INVESTMENT LENDING REFORM:

CONCEPT NOTE

OPERATIONS POLICY AND COUNTRY SERVICES

January 26, 2009
### Abbreviations and Acronyms

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Description</th>
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<tbody>
<tr>
<td>APL</td>
<td>Adaptable Program Lending</td>
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<tr>
<td>BP</td>
<td>Bank procedure</td>
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<td>CAS</td>
<td>Country Assistance Strategy</td>
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<td>CSR</td>
<td>Controllers, Strategy and Resource Management</td>
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<td>FIL</td>
<td>Financial Intermediary Loan</td>
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<tr>
<td>GAC</td>
<td>Governance and anticorruption strategy</td>
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<tr>
<td>IBRD</td>
<td>International Bank for Reconstruction and Development</td>
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<td>IEG</td>
<td>Independent Evaluation Group</td>
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<td>IFC</td>
<td>International Finance Corporation</td>
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<td>IL</td>
<td>Investment lending</td>
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<td>IT</td>
<td>Information Technology</td>
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<td>LIL</td>
<td>Learning and innovation loan</td>
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<tr>
<td>MICs</td>
<td>Middle Income Countries</td>
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<td>OP</td>
<td>Operational policy</td>
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I. INTRODUCTION

1. Investment or project lending (IL) continues to be the primary lending instrument of IBRD and IDA, accounting for the largest share of their lending—about two-thirds of combined IBRD and IDA annual commitments and about 70 percent of their active lending portfolio. IL is used in all sectors where the Bank is active, with concentration in the infrastructure, human development, agriculture, and public administration sectors. Today IL finances a wide range of activities, including physical capital-intensive investments, rehabilitation and maintenance, service delivery, micro and other credit and grant delivery, community-based development, and institution building.

2. **Enduring Importance of IL.** The value and importance of IL extend beyond the financing it provides. Unlike commercial lending, Bank support for investment projects not only supplies borrowing countries with needed financing but also serves as an important vehicle for sustained, hands-on global knowledge transfer and technical assistance. This includes support with analytic and design work in the conceptual stages of project or program preparation, technical support and expertise (including in the areas of project management and fiduciary and safeguards activities) during implementation, and institution building throughout the project. That the Bank's borrowers value these aspects of IL is evidenced by continually high demand for IL from most borrowing countries and its predominance in the portfolios of many countries.

3. **Challenges Facing IL.** The Bank’s business model and products continue to evolve. Clients are seeking—and Bank staff are developing—new and innovative lending products that provide quicker and more customized solutions, and operational practice often outpaces operational policy. The Bank’s IL model has not kept up with borrowers’ needs; and has become encumbered by a web of internal, rule-based processes and requirements. Some borrowers—especially middle-income countries (MICs) that have access to alternative sources of financing—have begun to feel that the nonfinancial costs and rigidities associated with IL may outweigh the benefits associated with Bank involvement. The Bank's efforts remain heavily focused on preparation and design work for the traditional, ring-fenced infrastructure project rather than on implementation support and broader concerns with getting results, ensuring effective public expenditure, and strengthening institutions. Moreover, the supervision model often falls short in bringing the right expertise, attention to issues and the more proactive portfolio management needed to respond to the development challenges of our projects and the uncertain environment in which we operate.

4. **Transformation Needed.** Concerns about the shortcomings of the IL instrument are not new; they have been the focus of numerous reviews (dating as far back as the 2000 Cost of Doing Business with the Bank), the MIC Strategy, and of such important reform initiatives as the policy changes for expenditure eligibility and additional financing; fiduciary reforms in the areas of audit, financial management, procurement, and disbursements; and the introduction of country systems pilots in safeguards, financial management and procurement. These efforts have yielded significant improvements in
addressing some of the concerns, but they have not produced the fundamental reform the IL instrument needs. It is time to transform the Bank’s IL instrument and bring it into the 21st century. This will mean replacing the plethora of existing IL policies with a modern, concise, and integrated policy and operational framework, accompanied by efforts to improve risk management, move away from the corporate culture of project approval, and strengthen accountability.

5. **Purpose and Structure of Paper.** This paper lays out the context in which the Bank is working and identifies the issues facing IL. The Board of Directors has a major role to play if IL reform is to succeed; thus this paper seeks the views and inputs of the Executive Directors before significant technical work on IL reform is launched. Following this introduction, Section II of the paper identifies and discusses a range of issues to be tackled as part of IL reform, and Section III explores where reform can be most effective. Section IV proposes a process (including consultations) and timetable for work on IL reform.

II. **INVESTMENT LENDING ISSUES**

6. Despite enduring as the Bank’s primary lending instrument that has served many clients and sectors well in the past, IL is being increasingly criticized inside and outside the Bank because of its inability to adapt to the varied needs of the Bank’s clients and the inefficiency, rigidity, and insularity of the processes and requirements that apply to it. Bank staff working on IL operations feel a growing sense of frustration1 and complain that under the current IL model they cannot easily offer the design and financing options client countries want and need to better meet their development goals and results. The rule-based IL processes, combined with a sometimes risk-averse culture, lead staff to take in many cases an excessively conservative approach to project design with inadequate emphasis on making midcourse corrections during project implementation. As a consequence, substantial amounts of time and effort are used to satisfy internal processing, review, and documentation requirements at the expense of work with and in client countries. There is a growing consensus among staff and management, as well as partners, that the Bank should be moving away from focusing on its own funds to providing greater support to broader programs of effective public expenditure. The challenge is how to do all this while identifying and addressing key governance and corruption risks and vulnerabilities in Bank/IDA supported programs and projects.

7. **Changing Aid Architecture.** The availability of new financing sources has been one of the most significant changes in development assistance in recent years. New bilateral donors with significant resources, such as China, India and Brazil, are now active in their support of infrastructure development in Africa. Sovereign wealth funds and foundations are expanding their outreach and impact. And, notwithstanding the current crisis in the financial sector, domestic and international capital markets are playing a larger role in the financing strategies of middle-income countries. The Bank’s role as a partner for other multilateral and bilateral donors has grown to respond to

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1 See 2008 Staff Survey, Q&A re process overload.
requests for using the Bank’s work as a platform for pooled resources, taking advantage of the Bank’s technical design, fiduciary assessments and implementation support for projects and programs. Even more important has been the growing consensus among partners of the need for a focus on development effectiveness, where impacts on the ground are what matters as well as building more effective and inclusive partnerships as called for in the Accra Agenda for Action (September 2008). In sum, new challenges and a richer and dynamic environment for development assistance are pressuring us to deliver better, more effective, and more partnered solutions.

A. The IL Instrument

8. The Bank’s IL model has remained largely unchanged since the 1960s. The primary IL policy and process requirements are premised on a project-centric and input-focused instrument that revolves around the 30-year-old concept of the “project cycle” and the Bank’s role as the dominant project financier. This model was developed for projects with a predetermined design, or “blueprint”—a traditional capital investment project, such as construction of a new dam, building, or bridge. Appraisal of such projects was based on assessing the technical and financial viability and sustainability of the detailed engineering plans developed during project preparation, while supervision measured performance relative to the original engineering plan or blueprint, including performance against the original budget and implementation targets. Under this early concept, risk evaluation mainly focused on the extent to which the rate of return could stand up to increased costs and/or lower or delayed benefits—that is, the project’s robustness to essentially economic risks, not country, policy, design, nor reputational risks. While the Bank’s work has evolved since then, reflecting the complexity of client demands and what is needed for effective development outcomes, our IL policies and processes remain wedded to the original project cycle approach.

9. Evolving Project Model. Today the focus of the Bank’s assistance strategy has shifted from projects to countries’ overall development programs and country-level results, and the Bank’s support has expanded beyond the traditional sectors of infrastructure and agriculture to include social sectors, governance, and public administration. The discrete “blueprint” project model is no longer adequate to meet the expanding demands for investment lending: increasingly, IL projects are developed around programmatic or framework-based project models2 in which the Bank agrees to finance a portion of a borrower’s program in a given sector, or a range of eligible activities to be carried out by qualified beneficiaries. There is a growing disconnect between today’s focus on the country and its program—which lies at the heart of the Bank’s assistance strategy as reflected in the Country Assistance Strategy (CAS)—on the one hand, and on the other the static stages of the basic project cycle, which focus firmly on the stand-alone project as the unit of account. While staff, management and the Board have supported notable exceptions to this approach, it is time for the policies to catch up with operational reality.

2 The framework or programmatic project design is exemplified by sector-wide approaches, financial intermediary and social fund projects, and community-driven development projects and other demand-driven designs.
Limitations of the Instrument. The IL instrument is being stretched and is bumping up against limitations at both ends of the Bank’s client spectrum. For high-performing MICs, the IL instrument does not facilitate the Bank’s support for programmatic approaches rather than self-standing project investments, disburse against agreed results and outcomes rather than specific expenditures, and move to the use of government systems for our fiduciary and safeguards work. For countries with more limited capacity or fragile states, we need to find a better way to adapt to changing circumstances and provide higher levels of implementation support; consequently our positive efforts at tackling the problems of program/project start up and rapid response are not being matched with accelerating actions on the ground.

B. Policies and Processes

The IL instrument is facing both intrinsic issues that undermine the efficiency with which investment operations are prepared and implemented/supervised, and more fundamental constraints that keep the IL instrument from appropriately responding and adapting to the evolution in the global development paradigm and environment. The main issues with IL from the perspectives of countries, staff, management, and the Board are summarized in Box 1.

Box 1. Issues with IL: The Perspectives of Countries, Staff, and Management and the Board

<table>
<thead>
<tr>
<th>Countries’ Perspective</th>
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<tbody>
<tr>
<td>Delays and nonfinancial costs of prolonged project preparation often associated with the Bank’s internal requirements and processes.</td>
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<td>Delays, additional costs, and unpredictable flow of funds during project implementation often associated with the Bank’s fiduciary, safeguards, and reporting requirements and procedures.</td>
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<td>Limited design and funding options to meet countries’ needs, goals, and internal requirements.</td>
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<td>“Whose project is it anyway?”—continued reliance on a ring-fenced project model undermines the Bank’s ability to truly support country-led programs using borrower systems in close coordination with other donors.</td>
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<td>A disconnect between the Bank’s focus on results (outcomes and outputs) and continued concentration of appraisal and supervision efforts and requirements on inputs and expenditures.</td>
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<td>Uncertainty about the implications of the Bank’s governance and anti-corruption (GAC) efforts and remedies related to fraud and corruption at the project level.</td>
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<thead>
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<th>Staff Perspective</th>
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<td>Regulation, requirements, and expectations overload, especially in the fiduciary, safeguards, and, increasingly, fraud and corruption areas.</td>
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<td>Process inefficiencies, characterized by</td>
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<tr>
<td>- indiscriminate, inefficient, and often duplicative processes, reviews, and “controls”</td>
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<tr>
<td>- “one-size-fits-all” approach to due diligence and procedural requirements, irrespective of the level of risk, borrower capacity, track record, etc.</td>
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<tr>
<td>- growing confusion about who is accountable for what</td>
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<td>- inadequate IT support to facilitate workflow, document generation, and tracking</td>
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- **Risk-management gap:** lack of appropriate tools, incentives, and resources for candid risk identification, reporting, and management, especially during project supervision.

- **Evaluation overload:** IL is subject to multiple evaluations by central control units (INT, QAG, IEG, IAD, Inspection Panel), all of which look at different aspects of the same issues using diverse and often uncoordinated methodologies.

- **Inadequate resources** (budget, skills, training, guidance, incentives, management support, IT support), especially during project supervision.

- **Instrument constraints:** rigidity and limitations of instrument to meet borrowers’ diverse needs.

- **Results gap:** disconnect between results focus and inputs-based “wiring” of IL.

- **Supervision disconnect:** a disconnect between the current supervision model and the new realities of decentralization, increased reliance on partnerships, and the Bank’s role in supporting (and not just supervising) implementation.

- **Uncertainty in the fraud and corruption area:** lack of clarity on expectations, responsibilities, and tools for handling fraud and corruption.

### Management and Board Perspectives

- **Inefficiency** in terms of costs, timeliness, bunching, etc.

- **Suboptimal effectiveness** in meeting different borrower needs and achieving agreed development outcomes/results.

- **Due diligence and accountability issues** in terms of candor and timeliness in identification, monitoring, and reporting and management of risks during all stages, especially supervision.

- **Reputational risks** associated with noncompliance with Bank policies, particularly in the areas of safeguards and fiduciary requirements, and real or perceived mishandling of fraud and corruption issues.

12. **Addressing the Policy Maze.** IL is the most overregulated Bank lending instrument: it is subject to about 30 of the Bank’s operational policies and procedures, some of which date back to the 1980s (e.g., the 1984 statement governing project appraisal). Many of these policies are inconsistent with today’s approaches, and they do not adequately reflect such areas as the emphasis on aid effectiveness and outcomes and the need for proactive risk management. Many policy statements also commingle policy with procedure and even guidelines, focusing on detailed and narrow rules rather than true policy principles that could better withstand the test of time. The sheer number of applicable policies inevitably leads to inconsistent treatment of issues and leads to concerns about appropriate levels of due diligence and real accountability, as management and staff find it increasingly difficult to know, apply, and comply with them. Even worse is the possibility that staff and managers will feel artificially reassured about quality, just because they have complied with these extensive regulatory demands.

13. **Process Overload.** The IL instrument is encumbered by inefficient and often duplicative processes and reviews that are applied to all operations, irrespective of the level of risk, borrower capacity, or prior experience or track record. While many of these processes and requirements were put in place over time to enhance the development effectiveness and sustainability of IL projects (or to deal with mistakes or management failures), they have resulted in a complex IL framework that may in fact undermine rather

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3 See OMS 2.20, Project Appraisal.
than help achieve these goals. Management and staff are often confused about the rationale for some of the rules, which contributes to inefficiency and inconsistency in their application. And even when corporate processes do not necessarily lead to bureaucratic “churn,” Regions may put in place practices that have the same deleterious effect. Critiques from clients and staff often focus on difficulties in speeding up project preparation; but these concerns are not about seeking a speedier process for its own sake, but rather about the low value-added of internal reviews that are often more about sharpening presentation and providing excessive detail than dealing with substantive project design issues. These review processes also create major demand for staff resources at the expense of working with clients and undertaking supervision.

14. **IDA Controls Review.** Many of these issues were recently highlighted in the context of a review of internal controls over IDA operations (paper forthcoming). As part of this review, management identified, mapped, and “tested” processes and associated controls that apply to IL operations. This work identified significant inefficiencies in IL processes and controls, especially during the project preparation stage (from concept to approval). As management noted in its report:

> The absence of a risk-based approach to IL processes and controls undermines efficiency and effectiveness of these controls by over-regulating low-risk projects while diverting resources and management attention from addressing higher-risk situations. Resources and attention to proper risk identification and results monitoring during project supervision are similarly diverted by excessive focus on preparation/appraisal stages. This excessive focus on project preparation also contributes to increased project preparation/appraisal costs and delays in bringing projects to the Board for its consideration and approval. ⁴

15. **Safeguards and Fiduciary Operational Practices.** Most staff and managers do not doubt the importance of carrying out proper environmental and social assessment work and identifying mitigation actions needed to ensure the quality of operations and successful results. Equally, managers and staff understand the importance of systems that can ensure the proper management of funds and the handling of contracts according to principles of transparency, cost effectiveness, and efficiency. In fact, the Bank’s work on safeguards for complex and controversial infrastructure projects is often considered a competitive advantage for the Bank in MICs that can draw on alternative financing sources. Yet many staff and managers also identify the demands of the Bank’s safeguards and fiduciary work as one of the critical bottlenecks that slow delivery and increase preparation costs. For safeguards, the issues are risk identification and management that occurs too late, a shortage of specialist staff, and insufficient training of team leaders. On the fiduciary side, concerns range from overreliance on Bank procedures rather than country systems, the lack of integration of fiduciary staff into task teams, and risk aversion, which frequently escalates decision-making and delays responses to clients. Moreover, staff and managers remain uncertain on the best ways and tools to use in tackling the challenges of fraud and corruption in country contexts and in specific sectors and projects. Lastly, the move to greater reliance on country systems

will be critical to our safeguards work, building on the principle of improving standards and strengthening policies and institutions based on best practice.

C. The Importance of Implementation

16. Although there is growing awareness of the importance of focusing on the development outcomes of projects, in the Bank the majority of staff and budget resources, managerial oversight, and processes to assure quality are targeted to project preparation and appraisal. The oversight of the use of Bank funds are the primary focus of concern, even when the Bank’s share of financing of many projects and programs is a small proportion of overall public expenditure. In many ways the Bank’s model for IL supervision is outdated. For example, it does not reflect decentralization and the replacement of the periodic mission-based supervision with continuous field-based supervision; does not adequately focus on the Bank’s role in providing implementation support throughout project execution; suffers from gaps and disconnects in the area of results monitoring and reporting, which should be (but often is not) the central focus of the implementation and supervision effort; and does not adequately reflect the need to monitor, report, and address risks encountered during project implementation. Proactive management of the portfolio is not widely done, and the incentives for restructuring and shifting resources away from poor-performing projects are weak—especially in IDA projects, since funds so liberated return to the central IDA pool. Efforts have been made to sharpen development objectives and define monitorable indicators, but this is still a work in progress: there is still considerable emphasis on input measurement.

17. Implementation of IL operations is often far slower than the plans and projections in project appraisal documents: for many projects, closing dates are extended much beyond the original timeframe, and disbursement projections are frequently readjusted. Countries complain that some of these delays (and the additional costs they entail) are associated with the need to comply with the Bank’s procedural, reporting, documentation, and substantive requirements during project implementation, which often differ from the country’s own requirements and procedures and from those of other donors co-financing Bank-supported projects. The situation has been exacerbated by uncertainties surrounding the GAC agenda and its effect on project supervision and implementation. Some improvements in this area have been achieved through reforms in the fiduciary area—the reforms of expenditure eligibility, audit, and other aspects of financial management, and the revision of the Bank’s disbursement policies and procedures—and additional improvements are expected in projects that rely on country systems under the safeguards and procurement pilots. However, much remains to be done to improve development outcomes and ensure more timely, effective, and predictable project implementation.

18. Management’s review of internal controls over IDA operations, combined with work in response to the Volcker Report and the India Detailed Implementation Review (DIR), identified the need to improve due diligence aspects of supervision through (a) enhancing task team effectiveness by achieving greater integration and clarifying accountabilities of task team members; (b) improving tools for monitoring and reporting on results and risks by reforming the Implementation Status and Results report (ISR); and
(c) developing and mainstreaming better tools and clarifying options, expectations, and responsibilities for addressing fraud and corruption. IL reform will need to deal with all of these concerns.

D. Other Enabling Factors for IL Reform

19. Any discussion of IL reform arrives quickly at the role and importance of the Bank's incentive regime and how the Bank manages accountability. Like other organizations, the Bank emphasizes what it can easily measure. Until recently, it has focused its measuring efforts on loan/credit project approvals and the associated volumes of lending. While there has been a shift in emphasis toward results and impacts, most staff—and managers—still perceive project delivery and task team leadership as required stepping-stones to recognition and career development. Supervision often takes a back seat to the lending preparation process: much greater attention and review are devoted to project preparation and appraisal than to project implementation and the Bank's supervision efforts. Similarly, excessive review processes and approvals, unclear functions and responsibilities, and sometimes the lack of continuity of teams from project design through implementation diffuse accountability (everyone is responsible). Moreover, there is currently no systematic way of defining accountability and linking it to performance. The capture and dissemination of knowledge is also a largely untapped potential area for improving quality and responsiveness of the Bank's IL. Similarly, the Bank has yet to fully utilize information technology (IT), especially to reflect the growing decentralization of IL work. Any reform of the IL process will need to tackle these important elements of the enabling environment.

E. Lessons from Past IL Reform Efforts

20. In transforming the IL instrument and overhauling the regulatory framework governing IL, the Bank should draw on the following lessons of earlier modernization efforts:

- Process change within the current model can generate finite gains in terms of speed (reducing average processing from about 24 months to 16-18), but little in terms of average costs of preparation.

- Process changes within the same model—adaptable program loans (APLs), learning and innovation loans (LILs)—have had little significant impact (LILs have essentially disappeared). Reforms that recognize and build on new realities and introduce fundamental changes—e.g., additional financing and eligibility of expenditures—have had major returns and produced real changes.

- A shift from a rules-based to principles-based approach improves impact, results, and efficiency without undermining due diligence or diluting accountability, as has been demonstrated by the implementation of additional financing and rapid response, the Global Food Crisis Response Program, and reforms of expenditure eligibility, audit, and disbursement.
Successful reforms not only reduce the costs of doing business with the Bank, but—responding to the demands of client countries, especially MICs—also recognize the fundamental change in the nature of Bank/borrower relationship.

- It has become increasingly evident that much greater differentiation is needed—among borrowers, risks, sizes, and circumstances.

- The Bank needs flexible and agile instruments that can easily adapt and respond to changes in the global development business.

All of this suggests that the Bank needs to make a quantum change in the IL model, not a mere adjustment to some of the processes or modernization of the OP/BPs around and within the existing IL model. The next section describes how the Bank proposes to approach this significant reform.

III. TRANSFORMING IL FOR GREATER DEVELOPMENT EFFECTIVENESS

21. IL reform is all about catching up with our clients' needs and staff practices where the achievement of greater development effectiveness and results focus is paramount. The challenges for carrying out a successful reform should not be underestimated due to its comprehensiveness and the many constituencies involved. The less than successful previous attempts at reform are testament to the challenges of both a technical nature and for changing the Bank's corporate culture.

22. Management hopes to use the previous efforts as building blocks as well as the lessons learned from the success of recent reforms such as expenditure eligibility, additional financing, and rapid response—all of which provided clients with development solutions that are responsive to their needs and timeframe, and had a real impact on the ground. Work on reforms is expected to be organized around four pillars or components: (a) adoption of a risk-based approach for processing IL; (b) a consolidated and rationalized menu of IL; (c) greater emphasis on supervision and implementation support; and (d) actions to provide an enabling environment for supporting and reinforcing the implementation of the reforms.
Box 2. How Will Things Be Different after IL Reform?

- We will have clear risk criteria for assessing proposed operations and the investment lending portfolio, and identifying low risk operations.
- These low risk operations will be processed quickly and simply and at a much lower cost.
- Significantly more resources will be allocated to smart supervision and to implementation support to clients, especially in fragile states.
- We will have new ways to support our clients directly in achieving development results.
- There will be clarity in the policy and processes will be more accessible and digestible.

A. Risk-based Approach

23. To improve the efficiency of IL preparation and appraisal, the current “one-size-fits-all” processes and requirements that apply to IL would be replaced with a risk-based model to differentiate projects and the processing requirements to be applied to them along with including risk management as part of Bank supervision. Risk management already forms an important part of the Regions’ work for preparing, reviewing, and monitoring IL, especially in the fiduciary and safeguards areas. The reform would build on and expand these experiences and those of other parts of the Bank Group that use a risk-based model in their work (including CSR, Treasury, and IFC). The primary outputs of this work would include:

- refinement of the universe and types of risks to be considered;
- development of consistent methodology, criteria, and processes for early risk determination and ongoing risk monitoring in IL operations under preparation and supervision;
- rationalization of processes and controls based on risk, with a view to (a) mainstreaming for low-risk operations the simpler and more efficient processes, controls, and documentation used for additional financing operations; and (b) clarifying the processes and controls that would apply to higher-risk operations that merit additional due diligence and management attention and consideration; and
- exploring ways to better integrate task teams (especially at the field level) and finding practical solutions for addressing safeguards and fiduciary concerns.

24. To maximize the impact of these measures, work would also focus on simplifying and streamlining IL documentation and templates; developing clear and consistent processing guidance; and developing and piloting a new platform for automating and simplifying IL workflow and documents preparation, retention, and tracking. It is expected that following the reform at least 40 percent of operations would be processed as low-risk under simplified procedures.
B. A Consolidated and Rationalized Menu of IL

25. One of the goals of the proposed reform is to consolidate and rationalize the IL menu to respond to clients' diverse development and financing needs. Such a menu is expected to include: IL projects differentiated by risk -- where high risk projects get full preparation and due diligence and low risk projects can be prepared in a streamlined way (a la additional financing); rapid response projects under the already reformed OP 8.0 for emergencies and for fragile states; and programmatic IL which would focus more on outputs/outcomes rather than specific project expenditures. Additional financing would remain available for building on all of the above. These options would replace the current submenu of IL products, such as Specific Investment Loans (SIL), Sector Investment Maintenance Loan/Program (SIM), Adaptable Program Loan (APL), Learning and Innovation Loan (LIL) and Financial Intermediary Loan (FIL). Work on the reform will also look at options for supporting regional projects as the current approach involves individual national operations that are coordinated rather than the possibility of a single project.

26. It is important to recognize that for the foreseeable future, complex and large investment projects will remain part of the Bank's lending support to its member countries. And these projects will still require detailed, upfront technical and analytical work and extensive due diligence that is both costly and requires time to complete. Under the proposed reform and as noted above, all IL projects would be subject to a more robust and candid risk assessment which would define processing requirements. For large, complex IL projects, the key benefits would be more complete and better skilled teams and greater implementation support. For the lower risk projects, clients would see a quicker response and less onerous demands than what is required today building on the experience with additional financing. Reform efforts on Rapid Response operations would be directed to finding ways to adapt to the reality on the ground and provide greater implementation support.

27. The new programmatic instrument would be designed to support a government's program in a particular sector or subsector with a clearly defined results framework. Such a program loan would start from a diagnosis of the constraints facing the sector, and the policies and associated public expenditure programs to address these constraints, and would identify the results to be achieved during implementation. Resources would then be disbursed not against individual expenditures on the input side, but against demonstrated and agreed outputs/outcomes. Such an instrument would also entail ex-ante due diligence by Bank staff to determine that the country has the following in place:

- A sound financial management system that will generate regular accounts (which would be provided to the Bank) and is subject to in-depth and transparent audit and oversight.

- Appropriate procurement arrangements and capacity to ensure that this public expenditure is taking place in line with the principles of economy, efficiency, transparency, and competition.
• Environmental and social safeguard frameworks and institutions that would require sound impact analysis when triggered by the planned expenditures.

• A system that will generate the indicators to assess progress toward results, and that can be independently verified.

28. What is proposed, therefore, is to create an instrument (not just an “approach”) to support programmatic engagements in which the Bank finances outputs and outcomes within sound fiduciary and safeguard frameworks, but without the need for direct accounting linkages between disbursements of Bank resources and expenditures by the client. Rather, the client’s accounting and reporting system would demonstrate that resources are being used in the program, and performance and financial audits would certify the appropriateness of the procurement and safeguards practices. The focus of the Bank’s analysis would thus be on the soundness and technical quality of the program being supported, the pattern of the expenditures, the quality of the systems within which expenditures take place and the monitoring and verification of results achieved. The Bank has developed and the Board has approved operations with these characteristics and operating modalities, including Brazil - Bolsa Familia, Indonesia - Bos Kita, Mexico - Strengthening Private Housing Finance Markets and Ethiopia Protection of Basic Services. Another example, the Provincial Maternal-Child Health Investment Project (Plan Nacer) in Argentina is presented in Box 3.

29. **Policy Framework.** A revitalized menu for IL would have to be supported by, and embedded in, a new policy framework that would (a) lay a foundation for a more flexible approach that could accommodate a range of design and financing options based on different needs and risks and reflecting the increasing reliance on programmatic support for country-led programs; (b) address the confusion, complexity, and inefficiencies of the current disjointed set of policies governing IL by creating a new, single, consolidated principles-based umbrella policy that would govern IL operations from inception to completion; and (c) align IL “wiring” with its results focus. This third goal is likely to be one of the most challenging aspects of this reform, potentially requiring the Bank to broaden the interpretation of “intended purposes” under the Articles. This would also help bridge the gap between project evaluation against “intended outcomes and results” and the continued focus of accountability and due diligence work on inputs. A breakthrough here would represent one of the most significant actions the reform could embrace.

30. **Safeguards and Fiduciary Issues.** Some of the challenges that staff face in the areas of the Bank’s fiduciary and safeguards policies were noted above (paragraph 15). Progress in addressing these challenges can be achieved in the context of the proposed IL reform. First and foremost, the Bank has in place a firm commitment in the context of the Accra Agenda for Action to use country systems when appropriate standards exist and to make capacity building to achieve those standards a high priority for the Bank’s support to its clients. There is a policy framework for how the Bank can rely on such systems and pilot programs are ongoing. Within the context of the proposed IL instruments, emphasis would be placed on ensuring that the country has appropriate fiduciary and safeguard systems for the public expenditure programs being supported.
Second, there is scope for improving the way staff and management interact with the Inspection Panel so as to address the concerns of requesters and problems identified by the Panel in a more proactive and less legally adversarial way, without reducing the Panel’s independence and mandate. Third, a review of the experience with the Bank’s Safeguards will soon be launched by IEG, and an evaluation of IFC’s experience with its Performance Standards is also being carried out in 2009, and these two exercises will guide further reforms in this area in the future.

**Box 3. Results-based Lending—The Provincial Maternal-Child Health Investment Project (Plan Nacer) In Argentina**

This project is part of a two-phase Adaptable Program Loan of about US$440 million that supports the implementation of Argentina’s public national maternal and child health program. The program is intended to:

- Increase access to basic health services for uninsured mothers and children, contributing to decreased infant and maternal mortality.
- Strengthen the health system and introduce structural changes in the incentive framework for national-provincial and provincial provider relationships, linking project financing with results.

Financing of the program is strictly linked to outputs and outcomes, as verified through independent audits. Disbursements are made against the submission of audited enrollments (60 percent) and 10 output and intermediate outcome goals (40 percent). Adequate program governance is achieved through: the use of an independent concurrent auditor for verification of enrollment lists; the introduction of results indicators to regulate the flow of funds; and combined performance and financial auditing to ensure accountability. Detailed analysis of program costs and baseline data for monitoring and evaluation were carried out during project preparation. The program supports increased capacity of the implementing institutions, particularly in financial management, oversight and technical advice.

By November 2006, more than half of the originally targeted population had been enrolled, (more than a half million mothers and children) and more than two million consultations and 20,000 deliveries had been financed by the program. Infant mortality in the target provinces has dropped.

In addition to increasing access to services, the program has had significant health system strengthening effects. Provinces have introduced output-based payment for providers, contracting (public and/or private sector) mechanisms, health service purchaser agencies, independent concurrent auditors, incentives to high performing personnel, significant upgrades to monitoring and information systems and demand-boosting actions such as linking *Plan Nacer* with conditional cash transfer programs already existing in the country.
C. Enhancing Supervision and Implementation Support

31. The review of the Bank’s supervision model would focus on how to realize the shift in emphasis from preparation to supervision and to provide implementation support that goes beyond our current concern with disbursements and inputs to getting better results. It would define the skills, resources, and incentives needed to identify, monitor, report, and manage risks proactively. The new supervision model also envisions larger and better integrated and skilled teams which would go a significant way in earlier identification of problems and more effective actions for dealing with them. This work will need to recognize the role and impact of decentralization of staff and management in how the Bank engages clients in a continuous supervision effort rather than just episodic mission work. The work on the supervision model would also include a review of the restructuring mechanisms for IL operations to support timely and effective adjustments to projects during implementation, as needed. In terms of reporting systems, the current supervision and implementation progress and portfolio management would be revised to track risks and their management and improve results definition and monitoring. Finally, the reform work would also benefit from and build on responses to and experience with the IDA internal controls review, the ongoing work on GAC implementation, and actions under way in response to the Volcker Report and India DIR.

D. Enabling Environment for IL Transformation

32. Policy reform and a more flexible menu of options for IL will not be enough to bring about the desired shift to development results, improved project quality, and increased supervision and implementation support. The reform effort will also need to explore actions in the enabling environment to:

- align incentives, rewards, and resources with the shift in focus;

- provide greater clarity on functions and responsibilities, especially for team composition and leadership, and develop a stronger link between staff and Management and the quality and results of the operations they have led, contributed to, or managed;

- improve the capture and use of knowledge, as well as define staff training requirements, particularly for team leadership roles, as well as enhance access to “state of the art” practices at all stages of project design and implementation, including the complementarities of public and private sector roles in infrastructure and service delivery; and

- better use information technology to monitor, report, and retain key analysis and decisions and to facilitate project processing.

33. To make concrete progress on the above actions, IL reform efforts will need to dovetail with other important initiatives underway or about to start like HR reform, the knowledge agenda, review of quality processes, the GAC agenda, and IT actions. Management and the Board will need to work in concert for this to succeed because of IL
reform’s comprehensive nature (see para. 39). Management does not underestimate the importance and the difficulty of work on these issues.

IV. WAY FORWARD AND NEXT STEPS

34. If the proposed IL reform is to achieve its ambitious goals, it will have to be designed, managed, and implemented in a manner that:

- ensures buy-in from client countries, Bank staff, Management, the Board, the Bank’s development partners and external stakeholders;

- builds on successful features of the IL instrument with which clients are familiar, such as the recent additional financing reform;

- reflects absorptive capacity for change among staff and country counterparts, recognizing that even changes for the better require a concerted roll-out effort and time for adjustment;

- contains expectations while going after more immediate “quick wins” to ensure continued commitment and support for the longer-term effort, such as early actions to strengthen supervision and implementation; and

- links effectively to other important and related Bank initiatives.

35. Organizing the IL Reform Work. IL reform will encompass a large set of activities and multiple outputs. OPCS, working closely with the Regions and other Bank units, will lead the effort on behalf of Bank management, and will coordinate the various inputs. The work will be delivered through a series of products organized around the various pillars or components of the reform outlined in Section III of this paper. The expected timeframe for the main outputs is 12 to 18 months. To guide the work and monitor progress, Management proposes to create a Bank-wide task force for IL reform that includes representatives of the Regions, Networks, LEG, CSR, and different groups within OPCS. Client and outside stakeholder views will be sought initially and as the work progresses through consultations in country and in Washington. A small number of working groups will be established for various tasks; this approach will allow broader participation from units throughout the Bank in the preparation and design of the reform, helping to ensure a rich sharing of experience and multiple viewpoints and to build broad-based ownership of the outcomes. Specialized consultants will be engaged as necessary to support the working groups.

A. Key Outputs

36. While the work will commence on all the reform pillars, the delivery of the products and reforms will be sequenced: the “quick wins” of process rationalization and supervision improvements will provide early positive changes, while pursuing the broader goal of rationalizing the IL menu and reforming IL policy will take a bit longer. All parts of the work will be closely linked and coordinated. The work program will be
developed in more detail after the Board provides comments and discusses this paper. A preliminary description of key outputs, differentiated by those expected to be completed towards the end of this fiscal year (intermediate) and those that will continue into FY10 (final), is provided below.

37. **Intermediate Outputs.** Many of the intermediate outputs will tackle the issues underlying IL inefficiency, particularly during the preapproval stage of project processing, to provide the building blocks for addressing the longer-term challenges for IL reform that will be delivered in the later phase of the work. They would include the following:

- A risk-based IL process, built around the main categories of risks to be considered, to allow low-risk operations to proceed under more efficient and simplified processes and documentation (along the line of the additional financing model). Work will also address fiduciary and safeguards operational practices, where analysis and initial diagnostic work has been done.

- A new concept for project supervision that takes into account the Bank’s important role in providing implementation support, the need for better risk and results monitoring during the supervision of the project, mainstreaming governance and anticorruption implementation at the project level, facilitating better integration and more effective functioning of task teams, and decentralization of staff and task leadership in the field. The work will also look into other supervision issues as restructuring, and exploration of new approaches and options for more effective and proactive supervision and portfolio management (including new tools) that would later be developed into an updated supervision model.

- An extensive process of consultations with client countries, staff, and Management across the Bank, and development partners. The consultations will pay special attention to demands which the current IL model is unable to meet, opportunities to better respond to development needs, and options for addressing such key enabling factors as strengthened accountability, better training and knowledge flow, rebalancing of budget expenditure from preparation to supervision, and enhanced focus and commitment of Management and staff on the results agenda.

38. **Final Outputs.** Outputs expected in the subsequent phase of the reform would include the following:

- A new design for IL that provides a more flexible menu of financing and design options to better respond to the development and financing needs of the Bank’s varied clients.

- Design of a new instrument in support of results-based lending.
• A principles-based consolidated policy statement on IL (OP 10.00) that will govern IL operations from concept to completion.

• New IL procedures that will capture key processes and controls for appraisal and supervision to support the new IL instrument and will reflect the differentiation of projects by level of risk, the process rationalization, and the supervision reforms.

• Revised supervision guidelines that will reflect changes associated with a redesigned IL instrument and new supervision approach.

• A proposal for addressing issues related to the enabling environment and the identification of new or enhanced tools to track the project’s implementation and the Bank’s supervision work.

• A roll-out plan, developed in close collaboration with the Regions, to support successful implementation of the new IL policy and process framework.

39. **A Compact with the Board.** Transforming IL will require a concerted effort from staff, Management, and the Board. It will necessitate a willingness to retire old IL policies and replace them with a new, single policy framework constructed around a new OP/BP 10.00 comprising preparation and supervision (“cradle to grave”). And in return, simplify requirements with greater clarity on accountability. Actions will be needed to rebalance the allocation and use of resources for preparation and supervision on the basis of two principles: risk and results. Given the reform’s far-reaching linkages to numerous Bank initiatives, Management proposes to undertake this effort though a compact with the Board to make this a shared undertaking. Management would welcome the Executive Directors’ views on this proposal and the elements to be embraced under such a compact.

40. **Next Steps.** Following the Board discussion of this paper, a retreat of the Bank-wide task force will be held to identify and agree on next steps (including deliverables, responsibilities, timelines, consultation process and audiences, and schedule for task force actions to monitor progress). Working groups will also be organized, with clear timelines and deliverables. If the Board agrees, Management would propose to report periodically to, and seek inputs from, a subset of Board members. Management would provide a full report and the first set of reform proposals to the full Board by July/August 2009. A second report and reform proposal would be discussed upon reform completion, now considered for July/August 2010.