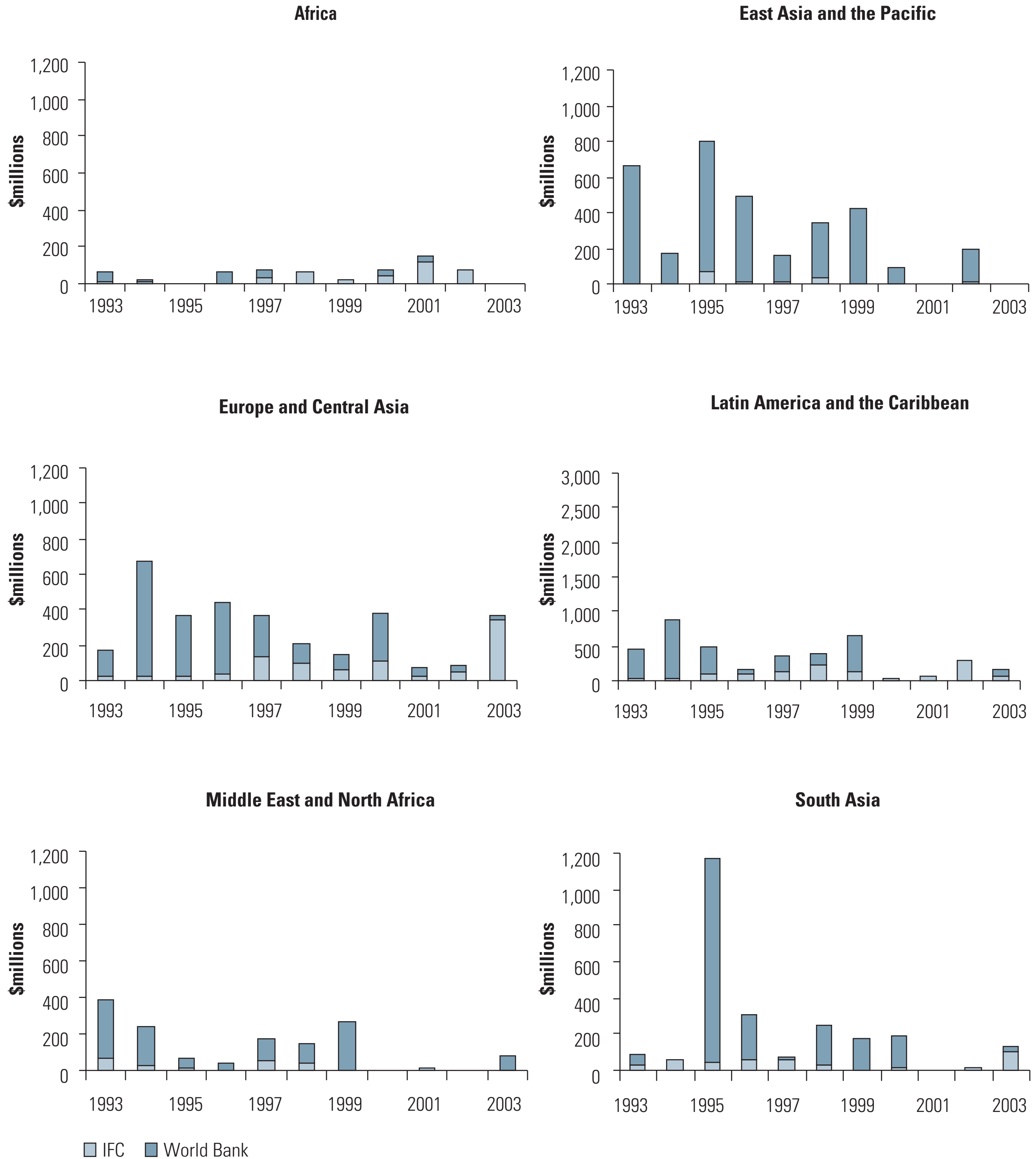


Figure B.3: LOC Lending, by Sector[a]



a. Financial sector and rural sector LOC lending are shown in chapter 3.

Figure B.4: IFC and Bank Lending, by Region and Year



Source: Independent Evaluation Group, IFC.

Figure B.5: MDB Lending and Bank Lending, by Region and Year

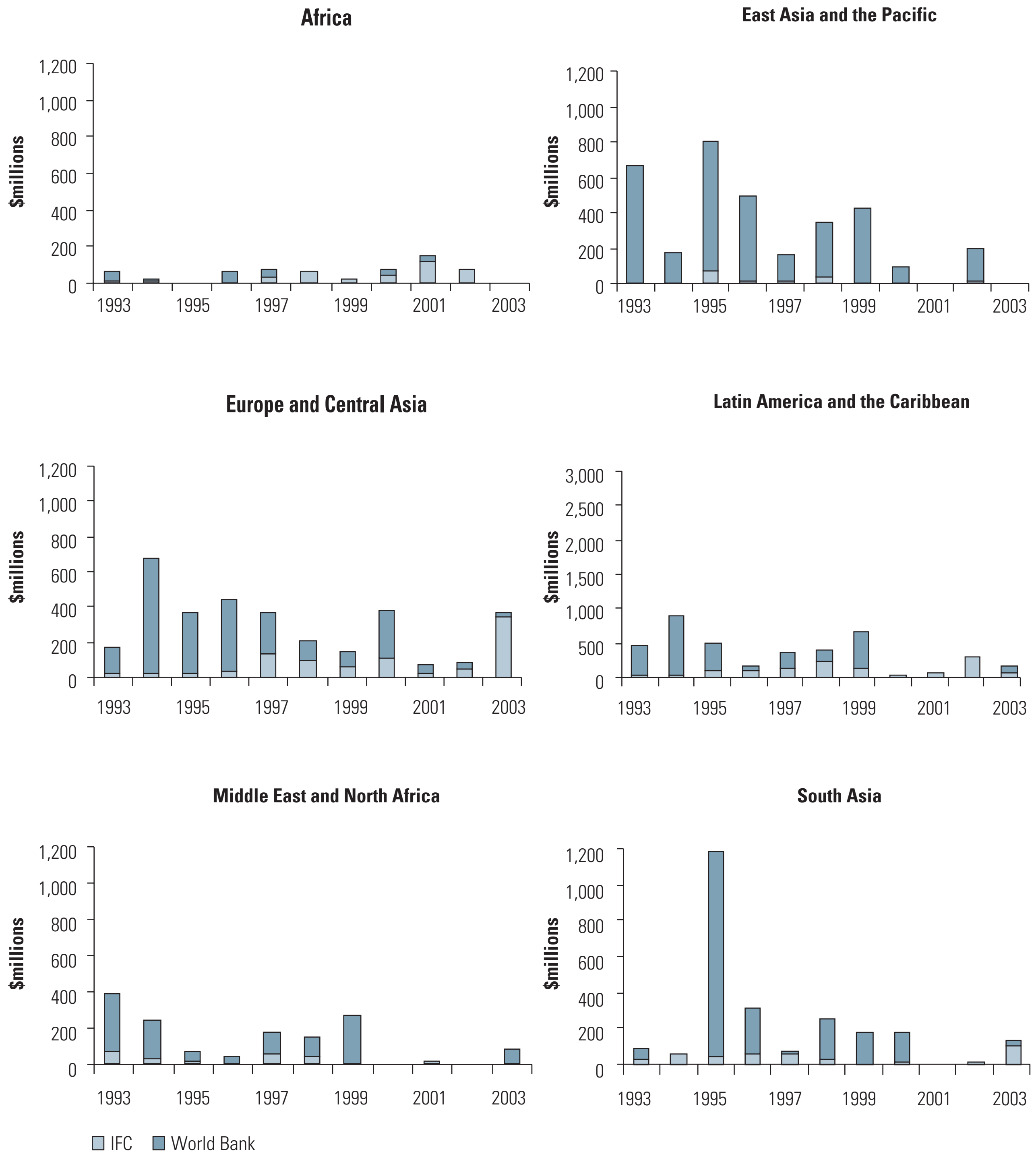


Figure B.6: Distribution of Regular LOC, by Proportion of Total Commitment

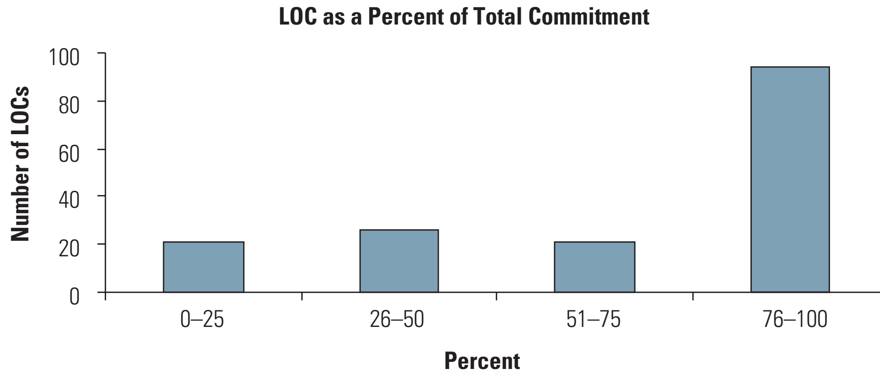


Figure B.7: Distribution of Regular LOC, by Size

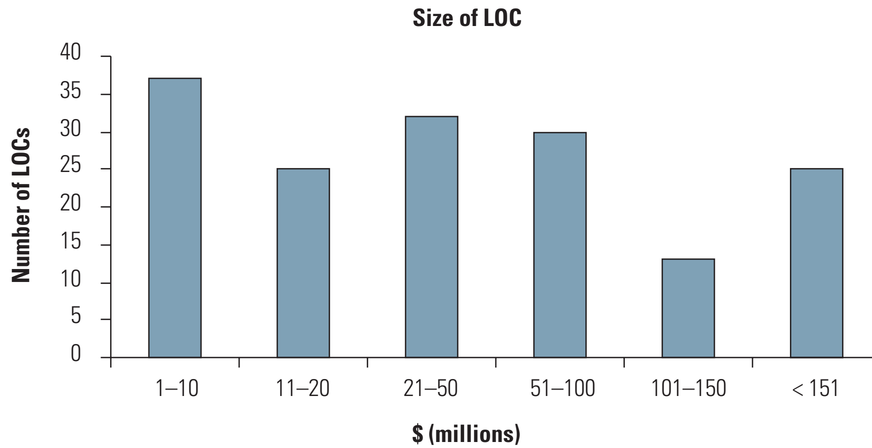


Figure B.8: Closed LOC: Disbursements as a Percentage of Original Commitments, by Fiscal Year

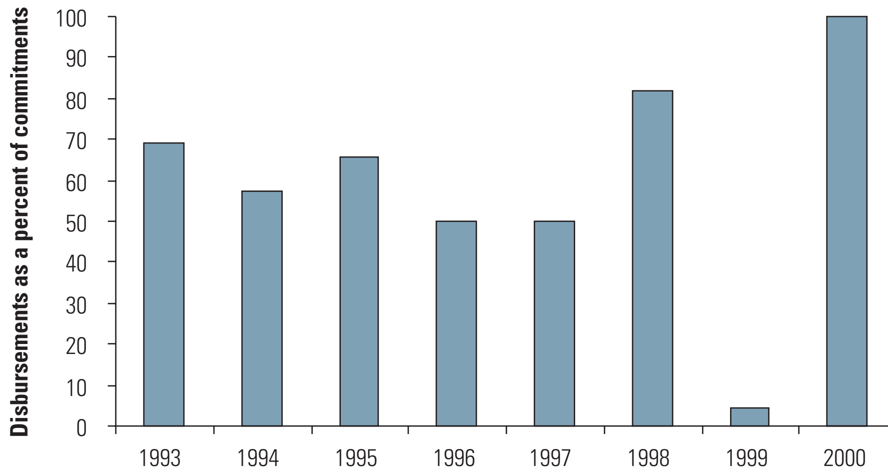
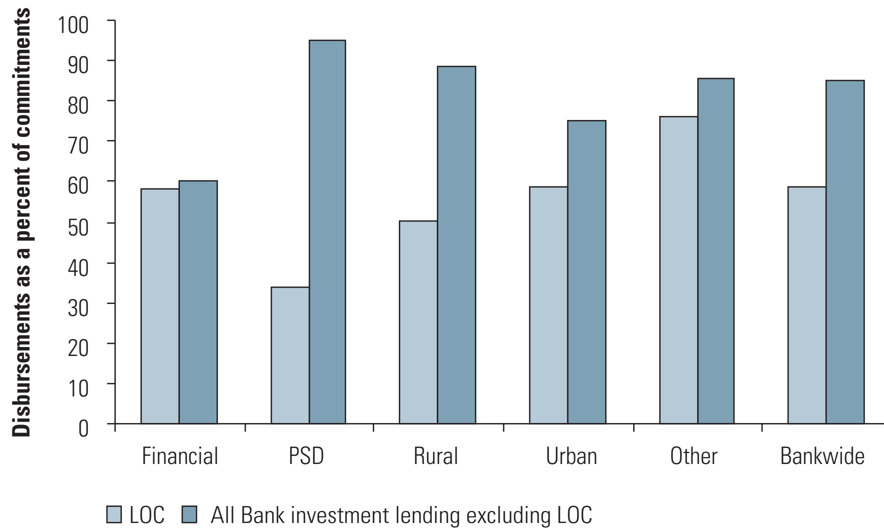


Figure B.9: Closed LOC: Disbursements as Percent of Original Commitments, by Sector



APPENDIX C: LOC LESS THAN 5 PERCENT OF TOTAL COMMITMENTS

The projects listed below are excluded from the LOC analyzed in this report.

Region	Country	Project ID	Name of project	Total loan commitment (US$m)	Estimated LOC amount (US$m)
Africa	Burkina Faso	P000297	Urban Environment Project	59.0	0.8
	Burundi	P000227	Social Action	10.4	0.2
	Chad	P035601	Population and AIDS Control	20.4	1.0
	Eritrea	P039264	Community Development Fund	16.0	0.5
	Madagascar	P072160	Second Private Sector Development	23.8	0.4
	Mali	P041723	National Rural Infrastructure Project	265.1	5.1
	Mali	P001755	Agricultural Trading and Processing Promotion Pilot	6.0	0.1
	Togo	P002891	National Agricultural Services Support	26.2	0.9
East Asia and Pacific	China	P036414	Guangxi Urban Environment	92.0	2.0
	China	P003598	Liaoning Environment	110.0	4.0
	China	P003599	Yunnan Environment	150.0	5.0
	China	P003590	Qinba Mountains Poverty Reduction	180.0	1.8
	China	P064729	Sustainable Forestry Development	93.9	0.3
	Lao PDR	P044973	Southern Provinces Rural Electrification	34.7	1.0
	Philippines	P058842	Mindanao Rural Development	27.5	0.1
	Vietnam	P042568	Coastal Wetlands Protection and Development	31.8	0.3
Europe and Central Asia	Azerbaijan	P035770	Pilot Reconstruction	30.0	0.4
	Slovenia	P055304	Real Estate Registration Modernization	15.0	0.1
Latin America and the Caribbean	Argentina	P045687	Health Insurance TA	25.0	0.8
	Argentina	P035495	Social Protection	152.0	0.5
	Colombia	P006870	Export Development Project	50.0	2.2
	Honduras	P007396	Environmental Development Project	10.8	0.5
	Nicaragua	P007780	Agricultural Technology & Land Management	44.0	0.9
	Peru	P008045	Transport Rehabilitation	150.0	0.4
	Venezuela, R.B. de	P040174	Caracas Slum Upgrade	60.7	0.2
Middle East and North Africa	Algeria	P038695	Mascara Emergency Reconstruction	51.0	1.6
	Algeria	P004976	Housing Completion and Sector Development	200.0	5.0
	Tunisia	P005733	Northwest Mountainous Areas Development	27.5	1.0

APPENDIX D: OPERATIONAL POLICY 8.30 AND BANK PROCEDURE 8.30

OP 8.30 - Financial Intermediary Lending

These policies were prepared for use by World Bank staff and are not necessarily a complete treatment of the subject.
OP 8.30 July, 1998

Note: **OP and BP 8.30 replace the policy and procedural elements of OD 8.30, *Financial Sector Operations,* and also replace OMS 3.81, *Interest to be paid by Commercially Oriented Project Entities,* and the Operational Circulars 12/78, *Interest Rates for Relending* (revised), and 3/83, *Interest Rates Policy.* These statements apply only to Bank loans made available to financial intermediaries for lending/investment; they do not apply to (a) transactions in which financial intermediaries act as conduits for Bank funds without assuming any credit or investment risks; or (b) such programs as emergency recovery operations, pilot programs, and operations in the social sectors, which may have credit components but do not aim at supporting sustainable institutions or programs. The OP and BP take effect with respect to all financial intermediary loans for which the Project Concept Document is first prepared after the date of this OP. Guidance in implementing the policy set out in OP 8.30 will be issued to staff separately. Questions may be addressed to the advisers in FSD.**

Financial Sector Context and Objectives

1. The Bank's[1] involvement in a country's financial sector is anchored in the Country Assistance Strategy (CAS) and driven by the Bank's overarching poverty reduction objective. As relevant, the CAS shows how the financial sector affects country development prospects; it highlights reforms to be supported by Bank financial sector operations, including their sequencing; and it states why the proposed operation is the appropriate vehicle for Bank support for reforms. As appropriate, the Bank consults with IFC, MIGA, the IMF, multilateral development banks, and selected donors on its proposed financial intermediary lending, and it coordinates its financial sector strategies and operations with theirs.
2. One form of the Bank's intervention in the financial sector is a financial intermediary loan (FIL).[2] Under a FIL or a FIL component of an investment loan, the Bank provides funds to eligible participating financial intermediaries (FIs) for onlending, at the FIs' risk, to final borrowers. The goals of such lending include:
   - (a) supporting reform programs in the financial sector or related real sectors;
   - (b) financing real sector investment needs;
   - (c) promoting private sector development;
   - (d) helping to stabilize, broaden, and increase the efficiency of financial markets and their allocation of resources and services;
   - (e) promoting the development of the participating FIs; and

(f) supporting the country's poverty reduction objectives. FILs are provided in the context of sound analytical work on sector issues, appropriate technical assistance, and, as relevant, adjustment operations to address policy issues.

Coordination between the Bank and IFC

3. In countries and operations in which the World Bank Group's institutional advice and financial support can appropriately be provided without significant governmental involvement or any governmental guarantee of repayment, IFC normally plays the lead Bank Group role in financial intermediary lending. The Bank normally leads in financial intermediary lending operations with important sector and policy reform goals that are included in the Bank's country dialogue. In countries where both the Bank and IFC are active in the financial sector, they coordinate the nature and design of their respective activities.[3] Both institutions aim at enabling FIs and final borrowers eventually to raise funds from market sources rather than from official lenders.

Policy Framework for FILs

4. The design and timing of FILs consider the prevailing and expected macroeconomic environment, including the exchange rate regime and international capital mobility, as well as conditions in real sectors. Given the critical importance of the macro-economic and sectoral framework for financial sector sustainability and efficiency, the Bank considers FILs only in the context of a satisfactory macroeconomic and sectoral framework. Within this framework, the Bank uses its lending and nonlending services to focus on improving the incentive environment for intermediaries.
5. Bank involvement in the financial sector through FILs does the following:
   (a) supports incentives for market participants, including eliminating hurdles in the way of organizing and giving out resources;
   (b) supports building infrastructure, including creating and strengthening sound and competitive financial institutions and markets, and improvements in financial and prudential regulations, banking supervision, and accounting and auditing standards; and
   (c) aims to remove or substantially reduce subsidies, whether given through interest rates, directed credit, institution-building grants,[4] or otherwise.

Interest Rates

6. The level and structure of interest rates are key determinants of economic efficiency,[5] and of financial sector viability. Interest rate distortions may misallocate resources, resulting in forgone national income. Removal of interest rate distortions in the country, therefore, is a key goal of financial sector reform programs supported by Bank FILs. When there are major interest rate distortions in the country (for example, large interest rate subsidies, pervasive interest rate controls, or policies that cause extremely high interest rates), the Bank does not support a FIL until the country sets up agreed programs[6] to remove or substantially reduce the distortions during the implementation of the FIL.[7] However, the Bank may support programs that include directed credit or subsidies (see paras. 7–8)

Directed Credit

7. Bank-supported FILs also aim to remove or substantially reduce the use of directed credits. Such credits are akin to interest rate subsidies, because they allocate resources outside the market. In many borrowing countries, increasing access to credit by specific sectors (for example, micro-finance institutions or the rural sector) is a major policy goal of the government, and some use directed credit to pursue this objective. A Bank FIL may support directed credit programs to promote sustained financing for such sectors,[8] provided the programs are accompanied by reforms to address the underlying institutional infrastructure problems and any market imperfections that inhibit the market-based flow of credit to these sectors.[9] Such reforms include measures to:

(a) address obstacles that block or delay funds from going to credit recipients, or
(b) bolster the creditworthiness of the intended beneficiaries through appropriate approaches such as mutual group guarantees.[10]

Subsidies

8. In some cases (for example, poverty reduction programs), subsidies may be an appropriate use of public funds. The Bank supports programs involving subsidies only if they:
   (a) are transparent, targeted, and capped;
   (b) are funded through the government budget or other sources subject to effective control and regular review;
   (c) are fiscally sustainable;
   (d) do not give an unfair advantage to some FIs as compared with other qualified and directly competing institutions; and
   (e) are economically justified, or can be shown to be the least-cost way of achieving poverty reduction goals. Subsidies not meeting these tests are phased out or are substantially reduced during the course of the FIL.

Eligibility Criteria for FIs

9. The Bank requires an assurance that FIs acting as onlenders in FILs and other investment operations are viable institutions, having:
   (a) adequate profitability, capital, and portfolio quality, as confirmed by financial statements prepared and audited in accordance with accounting and auditing principles acceptable to the Bank;[11]
   (b) acceptable levels of loan collections;
   (c) appropriate capacity, including staffing, for carrying out subproject appraisal (including environmental assessment)[12] and for supervising subproject implementation;
   (d) capacity to mobilize domestic resources;
   (e) adequate managerial autonomy and commercially oriented governance (particularly relevant when state-owned or state-controlled FIs are involved); and
   (f) appropriate prudential policies, administrative structure, and business procedures. Using these criteria, the Bank determines the eligibility of the proposed FIs, or it may require an apex institution[13] or other appropriate entity to do so.
10. FIs not meeting the eligibility criteria for being intermediaries (paragraph 9) may participate in a Bank FIL. To do so, they must agree to an institutional development plan that includes a set of time-bound monitorable performance indicators and provides for a midterm review of progress. When a FIL includes such FIs, the size and complexity of the FIL are commensurate with the FIs' implementation capacity; and the FIL may include an institution-building component that the borrower may pass on in the form of grants. Such FIs' continued participation in the FIL is subject to their satisfactory implementation of their institutional development plans. When progress is unsatisfactory, the Bank considers appropriate remedial actions, including suspension.[14]
11. FIs whose performance has long been unsatisfactory are required to take substantial corrective measures and demonstrate improvement before they are permitted to participate in a FIL, under an institutional development plan as described in paragraph 10.

Appraisal

12. The Bank's appraisal of a proposed FIL:
   (a) determines if it is the appropriate intervention to achieve the desired goals with regard to the sustainability of the financial sector;
   (b) establishes the economic justification of the operation;[15]
   (c) confirms, for a FIL justified by its poverty-reduction goals, that it is a practicable, cost-effective way of achieving such goals;
   (d) confirms the eligibility of FIs proposed for inclusion; and
   (e) ascertains that implementing the FIL is unlikely to undermine the financial condition of participating FIs.

Use of Bank Funds

13. FILs are used to finance investments in subprojects for increased production of goods and services.[16] The subprojects meet eligibility and development criteria[17] agreed with the Bank. The Bank agrees with the borrower on appropriate arrangements to monitor subproject compliance with these criteria. The borrower may pass on Bank funds to an FI either as a loan or as borrower's equity;[18] similarly, FIs may pass on Bank funds to subborrowers as subloans or equity investments. In all cases, Bank funds are disbursed against eligible expenditures for goods, works, and services.[19]
14. FILs are normally amortized by the Bank's borrowers on country terms[20] and not on a back-to-back basis.[21] The borrower may pass the funds on to FIs either on a back-to-back basis or on the basis of another amortization schedule acceptable to the Bank. When FIs' loan repayments to the borrower are not on a back-to-back basis, FIs may, within their overall loan amortization schedules, use repayments for purposes that are consistent with their business strategies or for prepayments to the borrower.

Onlending Terms

15. FIL onlending terms are set in the context of a borrowing country's interest rate structure and any agreed program for interest rate reforms (see paragraph 6). Bank funds are competitive with what the participating FIs and their subborrowers would pay in the market for similar money. They consider maturities, risks, and scarcity of capital.[22] When interest rates are not market-determined and there is an agreed program of interest rate reforms, FIL funds are onlent to participating FIs at interest rates agreed with the Bank that:
    (a) are not negative in real terms;
    (b) provide adequate margin to FIs to cover all costs, including credit and other risks, and an adequate profit margin; and
    (c) do not discourage resource mobilization from the market by providing a price advantage in using FIL funds.
16. Bank funds may be onlent to participating FIs and their subborrowers in either foreign exchange or domestic currency the basis of prudent credit decisions, including prospective subborrowers' ability to bear the foreign exchange risk to avoid later credit risk.
    (a) Where interest rates are market-determined and capital movement is relatively easy, local currency interest rates include an implicit premium that reflects market expectations in regard to exchange rate changes. In such situations, (i) Bank FIL funds are onlent to FIs in either local or foreign currency, provided the onlending interest rates are consistent with prevailing interest rates in the borrowing country for comparable credit; and (ii) FIs normally onlend to subborrowers in the same currency or currencies the FIs borrowed.
    (b) If interest rates are not market-determined but set administratively, it is not possible to determine market expectations of exchange rate changes. Foreign exchange risks may be underpriced in local currency interest rates. Therefore, the foreign exchange risk of FIL funds is borne either by (i) subborrowers through borrowing and repayment in foreign currency, or (ii) the government, if onlending and repayment are in domestic currency at prevailing administered interest rates. In the latter case, the government charges a fee that is passed on to FIs and subborrowers to offset the anticipated foreign exchange risk.

Monitoring

17. During project appraisal and negotiations, provision is made for effective monitoring and evaluation of the FIL's progress toward its goals and development impact throughout the project. The performance indicators cover sectoral, financial, and institutional variables. The variables for the FIs include, inter alia, adequacy of capital, quantity and quality of earnings, quality of assets, sufficiency of liquidity,

extent of subsidy dependence, effectiveness of FI loan administration (appraisal, supervision, and collection performance), and adequacy and timeliness of preparation of audited financial statements. During implementation, the Bank, the borrower, and the FIs use the agreed performance indicators, implementation progress reports, and a review of a sample of subprojects to monitor the FIL's progress. At least once each year during implementation, the Bank formally reviews the condition and performance of participating FIs, including a review of their audited financial statements, to determine their continued compliance with eligibility criteria. The findings of this review are recorded in Bank supervision reports.

Note: "Bank" includes IDA, and "loans" includes credits.

BP 8.30 - Financial Intermediary Lending

These policies were prepared for use by World Bank staff and are not necessarily a complete treatment of the subject.
BP 8.30 July, 1998

Note: **OP and BP 8.30 replace the policy and procedural elements of OD 8.30, *Financial Sector Operations,* and also replace OMS 3.81, *Interest to be paid by Commercially Oriented Project Entities,* and the Operational Circulars 12/78, *Interest Rates for Relending* (revised), and 3/83, *Interest Rates Policy.* These statements apply only to operations in the financial sector (see OP 8.30, paragraph 2); they do not apply to such programs as emergency recovery operations, pilot programs, and operations in the social sectors, which may have credit components but do not aim at supporting sustainable institutions or programs. OP and BP 8.30 take effect with respect to all financial intermediary loans for which the Project Concept Document is first prepared after the date of this OP. GP 8.30 (forthcoming) will discuss issues that the Bank and borrower frequently deal with in formulating financial sector strategy and will provide guidance on many of the elements in OP and BP 8.30. Questions may be addressed to the advisers in FSD.**

1. In formulating a Bank financial sector strategy and developing financial intermediary loans (FILs) for a country, Bank staff consult with the country's government and major financial institutions and, as appropriate, the staffs of the IFC, IMF, MIGA, and other donors and lenders.
2. FILs are processed in accordance with *BP 10.00, Investment Lending: Identification to Board Presentation*. Bank staff ensure that credible professional standards are applied to the design, implementation, and evaluation of FILs.
3. When an investment operation that is not a FIL includes a credit component, Regional staff consult with the Financial Sector Board; on the basis of that consultation, the Project Concept Review meeting decides to what extent OP and BP 8.30 apply to the component.
4. Any proposed back-to-back amortization for a Bank loan to a financial intermediary is subject to approval by the Regional vice president in consultation with the Vice President, Financial Policy and Risk Management (see *OP 8.30, paragraph 14)*.
5. Documentation for proposed FILs contains an analysis of relevant financial sector issues.
6. The Bank's standard procedures on the various aspects of project implementation (e.g., project supervision, disbursements, suspension of disbursements) apply to FILs.

Note: "Bank" includes IDA, and "loans" includes credits.

APPENDIX E: MANAGEMENT RESPONSE

Introduction

Management welcomes the comprehensive evaluation by the Independent Evaluation Group (IEG) of lines of credit (LOC) in all sectors and all types of projects as a valuable contribution toward clarifying the role they play in development lending. The IEG review is a new contribution to a long debate on Bank support through LOC—and the introductory section of the review provides a good summary of many elements of that debate. This response first summarizes the main findings, conclusions, and recommendations of the IEG study, and then sets forth Management comments on the analysis and conclusions as well as Management views and actions in response to the study's recommendations.

Summary of IEG's Findings and Recommendations

The major findings and recommendations of the report deal with Bank guidelines for LOC and their implementation.

Main Findings. The following are the main findings of the study:

- LOC are potentially useful, among other things, as a means of expanding access to specific sectors, introducing new technologies, and strengthening financial intermediaries.
- Most LOC, however, show poor results, primarily because relevant Bank guidelines—codified in Operational Directive (OD) 8.30, *Financial Sector Operations*, and later in Operational Policy (OP) 8.30, *Financial Intermediary Lending*, have often been ignored in project design and implementation. As a result, funds were not always used as intended, project objectives were not met in many cases, and overall ratings for LOC have been unacceptably low.
- Notwithstanding poor results and several years of declining Bank commitments, LOC are unlikely to disappear; indeed, the study documents signs of an increase in demand from client governments.

IEG's Recommendations. Monitorable recommendations for Bank Management include the following:

- Guidelines should be updated to reflect changes in Bank strategy (for example, IFC's "right of first refusal") and recent developments in the use of financial instruments (for instance, efforts to mitigate foreign exchange risk). The updated guidelines should apply to all LOC components, regardless of sector, thematic area, or objective.
- All LOC components should be identified in Bank loans.
- The Bank's LOC approach should be harmonized with those of other donors.
- The Quality Assurance Group (QAG) should use Bank guidelines in quality-at-entry reviews (QERs) and ratings.
- The Financial Sector Network should ensure quality control during the appraisal process.

The Report's Recommendation for IEG Itself. The report also has one recommendation for IEG. It recommends that satisfactory ratings in IEG assessments of Implementation Completion Reports (ICRs) for LOC should be contingent on the presence of quantitative financial evidence on project outcomes.

Management Comments

On the Analysis and Conclusions

Management finds the study comprehensive and rigorous in analyzing LOC operations, to the extent allowed by the information available. Moreover, Management agrees with IEG that there are significant quality issues with LOC, especially as regards implementation of Bank guidelines. Management submits, however, that the footnoted disclaimer regarding the scope of IEG's review deserved more prominence: "*This evaluation did not assess the adequacy of the LOC instrument for addressing constraints identified in the financial sector of the borrowing country or whether the constraints were appropriately identified*."[1] This is a crucial clarification, as the most common scenario in Bank operations that include an LOC is precisely one of addressing financial sector constraints and market failures. Whether LOC used in combination with other components such as technical assistance are effective in fostering borrowing countries' policy objectives and removing financial sector constraints remains an unanswered question.

LOC Definition. The IEG report defines LOC as "funds that are passed through an intermediary bearing the credit risk, for demand-driven purposes, and where the final end user has to repay the loan, usually with interest." Management suggests broadening the definition to include those funds with credit guarantees that transfer the credit risk to other entities. Management agrees with the clarifications in chapter 3, footnote 1 regarding matters excluded by an appropriate LOC definition, such as projects in which the intermediary serves only as a funding channel or funds are clearly used for public investment or fiscal transfer purposes.

LOC in Financial Sector Operations. The study does not clearly indicate the relevance of LOC in the Bank's overall financial sector operations or within country programs involving financial sector work. Given the two-phase approach adopted by IEG to evaluate Bank support to the financial sector, perhaps the conclusions regarding LOC should be revisited once the second phase, dealing with the overall support for financial sector reforms, is completed. The conclusions of the overall evaluation would put into perspective the use and contributions of instruments of Bank support, including advisory support, development policy lending, investment lending (including LOC), and technical assistance operations focusing on financial infrastructure (including payments systems, insurance, and credit information).

Assessing the Performance of Participating Financial Institutions. The study correctly emphasizes the importance of assessing the financial performance of participating financial institutions through reporting on key financial indicators and analyzing the impact of subsidies. Recognizing that institutional sustainability should be the dominant factor when assessing LOC, Management would argue that a comparable effort should have been made to assess the adequacy of LOC as a tool for addressing the financial development issues the country intended to solve. Management acknowledges that it may be difficult to add the analysis at this point.

Factors Affecting LOC Performance. The approach adopted in the study focuses on essentially two questions: (a) are the guidelines adequate, and (b) do operations adhere to the guidelines? While the guidelines reflect the key principles in the appropriate design of LOC (see below), the report points to poor or inconsistent implementation of the guidelines as the main cause of weak performance. Management would note that other possibilities beyond deliberate avoidance of the guidelines, including cost pressures and competing demands for time arising from other project elements in LOC operations, might have contributed to the finding. Management plans to explore this question further in a follow-up note to CODE and in the follow-up on actions designed to address the issues raised by IEG.

On the Recommendations

Management sees all of the recommendations as useful. However, in its response, it lays out

alternative paths to the achievement of some of the objectives.

> *Recommendation 1. The Operational Policy (OP) governing lines of credit should be updated to: cover all line of credit components and projects, regardless of sector or thematic area; and incorporate recent developments in financial instruments. IFC's right of first refusal should either be incorporated explicitly in the OP, or a mechanism should be put in place to ensure that it is systematically implemented at a project level.*

Operational Policy Review. As part of the implementation of the Private Sector Development (PSD) strategy, the Financial Sector Board (FSB) consulted with Regions and other sector boards regarding the application of the OP for LOC in all relevant Bank operations. These consultations concluded that the Operational Policy, in its current form, can be implemented to cover LOC in all sectors, with a systematic process of quality assurance. Against this background, Management will put in place the process of quality assurance outlined in Recommendation 2 below, which will cover LOC in all sectors. Management believes that this quality assurance process will clarify to staff the scope of the application of the OP, and signal strongly the need to implement the principles of the OP.

Enhanced Guidance. The FSB will prepare, as guidance to staff, detailed notes on practical applications of the principles laid out by the OP. This guidance will include the possible application of recent innovations in financial instruments to mitigate foreign exchange risk, as recommended by the IEG report. These notes fall within the umbrella of the current policy.

Possible Future Policy Revision. Of course, future findings may bring out problems with the current policy that will require revisions. As the quality assurance process is strengthened, Management will continue to monitor the need to amend the OP in order to ensure quality in LOC operations. If such amendments are needed, they will be considered in light of the ongoing investment lending modernization and simplification process, which, as noted in the PSD Strategy Implementation Progress Report,[2] was launched after the drafting of the PSD strategy.

The Roles of the Bank and IFC. As part of the discussions around possible revisions to OP 8.30, Management also reviewed the concept of IFC's "right of first refusal" with regard to LOC. After this review, Management believes that World Bank and IFC LOC operations are not easily interchangeable, and are at times complementary. The Bank's financial intermediation operations typically support policy reforms, address institutional issues and perceived distortions within the financial sector, and may, therefore, go beyond the investment objectives that are normally central to IFC LOC. Nevertheless, Management concurs that greater consultation and coordination is needed within the World Bank Group on our financial sector instruments to realize better realize synergies. This coordination has been an important part of the follow-up to the PSD strategy, for example, with joint initiatives such as the Africa small and medium-sized enterprise (SME) program, and the India SME loan.

Better World Bank-IFC Coordination. Management suggests that, rather than using an OP to address Bank and IFC coordination in financial sector work, it continue to use the mechanisms of joint CAS preparation and dialogue, and to strengthen Bank/IFC consultations at the project level. In these consultations, Management will expect project teams to adopt a "decision tree" to address the relative strengths and contributions of the World Bank and IFC in achieving developmental objectives using LOC. The roles and involvement of each will be determined on the basis of the type of risk involved, the capacity of participating financial institutions to manage risks, the extent to which the project objectives are linked to policy reforms or other sectoral issues, and the possible justification for a sovereign risk guaran-

tee. Operations that both the Bank and IFC support in a complementary fashion would obviously be a feasible outcome of such a decision-making process, as would the conclusion that neither institution should be involved. Management is preparing a guidance note on Bank/IFC coordination in LOC projects, and will link the note to the new guidance to staff related to OP/BP.

Recommendation 2. Bank Management should ensure that all LOC components are identified as part of the basic information on Bank loans or credits and that all LOC projects and components follow the guidelines governing the LOC, particularly with respect to: macro-economic conditions; financial sector strength; use of quantified eligibility criteria to govern selection of appropriate financial intermediaries; use of external audits; measure of subsidies; and key indicators established at appraisal and monitored during supervision, to include repayment rates on Bank-funded portfolio; quality of overall loan portfolio, and other key ratios (such as capital adequacy) established by the prudential norms in the country. The Financial Sector Network should ensure quality control during the appraisal process. All Regions should adopt a practice of review of LOC components by their financial sector staff.

Addressing Quality Issues. Management agrees with the principles underlying this recommendation. The quality assurance mechanisms, which are outlined in the Management Action Record below, will involve the early identification by the Regional Quality Directors of planned operations with LOC components in all sectors, and this list, to be updated regularly, will be shared with the FSB. For the next two years, the FSB, together with the Regional Quality Units, will organize Quality Enhancement Reviews (QERs) for each operation on the list. The line manager of each LOC operation will be responsible for ensuring that the findings and recommendations emerging from the QER are reflected in the final design of each operation. Performance indicators defined at appraisal will be explicitly included in the contents of subsequent Project Supervision Reports. QAG will include loans with LOC components in its samples for quality-at-entry and quality-of-supervision reviews for the next two fiscal years. After two years, the FSB will conduct an assessment and advise Management whether there is a need to continue this mandatory quality assurance practice.

Recommendation 3. Bank management needs to engage with other MDBs and major donors to assess the extent to which there are differences in guidelines and to work toward harmonizing them to the extent practical. Aid coordination at the country level should focus on improving coordination in practice.

Harmonization. Management largely concurs with the usefulness of in-country coordination. Harmonizing approaches on LOC with other donors, however, may elicit understandable resistance, as other donors may perceive this as an effort to harmonize around Bank guidelines. As with any harmonization effort, Management cannot commit to an outcome, given the partnership and consensus nature of harmonization. Management, however, recognizes the utility of sharing best practices among donors on their experiences on LOC. Toward this end, Management proposes to invite other donors to consultations on institutional experiences with lines of credit, with the aim of establishing some consensus on good practice.

Recommendation 4. QAG should use Bank guidelines in its quality-at-entry reviews and its ratings should reflect the extent to which the guidelines are respected.

QAG Reviews. Management agrees that QAG should use OP/BP 8.30 as the basis for its quality-at-entry reviews.

IEG Review of Bank Lending for Lines of Credit
Management Action Record

IEG Recommendation	Management Response
The Operational Policy (OP) governing lines of credit should be updated to: cover all lines of credit components and projects, regardless of sector or thematic area; and incorporate recent developments in financial instruments. IFC's right of first refusal should either be incorporated explicitly in the OP, or a mechanism should be put in place to ensure that it is systematically implemented at a project level.	*Management will implement a quality assurance system that will apply the existing OP/BP 8.30 to all LOC in all sectors, as outlined in Recommendation 2 below.* This response is in line with the IEG review's main finding that the poor performance of LOC seems largely to derive from poor implementation of the policy. The FSB will prepare guidance notes on coverage of LOC and on recent developments in financial instruments by March 2005. Management will monitor progress of the implementation of OP 8.30, and will consider needed changes to OP 8.30 in light of the ongoing investment lending modernization and simplification process. Management believes that WB/IFC coordination and synergies is more effectively accomplished through existing mechanisms of joint CAS preparation and dialogue, and strengthening WB/IFC consultations at the project level. In response to the recommendation, Bank Management will prepare a guidance note on WB/IFC collaboration expected in projects with LOC, which will address the relative strengths and comparative advantages of each institution and lay out a path for making a decision on which institution will support the client. This note will be available to staff by March 2005.
Bank management should ensure that all LOC components are identified as part of the basic information on Bank loans or credits and that *all LOC projects and components follow the guidelines governing the LOC*, particularly with respect to: macroeconomic conditions; financial sector strength; use of quantified eligibility criteria to govern selection of appropriate financial intermediaries; use of external audits; measure of subsidies; and key indicators established at appraisal and monitored during supervision, to include repayment rates on Bank-funded portfolio; quality of overall loan portfolio, and other key ratios (such as capital adequacy) established by the prudential norms in the country. The Financial Sector Network should ensure quality control during the appraisal process. All Regions should adopt a practice of review of LOC components by their financial sector staff.	*Management agrees with the principles underlying this recommendation.* It will put in place immediately a quality assurance system with the following elements. • Regional VPUs will provide FSB with a list of planned lending operations with LOC components, prior to appraisal. The list will use the definition of LOC in the IEG review, and will be updated regularly. • The FSB, together with the Regional Quality Unit, will organize Quality Enhancement Reviews (QERs) for each operation on the list. • The respective line managers will be responsible for ensuring that the findings and recommendations emerging from the QER are reflected in the final design of each operation. Performance indicators defined at appraisal will be explicitly included in the contents of Project Supervision Reports. • FSB will conduct an assessment after two years to determine whether there is a need to continue this practice. • QAG will include loans with LOC components in its quality-at-entry and quality-of-supervision samples for the next two fiscal years.

(*Continued on the following page*)

IEG Recommendation	Management Response
Bank management needs to engage with other MDBs and major donors to assess the extent to which there are differences in guidelines and to work toward harmonizing them to the extent practical. Aid coordination at the country level should focus on improving coordination in practice.	*Management largely concurs with the need for in-country coordination and sharing of good practices among donors on LOC.* Management commits to invite other donors to consultations on institutional experiences with LOC, with the aim of establishing some consensus on good practices in this matter.
QAG should use Bank guidelines in its quality-at-entry reviews and its ratings should reflect the extent to which the guidelines are respected.	Management agrees. In preparing for upcoming reviews, QAG will explicitly note the need to evaluate LOC on the basis of OP/BP 8.30.

APPENDIX F: CHAIRMAN'S SUMMARY: COMMITTEE ON DEVELOPMENT EFFECTIVENESS (CODE)

On October 13, 2004, the Committee on Development Effectiveness (CODE) discussed the IEG Review of Bank Lending for Lines of Credit, and the Draft Management Response to the IEG Review of Bank Lending for Lines of Credit.

IEG Findings. This review is the first comprehensive evaluation of all Bank-funded lines of credit (LOC). It is also the first part of a two-part IEG evaluation that examines Bank support for financial sector reform; the second part will be forthcoming. This review has three objectives: (i) to show trends in Bank Lending for LOC over the past decade; (ii) to establish the extent to which Bank guidelines and strategy on lending for LOC are consistent with existing literature, and the extent to which the lending has been consistent with guidelines; and (iii) to examine the outcomes of LOC and to review the evidence that supports the outcome ratings. The Consultative Group to Assist the Poor is carrying out a similar analysis on microfinance LOC, and their findings are consistent and similar to the IEG evaluation findings on LOC. IFC is currently evaluating its support to small and medium enterprises through banks.

According to the IEG review, the number and amount of funding for LOC have decreased sharply over the past decade. All sectors and regions experienced this drop in nonmicrofinance LOC except the Africa region, which had a low level of LOC lending throughout the period. Microfinance LOC, by contrast, remained steady at a modest level.

IEG reviewed a large sample of the LOC approved in the past decade and found that many did not implement Bank guidelines, particularly with respect to ensuring the soundness and viability of financial intermediaries and monitoring their performance. LOC outcomes were unsatisfactory in roughly half the projects, although outcomes were better when Bank guidelines were followed. The review found that cancellation rates of committed funds were twice those of other investment projects, which may be due to the inherent difficulty of estimating demand for funds and more attractive lending for LOC by other donors.

Comments from Management. Management welcomed the comprehensive evaluation underpinned by factual analysis, which is a valuable contribution toward clarifying the role of LOC in Bank operations. It broadly concurred with IEG findings that are sobering, particularly those related to outcomes and general lack of adherence to Bank guidelines, and with the recommendations. Management highlighted the long history of debate concerning the suitability of LOC as a development tool, and reflected on the factors contributing to the declining trend of lines of credit in operations. It did not see LOC as a major component of the Bank's financial sector operations, although the instrument will continue to be used where appropriate and justified. It would also explore other innovative ways to support financial intermediaries. Management expressed its commitment to implement actions consistent with the overall thrust of IEG's recommendations, particularly in ensuring quality of LOC operations and adherence to Bank guidelines. In this regard, it proposed to quickly put in place a quality assurance process led at the regional level and supported by the Financial Sector Board. Management stated its intention to clarify the guidance supporting the operational policy to improve the application of that guidance,

taking into account the PSD strategy and coordination with IFC. It would monitor the progress of implementing OP/BP8.30 to consider if changes were needed. It agreed with the importance of harmonization with other donors, but suggested that this recommendation not be formally included given the practical challenge of monitoring outcomes.

Overall conclusions and next steps. The Committee welcomed the IEG report but was troubled by the findings. Members made a variety of comments on the draft Management Response. Some members were not fully satisfied by the draft. Others welcomed the steps Management has outlined for improving the quality of LOC operations supported by the Bank. The Committee noted that the decline in LOC caused concern because, as several speakers noted, LOC could well be “tomorrow’s tool” instead of “yesterday’s news.” There is client demand for this instrument, and it can be a vehicle for directly supporting private sector-led growth. The Committee was disturbed by the poor performance of LOC and stressed the need to improve project design, strengthen quality-at-entry, and improve supervision monitoring of project implementation. In this regard, speakers were particularly troubled by the lack of compliance with Bank guidelines. Several speakers wanted to know why guidelines have not been followed; whether there is a problem with the guidelines and whether they need to be updated in light of changed economic and financial circumstances of the borrowing countries. The Committee requested from Management an analysis of the causes as to why policy implementation fell short in many cases, and measures to address them.

Some others raised the issue of competitiveness of Bank LOC, including pricing and the associated nonfinancial costs (e.g. too many objectives, conditionality, safeguard requirements), which may be overloading operations and the need to simplify these requirements. There was general sentiment favoring Management’s proposal for coordination with IFC through a consultative IFC-PSD mechanism as opposed to a mechanical IFC right of first refusal. Members also generally supported IEG’s recommendation related to harmonization and Management agreed to pursue further consultation with other MDBs and donors/lenders.

The following main issues were raised:

Effective use of LOC. It was acknowledged that LOC do not have a satisfactory record of achieving development objectives, reasons for which have varied across countries. Nevertheless, a few speakers expressed disappointment that despite the long experience, the Bank does not appear to have an effective modus operandi to deal with the shortcomings. These speakers felt that LOC have the potential of being an important vehicle for supporting private sector activities in borrowing countries, strengthening the institutional capacity of domestic lending agencies, and improving the regulatory environment. Some others emphasized the need to better match the volume of LOC with demand. One speaker said that LOC should be prepared in a timely manner (6 to 12 months) to ensure their effectiveness. Many commented that LOC can play a useful role, with one commenting that the report could have provided more insight on the effective use of LOC, particularly to address financial sector constraints. Several looked forward to the review on financial sector reform, which will provide more information on Bank performance in the financial sector.

Sequencing. Several members stressed that sequencing is critical, and highlighted the importance of appropriate financial intermediaries for LOC performance. A few of them suggested that TA be used to strengthen financial intermediaries before LOC are provided. Noting that Management stressed the complementary use of TA in LOC, one speaker suggested that the two-year review by the Financial Sector Board (FSB) could consider the effectiveness of TA in LOC operations.

Avoiding LOC in unstable macroeconomic environment. Several members commented that LOC operate in an imperfect financial environment. Moreover, countries experiencing financial instability may benefit most from LOC. They

stressed the importance of tailoring LOC to address these circumstances. In this context, a few speakers cautioned about too many preconditions related to macroeconomic and financial system stability for extending LOC. One member felt the IEG analysis could have considered further the country capacity to address shocks. He suggested that countries may have learned from experience and are now better able to utilize LOC in less stable situations.

Interest rate. One member emphasized that the interest rate offered to financial intermediaries is a critical issue, and should be provided at the lowest rate possible. In response, another member stressed that LOC must be self-sustaining. To achieve this, interest rates should be market driven, and onlendingrates would have to be at a positive real rate. Another speaker cautioned about subsidized lending and its potentially adverse economic impacts.

Exchange rate risk. Some members felt that exchange rate risk is a key contributor to high cancellation rates since most final borrowers are unable or unwilling to bear such risks. They urged the Bank to address this in its project design, suggesting also greater lending in local currencies. One of them also proposed that the new financial instruments to manage exchange rate risk should be incorporated in the revision of the OP/BP 8.30.

Bank guidelines. Many speakers stressed that the Management urgently needs to address the serious issue of poor adherence to the OP/BP 8.30, with one asking Management why this matter was not brought to the attention of the Board earlier. Given the circumstances, one member felt that focus should be on improving the application of guidelines, and revisions of the guidelines should be considered based on the upcoming financial sector review. Others supported IEG's recommendation to update the OP/BP, with one member suggesting that limited compliance may be attributed to the content of the current guidelines. Management supported the IEG recommendation for QAG to use OP/BP 8.30 as a basis for its quality-at-entry reviews of LOC to monitor the implementation of Bank policy.

Supervision. A few members stressed the need for adequate supervision. For this purpose good project design and monitoring indicators were considered critical. Management responded that line managers will be held accountable and they expected the new project status report process to improve supervision.

Bank-IFC coordination. Some members suggested further review of IFC's differentiated role and its experience in extending LOC, taking into account its perceived role. A few members urged the Bank to improve coordination with the IFC, and one of them supported the IEG recommendation for a formal mechanism for coordination and providing right of first refusal to the IFC. Others supported Management views and considered that instead of a mechanical application of IFC's right of first refusal, coordination may be achieved through country assistance strategy and through an IFC-PSD mechanism. Management clarified that the current OP/BP 8.30 provides a good framework for consultation with the IFC and the "right of first refusal" is essentially incorporated in the consultation phase. Moreover, IFC is now a member of the Financial Sector Board and thus is involved from the early stages of project development.

Harmonization. A few members recommended that the IEG recommendation on harmonization be kept. They urged the Bank to reach out and learn more about other MDBs' LOC operations, which will help to determine sectoral needs, demand for LOC, and investment gaps. Some others, while urging the Bank to learn from other donors' experiences, sympathized with Management's concern about the expectations related to harmonization and clarified that harmonization should not mean reduced competition in LOC pricing and terms. Management clarified its intention to deepen consultation with other donors and MDBs and learn from their experience, and agreed to keep the recommendation.

Chander Mohan Vasudev, Chairman

ENDNOTES

Chapter 1

1. Previous IEG reviews that included LOC are the following: "A Review of Bank Lending for Agricultural Credit and Rural Finance, 1948–1992" (OED, 1993) and a follow-up report (OED, 1996a); "Industrial Restructuring, World Bank Experience and Future Challenges" (OED, 1996b); "Financial Sector Reform: A Review of World Bank Assistance" (OED, 1998), which evaluated institutional development by financial intermediation loans; and "The World Bank and Microenterprise Finance: From Concept to Practice" (OED, 1999). In addition, the Bank and others have periodically reviewed its portfolio of financial sector intermediation loans and microfinance loans.

Chapter 2

1. See the World Bank's 1989 *World Development Report* for a summary assessment.

2. Asymmetric information between borrowers and lenders (the former having better information about the riskiness of their investment projects), adverse selection (higher interest rates will tend to screen out borrowers with low-return projects), and moral hazard (higher interest rates may be a disincentive to repay or an incentive to invest in riskier projects) will cause lenders either to offer less credit at a given interest rate, or impose significant collateral requirements. In countries with poor accounting information, poor credit registries, poor collateral laws, poor creditor rights, and weak or inefficient judiciaries, the problems of asymmetric information, adverse selection, and moral hazard are likely to dominate, resulting in significant credit constraints and underinvestment.

3. These views were reflected in an internal document and a 1983 internal Bank report on the problems of development finance companies that had been supported by Bank funding.

4. Specific aspects of these guidelines are reviewed in chapter 5.

Chapter 3

1. All aspects of the definition are important. The definition excludes projects where the intermediary does not bear the credit risk and serves only as a channel; or where government lends funds to a government implementing agency which is required to repay the subloan, typical of most projects in China. It also excludes projects which are not demand driven, that is, those where the use of the funds is identified in detail at appraisal, even if the funds pass through a financial intermediary and the end user (such as a power or water company) repays the funds; these are considered public investments, rather than LOC. Finally, it excludes cases where the funds do not have to be repaid; these are considered grants.

2. IEG also identified 28 LOC estimated at appraisal to be less than 5 percent of their respective loans (in the aggregate, $37.2 million out of a total $1,963 million). They were excluded from the analysis here because of their small size. Although a modest part of each project, these LOC may nevertheless be significant from the point of view of the country: this seems to be the case, for example, in Eritrea, where $0.5 million was committed at appraisal for onlending. These LOC, which include microfinance, are excluded from the analysis.

3. Microfinance is defined in this study as an average (ex ante) subloan size of no greater than three times the average per capita income in the country. It tends to have distinct characteristics, including use of a nongovernmental organization as an intermediary, short-term lending, and an absence of collateral. Microfinance LOC have been analyzed and are presented separately from nonmicrofinance LOC.

4. LOC are categorized under the respective sector board; for microfinance LOC by sector, see table 3.1 and appendix B. In following chapters, municipal LOC are singled out as a special type of LOC; the patterns on lending are similar to those for urban lending and are not presented separately here.

5. These figures show IFC funds that are to be onlent to identifiable subprojects. IFC also makes corporate loans to (and equity investments in) financial intermediaries (FIs) whose end use is not specified. To the extent that such corporate loans also represent a source of long-term funding that support FI lending to private enterprises and which could substitute for a Bank LOC, the relative importance of the IFC in providing such support is understated in figure 3.4 by roughly 30 percent during the period.

6. It includes lending with sovereign guarantees (no private sector lending) by the African Development Bank, Asian Development Bank, Inter-American Development Bank, European Bank for Reconstruction and Development, International Fund for Agriculture and Development, and Nordic Development Fund.

Chapter 4

1. This evaluation did not assess the adequacy of the LOC instrument for addressing constraints identified in the financial sector of the borrowing country or whether the constraints were appropriately identified. That would have required a much deeper assessment in each borrowing country than what was done here.

2. At the time of this analysis, data on FY03 LOC were not available; thus the period covered in this chapter is FY93–FY02. However, only seven regular LOC were approved in FY03 at a total of $206 million.

3. IEG used a sample rather than the entire universe of LOC because of resource constraints. Where analysis is based on information throughout the project cycle, 14 LOC are excluded that were substantially canceled (at least 90 percent of original LOC commitment); thus, the sample size changes, depending on the analysis.

4. Major sectors are defined by their sector board classification (financial, private sector development, and rural), plus municipal LOC. Although municipal LOC do not fit into a sector or thematic area, they are examined separately because of their unique nature (see box 4.1), their relatively large number, and because the Bank is proposing to rely more heavily on municipal LOC in middle-income countries for infrastructure development. Of the 22 municipal LOC in this sample, 13 are from urban and the rest from water supply; environment; and energy.

5. One LOC in Sri Lanka was to prepare banks for the new millenium turnover, Y2K; one in India aimed to recapitalize and strengthen state banks; and one in Russia aimed to strengthen banking supervision and accounting as well as selected PFI.

6. Two examples of this include the Philippines *Second Rural Finance Project* (FY96), where any enterprise located at least 30 km outside of Manila, the capital, was considered rural: both Reynolds Aluminum and San Miguel Beer, two internationally recognized companies, received Bank-funded subloans. In Turkey, the recently closed *Export Finance Intermediation Loan* (FY95) involved subloans to mostly prime exporting clients of private commercial banks.

7. This review did not examine the use of apex institutions versus direct lending to PFIs, in part because of the wide variety in apex arrangements, which made generalizations and comparisons difficult. In some cases, the apex was only a pass-through arrangement for funds; in others, it was the focus of Bank efforts at institutional strengthening. For a discussion of this issue in ECA transition countries, see IEG background paper by Fred Levy (2003). For a discussion of the experience with apex institutions in microfinance LOC, see CGAP Occasional Paper (2002).

8. This created particular problems in Morocco and Turkey in the early 1990s.

9. IEG looked for any indication of quantified eligibility criteria, beyond phrases such as "sound management," "strong performance," or "acceptable quality of loan portfolio."

10. A minimum repayment rate should be around 95 percent.

11. See IEG background paper by Ilka Funke (2003a), for further details.

12. Schreiner and Yaron (2001); and Yaron (1992).

13. OED, 1996a.

14. Status reports are required to record the receipt of audits;this may be considered by task managers to be adequate evidence of their use. However, receiving audits and noting whether the auditors' opinion is qualified is not considered an adequate substitute for reviewing and analyzing them for reviewing the performance and health of the PFI.

15. It was not possible to test this hypothesis for variables related to closed projects because of the small number of LOC approved in the last five years that had closed.

16. In 1999 the environmental guidelines added a separate category for financial intermediary loans (FILs). Prior to that date, LOC could be categorized

as "C," meaning that environmental issues were not relevant to the project.

17. For further analysis of information on real sector outcomes, see the IEG background paper by Brandie Sasser (2003).

18. Of the 69 microfinance LOC analyzed, 42 were considered as LOC passed through an intermediary and 27 as revolving funds established at the village or community level. In this paper, IEG refers to both designs as microfinance LOC.

Chapter 5

1. The larger financial systems, measured by deposit size, are those listed in World Bank (2005): China, Egypt, Hungary, India, Indonesia, Korea, Mexico, Morocco, Pakistan, Philippines, Poland, and Russia. These results were also analyzed without canceled LOC, on the assumption that total cancellation might be unrelated to the size of the LOC; differences between groups shrink for smaller financial systems, but the general pattern remains unchanged.

2. As of the end of February 2004.

3. Outcome ratings apply to the entire project; therefore, projects were included only where the performance of the LOC would have likely driven the overall outcome rating. In addition to those analyzed here, three other LOC, which were greater than 50 percent of the original loan, closed but were unrated because the entire LOC was canceled.

4. IEG convention calculates ratings by net commitments, or disbursed amounts. If outcomes by commitments were analyzed on gross commitments, the figure would be 40 percent.

5. In many countries, high inflation prevailed in the three years prior to LOC approval, but dropped to stable levels for most of the period of LOC implementation. Thus, there is little difference between outcomes of LOC in countries with high inflation prior to LOC approval and in countries with stable prices prior to the LOC; a difference would show up if there was high inflation during implementation.

6. Two components of the Country Policy and Institutional Assessment criteria that relate to the financial sector were used to test differences in LOC outcomes.

7. For a fuller discussion of these findings, see the IEG background paper by Ilka Funke (2003b).

8. Rapid disbursements are not necessarily a good sign, however, as they can also signal highly subsidized funding.

Chapter 6

1. Currently, pilot operations, emergency LOC, operations where the intermediary does not take the credit risk, and social sector projects where the Bank does not aim to establish a sustainable program or institution may be exempt from the guidelines.

2. A private sector strategy from February 2002 indicated that the FSB would update the OP by the summer of 2002.

3. The ongoing review of lending to small and medium enterprises will cover over half (by number) of the IFC's LOC during the FY93–FY02 period.

Appendix D

1. The Bank's intervention in the financial sector may also be in the form of other lending instruments (e.g., structural and sector adjustment loans and technical assistance loans), guarantees, and nonlending activities (e.g., country economic and sector work, training, and financial advisory services). These instruments are not covered by this OP.

2. This coordination is done during the preparation of CASs as well as when individual operations are processed.

3. Institution-building grants and other non-interest-rate subsidies may be provided in a variety of ways, e.g., as preferential income-corporate tax treatment, free use of facilities, consultancies, guarantees, training, and subsidized staff costs and overheads.

4. By definition, interest rates reflect the opportunity cost of capital in undistorted markets.

5. Interest rate reforms should be appropriately phased to minimize adverse impacts on the solvency and liquidity of financial institutions and enterprises.

6. In determining whether there are major interest rate distortions, consideration is given to the following factors, inter alia: (a) whether domestic interest rates are administered, are determined noncompetitively, or are affected by the government's fiscal tax/subsidy and regulatory policies; and (b) when capital markets are open, whether there are significant differences between domestic interest rates and interest rates payable on borrowings of foreign capital (which cannot be explained by prevailing economic conditions).

7. Directed credit programs supported by the Bank may be channeled through specialized financial intermediaries—that is, those that concentrate their lending in certain subsector market niches for busi-

ness strategy reasons. When such targeted lending is commercially oriented, it is not considered to be directed credit.

8. It is a good practice to routinely monitor the contribution of directed credits and their associated concessional terms to growth of the targeted sector(s) and poverty reduction, taking into account any adverse impact on other parts of the economy.

9. Inclusion of measures to mobilize local savings greatly increases the viability and effectiveness of rural finance programs.

10. See *OP/BP* 10.02, *Financial Management*.

11. FILs, including subprojects, are subject to all relevant Bank policy requirements, as set out in the relevant ODs, OPs, and BPs, including *OP/BP* 4.01, *Environmental Assessment* (forthcoming); *OP/BP* 4.04, *Natural Habitats*; *OP* 4.36, *Forestry*; *OP 4.09*, *Pest Management*; *OP 4.11*, *Management of Cultural Property in Bank-Financed Projects*; *OD 4.20*, *Indigenous Peoples*; *OP/BP* 4.12, *Involuntary Resettlement* (forthcoming); *OP/BP* 4.37, *Safety of Dams*; *OP/BP* 7.50, *Projects on International Waterways*; and *OP/BP* 7.60, *Projects in Disputed Areas*.

12. Under an apex or two-tier lending arrangement, Bank funds are passed initially to an apex (first-tier) institution, which onlends them to the participating retail financial institutions. An FI with actual or potential conflict of interest does not serve as an apex institution.

13. See *OP/BP* 13.40, *Suspension of Disbursements*. As appropriate, any suspensions may expressly exclude disbursements for individual subloans previously committed.

14. The economic analysis of a FIL takes into account the prevailing and expected macroeconomic environment and substantiates that the proposed operation will lead to net economic benefits arising from policy and institutional changes and increased availability of investment funds. If the justification for a FIL depends critically on addressing perceived market failures (i.e., nonmarket effects or externalities), the economic analysis explains the assumptions and their empirical basis. If there is evidence of a subsidy involved in a FIL such that resources through interest rates or other forms are provided below their economic opportunity cost, the extent of subsidy dependence is calculated and assessed. Risk analysis shows how robust the projected economic benefits of the project are to possible changes in assumptions about the macroeconomy, borrower commitment to the reforms supported by the FIL, and institutional performance.

15. Increased production of goods and services is established at the subproject level. It derives from expanding existing productive capacity, increasing the efficiency of capacity utilization, or creating new types of productive capacity. Working capital financing to maintain existing levels of production would not be eligible.

16. These criteria ensure that subprojects are financially viable and technically, commercially, managerially, and environmentally sound.

17. The Bank does not make equity investments in FIs or subborrowers.

18. See *BP* 12.00, *Disbursements*.

19. See *OP/BP* 3.10, *Financial Terms and Conditions of IBRD Loans, IBRD Hedging Products, and IDA Credits.*

20. A back-to-back amortization schedule is a composite of the individual amortization schedules for the subloans financed by participating FIs with the proceeds of Bank loans. In exceptional circumstances, when there is a strong justification on project grounds and the borrower is an FI, the FIL may be amortized on a back-to-back basis; see *BP 8.30*, *Financial Intermediary Lending*, paragraph 4.

21. When the Bank lends directly to FIs, the terms under which the loans are provided require the FI to pay a guarantee fee to the member country, if such a fee is necessary to make the cost of FIL funds consistent with the market rate.

22. The government may waive this fee in part or in full when necessary to achieve a FIL's development objectives (e.g., poverty reduction, or development of small enterprises). Because such as waiver constitutes a subsidy, it is subject to the provisions of paragraph 8.

Appendix E

1. See endnote 12 above.
2. See World Bank (2003).

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