KfW Development Bank

››› Materials on Development Financing

No. 2, Mai 17, 2018

What is “policy-based lending”?
Overview of the principles and possible applications of a new financing instrument for advanced partner countries

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Policy-based lending (PBL) is still a relatively new financing instrument in German development cooperation (DC). It serves as a means of promoting (sectoral) policy reforms, which can help to tangibly improve the general conditions for sustainable development in partner countries. In addition, by mobilising private funds, it also makes a significant contribution to financing the Sustainable Development Goals (SDGs).

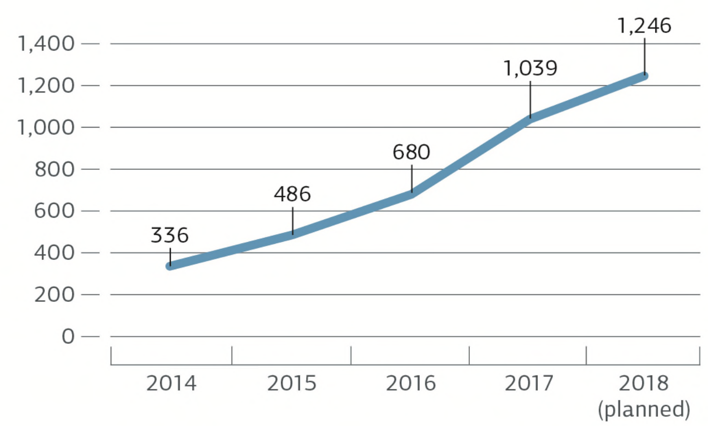
At present, interest in the instrument is on a highly dynamic trend. In light of the structural changes surrounding international DC (broadening of objectives, growing performance and changing needs of many partner countries), policy-based loans are expected to become a key permanent fixture in financing for advanced developing countries and emerging economies.

How do PBLs differ from other development financing instruments?

In an international context, roughly speaking, we can draw a distinction between three essential development financing categories:

- Conventional project/investment finance packages: These fund the cost of creating or procuring specific goods or services (e.g. power plants, hospitals, vaccination campaigns, etc.).
- Results-based financing packages: instead of funding the inputs

KfW’s commitment volume for PBLs (2014-2018)
in EUR million



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(costs), these reward proven outputs or outcomes (ex post) on a lump sum basis (e.g. x cents for each kilowatt-hour of power supplied to the grid from sustainable sources of energy).

- Policy-based financing packages: instead of linking payments to specific goods, services, or results, payments are made for the implementation of (sectoral) policy reforms (e.g. a national energy transition).

The abbreviations PBL (policy-based lending/loan) or DPL (development policy loan) are often used for the latter.

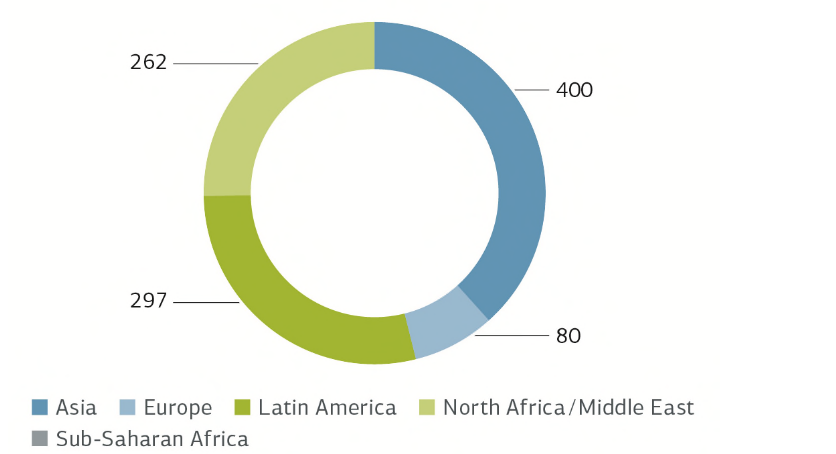
PBL is primarily offered by multilateral and bilateral development banks — in the context of German DC, this instrument rests with KfW.

In practice, PBL projects are often designed as multi-donor programmes (either in parallel or joint financing), as well as in combination with the other financing instruments mentioned above.

The key characteristic of PBL projects is a mix of:

- Policy dialogue on equal terms,
- Professional support for developing and executing the reforms,
- Large-scale concessional funding so that the reforms can be implemented quickly and comprehensively.

KfW's commitments for PBLs by region (2017)
in EUR million



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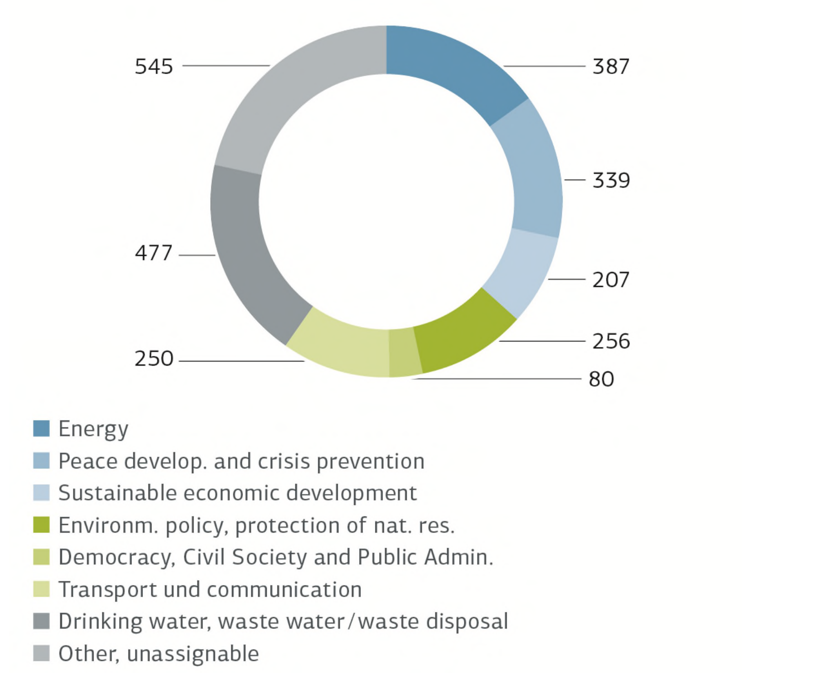
KfW's commitments for PBLs by priority area (2014-2017)
in EUR million



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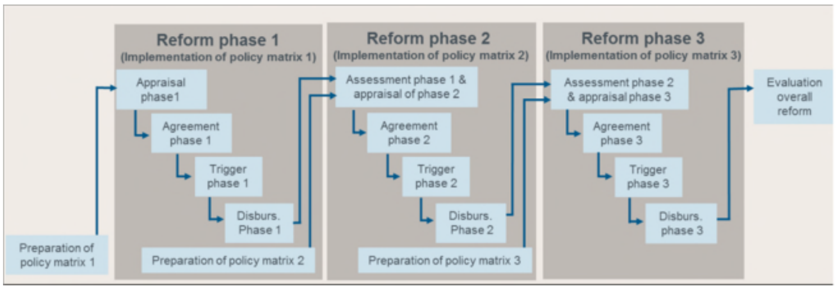
KfW Development Bank's PBL portfolio has seen a very dynamic upswing in recent years (with a current commitment volume of around EUR 1 billion a year and still growing). The portfolio is widely dispersed both sectorally and geographically. Priority sectors include water supply and disposal, energy, peace development, transport, and environmental protection, while geographically the focus is on the macroregions of Asia, Latin America, and MENA (there has not been any PBL commitment in Sub-Saharan Africa to date — see charts).

What is the "target" of PBL financing?

At the core of PBL projects are (sectoral) policy reform programmes, which are launched on the partner governments' own initiative and carried out with donor support. The basic prerequisites for PBL projects include a strong commitment on the part of the partner government to make reforms ("ownership and commitment") and an overarching national policy framework (development strategy) as the base of support for the PBL measures. The aim is to promote sustainable development in the partner country by reducing or eliminating structural barriers to development. The initial reform concept is worked out within a close dialogue between partner and donor countries, and is generally executed over multiple phases (see Figure 1). The partner country is always in the lead, with the donors providing support in the form of short-term consultancy inputs, policy dialogue (bringing in their own experiences) and financing. The reforms usually encompass a wide range of legislative, organisational, and investment-related measures. The most important reform steps ("triggers") and their implementation schedule are set

Figure 1
Support for a longer-term (multi-phase) reform project



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out in a policy matrix.

Although funds are almost always disbursed “ex post”, this is not a form of “retroactive financing”. Rather, the disbursements land right on time to co-finance the immediate costs of implementing the reforms, which put particular pressure on the sectoral budgets.

Execution over several phases ensures flexibility

Political reform projects are typically lengthy, come under the sway of specific forces (e.g. during election cycles), and their progression is difficult to exactly predict ex ante. Initially, there is always a larger-scale reform concept (e.g. to implement decentralisation policies or perform a national energy transition), which often has a time horizon of several years or even decades.

To make the longer-term reform measures manageable, they are generally executed over multiple phases, each usually lasting 1-3 years and building on one another. Only once one phase is coming to a close, the policy matrix for the next phase is defined in specific terms. This makes it possible to respond flexibly to results that are achieved in the meantime and to any unanticipated problems.

Opportunity to exit after each phase

Typically, a specific PBL project is designed for each reform phase (“PBL phasing”). In addition to making it easier to appraise projects of this nature (with the focus being on the ongoing phase, against the background of the longer-term reform project), this also allows to exit relatively easily from non-performing reform projects. This could be the case, for instance, if a project stalls as a result of changes in political majorities, in which case the donors would proceed to only finish the ongoing phase without continuing to support any subsequent phases. Other important benefits of this phased approach are that donors need not immediately block large own funds for future reform phases or get “locked-in” by political pressure to reduce large disbursement pipelines.

On what basic terms, when, and how do a PBL’s appraisal, conclusion of contract, and disbursement take place?

Unlike conventional budget assistance, the financing decision for a PBL is generally not made until discussions about the content of the relevant upcoming reform phase have concluded. For the most part, the agreed political reform decisions are already made by the time that the contract is concluded, and the measures are already in progress. This means that the funds can often be disbursed just a few days or weeks after conclusion of contract (usually as a “one-shot” complete disbursement). However, one must note that the conclusion of a contract is only the endpoint of a reform dialogue between donors and the partner government which will often have lasted for several months or years.

To facilitate uninterrupted support for a longer-term reform project, the upcoming phase is already prepared during the currently ongoing phase (with the next reform steps defined according to the results achieved so far). Initially after each phase, progress made with the reforms is reviewed, while the subsequent phase’s eligibility for promotion is appraised. If the progress made is satisfactory, a new contract is concluded for the new phase based on a realistic and sufficiently ambitious new policy matrix (see Figure 1).

What exactly does KfW appraise in the context of PBL projects?

The focus of the appraisal is always the current phase of the reform programme (against the background of the longer-term reform objectives). The appraisal of multi-donor programs often involves a division of labour between individual donors so that each donor specialises in the partner dialogue on specific sub-topics. The appraisal focuses on how reasonable the reform programme is (policy matrix), as well as how appropriate the national structures and approaches are for proper implementation of the reform programme under the partner’s own responsibility. The latter involves systematically appraising the government institutions’ performance capacity — e.g. in the management of public finances, or in the local environmental and social impact assessments due to be conducted (always with regard to possible risks for or from the project). In the event that the national systems are found deficient, improvement measures should be an integral part of the professional (sectoral) dialogue with the partner and of the reform programme. The execution of the reforms as a whole is reviewed against the implementation of the policy matrix (usually within the scope of an upcoming phase’s appraisal or within the scope of a final report or ex post evaluation (if German budget funds are involved).

How is the use of funds documented?

With this type of project, the funds are directly transferred into the partner’s budget. Since the funds can only be assigned to the reform programme as a whole and not to individual measures, the use of funds is docu-

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Case study 1: Urban Transport (NAMA) in Peru

As part of a multi-phase national climate protection programme (NAMA; Nationally Appropriate Mitigation Action), Germany is supporting Peru with promotional loans to back reforms in the sustainable urban transport sector (currently in preparation: EUR 70 million). The efforts planned include, for example, measures to limit pollutant emissions from private vehicles, to better coordinate public transport, and to promote non-motorised transport. Germany is the sole financier of these components and is currently actively involved in working out the policy matrix for Phase 1. The PBL project is an important supplement to KfW investment finance packages in the transport sector that are being implemented in parallel.

mented in these cases (as with conventional budget assistance) through:

- The records showing that the funds have entered the national budget, and
- The effective functioning of local Public Financial Management (PFM) systems (auditing bodies, budget transparency etc., to be evaluated by a PFM analysis)

Where does KfW add value?

First and foremost, the partner countries benefit from KfW bringing in its combined regional and sectoral inside knowledge, seconding short-term experts to help develop the reform programme and support its implementation, as well as its privileged access to international financial markets (providing the opportunity to even borrow larger sums under attractive conditions, passing these on to the partner governments). The volume of funds for PBL projects, which is typically large-scale, makes sure that the German contribution is a relevant part of the entire reform process in terms of its size and scope. Additionally, and in particular, these large amounts ensure that the German contribution enjoys high political visibility and attention, as well as having the unfettered access to the relevant national decision-making levels that is crucial for the German added value.

The "psychological" impact of external support for reforms is also worth noting. Gaining sufficient political momentum and backing for implementing the reforms in the partner countries has often required an external "nudge". In many countries, KfW acts as a "guarantor" (source of expert insight and neutral mediator) for professional and systematic execution of reforms. This can become a very important stabilising factor — especially when the government changes in the partner country during programme implementation. The offer of high-volume soft loan funds also often has a positive impact on political consensus-building in the partner country, as well as on the willingness to implement reforms more quickly and comprehensively than would have been the case without external support.

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Case study 2: Water Sector PBL in Tunisia

Germany has been supporting Tunisia with investment projects in the water sector for many years. To ensure that these projects are even more sustainable, including in the context of sectoral policy, Germany has also extended promotional loans anticipated to amount to EUR 300 million over three years to back reforms (2017-2019, with EUR 100 million disbursed so far). The measures fixed in the policy matrix provide sound support both to reforms in public financial management (PFM) and to water sector development, working in close cooperation with an IMF programme running in parallel to them. The activities in the water sector have included the passage of a new water law, national wastewater standards, and tariff changes.

To which purposes/countries are PBL projects especially well-suited?

As a financing instrument, PBL is an important addition to the range of support provided by Germany, and primarily aims to make structural impacts in advanced partner countries. PBLs are primarily used to improve important broad-based conditions for sustainable (sectoral) development, which are often difficult to influence with individual projects.
Often, PBLs are used to complement longer-term German project-type engagement in focal sectors: They can help to safeguard sustainability (e.g. with socially affordable reforms to tariff structures in terms of power and water supply, or by introducing, improving and enforcing environmental regulations). Germany's many years of experience within the sector in a given country often count as an important source of added value. PBLs may also take the place of investment finance packages in instances where partner structures are performing particularly effectively (in which case they are more prone to taking on the characteristics of budget or programme financing schemes). It is also possible to envisage situations in which Germany would use a multi-donor PBL to establish itself in a new priority sector in the partner country.

The aim of PBL projects is to support reform efforts intended to help partner countries to overcome structural barriers to their sustainable development. PBL projects are especially suitable for advanced developing countries and emerging economies (primarily middle-income countries) which fundamentally meet the following descriptions:

- Willing to reform, have reasonable basic ideas about what shape the reforms are to take (quick and visible implementation of the reform steps rather than a years-long policy consultation process), and are interested in a policy dialogue on equal terms about the reform measures
- Have effective implementing structures (as an executing agency) and implementing procedures of their own (including environmental and social impact assessments and transparent fi-

nancial management systems), allowing the intervention to operate at structural programme level rather than at individual project level)

- Creditworthy, manage debt sustainably, and (if the reforms are not self-financing over the medium term) have sufficient resources of their own to cover resulting costs that may persist in the budget (e.g. operating protected areas, social transfer systems).

Does it really make sense to finance political reforms with loans?

As with conventional investments, the formulation and execution of political reforms for the first time is generally associated with high additional costs (studies, training courses, recruitments/dismissals, including compensation payments, procurement, modifications, etc.) before these reforms come to pay off economically in the long run. For countries which are fundamentally creditworthy, it is often economically sensible to finance urgent reforms by concessional loans instead of delaying reform measures deemed necessary for many years, before they can be funded by that nation itself.

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Case study 3: Management of Public Finances in Indonesia

Along with the Asian Development Bank, Germany is supporting Indonesia with implementing a three-phase reform programme to improve its management of public expenditures (aligning expenditures to SDGs, ring-fencing spending in social sectors, budget transparency, subnational transfers of funds etc.) Germany is expected to co-finance the programme with reform assistance loans worth EUR 600 million in total (with EUR 200 million disbursed to date). In terms of specific activities, German attentions are focused on supporting the development of a model for prioritising spending.

How does this differ from conventional budget assistance?

PBL is unlike earlier general or sectoral budget support, which was offered to the least developed partner countries (LDCs) as straightforward grant financing in exchange for these nations formulating and adopting reform measures. Instead, PBL consists of large-scale (soft) loans, which, as a matter of principle, are only awarded to partner countries that have a high own implementation capacity and show strong commitment to and ownership for the reform agenda (mainly middle-income countries). In PBL projects, the partner country has absolute control over the reforms' design and execution.

In summary, not a cure-all, but a highly efficient instrument to promote sustainable development for strongly-performing middle-income countries

In conclusion, PBLs are a sensible addition to the selection of financing instruments that Germany has used to date, specifically for countries that are fundamentally willing to reform and creditworthy, with effective internal structures and processes:

- They are particularly well-suited for efficiently overcoming structural barriers to development and for supporting (sectoral) policy reforms.
- They can be an important tool to tangibly improve levels of synergy with conventional investment projects and results-based approaches (safeguarding sustainability on a sectoral level).
- They also match up to the increased self-confidence of advanced partner countries.
- They allow German DC to bring in its own experience in designing sustainable development strategies even in advanced developing countries and emerging economies.
- They clearly fit into the partner countries' overarching national development plans.
- They put the principles of the Paris Agenda (ownership, alignment, harmonisation, managing for results, mutual accountability) into practice in a close-to-ideal fashion.
- They are strictly geared to demand and require significant initiative (and contributions) from the partner countries (a good balance of "give and take").
- They enable good interplay between the political steering (German Federal Government) and the implementation (KfW).
- They clearly show and focus on the German added value and attract high visibility and relevance in the partner country.
- They structurally improve national conditions in partner countries, and in turn promote the general and sectoral investment climates.
- They can help to shape the transition from conventional development assistance to a partnership on an equal footing.
- They mobilise additional market funds, helping to close gaps in SDG financing.
- They allow the efficient use of German development budget funds ("blended finance") but contribute to Germany's Official Development Assistance (ODA) to the extent of the grant element included (provided that the minimum grant elements are achieved).
- As such, they make a reasonable addition to German DC's scope of instruments.

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Photos

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