BRAZIL

Designing a New Loan Prototype to Meet Client Needs

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“SWAps give us the opportunity to respond to client demand, to align our processes with country institutions, and by broadening our focus to whole sector programs, to scale up the impact of our work.”
- David de Ferranti, Special Advisor and former Vice President, Latin America and Caribbean Region of the World Bank

By 2003-4, the accumulated burdens of slow growth and debt overhang weighed heavily on Brazil’s state governments. The State of Ceará was no exception. Discretionary expenditures were frequently cut to a third of their budgeted amounts, and funding had dried up for priority programs and even essential services. The state’s development agenda was shelved as Ceará struggled to survive.

Desperate for help, the Government of Ceará, supported by the Federal Government, sought the assistance of the World Bank. The challenge for the Bank and State officials was to craft an operation that addressed fiscal needs while supporting development agenda objectives. Even in Brazil, one of the Bank’s most prolific borrowers, there were no sub-national lending models for this kind of work. Clearly something new was required.

Bank and State officials pooled their knowledge and came up with such a prototype operation – the Ceará Multi-Sector Social Inclusion Development Project. The loan addressed the State’s fiscal needs by disbursing directly to the State Treasury. At the same time, it supported the development agenda by incorporating a strong results-based management (RBM) framework based on the objectives already established by the State. Working across a half dozen sectors, the RBM framework turned the State’s priority fiscal and social targets into disbursement-linked indicators.

Adapting Lending to Client Needs

Two key questions faced those preparing the loan. First, how can disbursement be made to the Treasury and at the same time help Ceará meet its sectoral development agenda priorities? And second, how can incentives be provided and resources ensured for critical sector programs without funding them directly? The solution combined two World Bank lending instruments – the Sector-Wide Approach (SWAp), which disburses against client program expenditures; and the Adaptable Program Loan (APL), which provides sequenced loans for long-term development support. This new modality has been coined as the SWAPL (SWAp + APL) (See Box 1).

The Ceará SWAPL consisted first of a $150 million loan to be followed by a $90 million operation. Because the loan disbursers directly to the Treasury, the State can use the funds to manage its indebtedness problem. At the same time, the State has agreed to meeting: (i) predetermined expenditure levels in nine key budget programs across five line sectors, and (ii) annual macroeconomic and sectoral benchmarks that constitute disbursement conditions. Hence, the loan rejuvenates key sector programs and re-launches the State’s development agenda, comprising fiscal sustainability, social inclusion, state modernization and sustainable growth.

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Key SWAPL Features

Operational innovations. The Ceará SWAPL incorporated over a dozen significant lending innovations. The most important of these included the following:

1. Unlike traditional SWAps that normally support a single large Government sector program, the SWAPL worked in six main line sectors, namely education, environment, health, water resource management, water and sanitation, and public sector management. By addressing numerous sectors under one loan, it generated results that could only have been achieved by multiple operations.

2. The public sector management (PSM) component served as an umbrella, under which the other sector programs were structured. Innovative results-based management initiatives oriented work in each of the other sectors.

3. Thirteen benchmarks were established in the six sectors — two or three per sector. These benchmarks, which were derived largely from the State’s development agenda, became disbursement-linked conditionalities, each one worth about $2 million for the fourth and operations.

Box 1: Overview of the SWAp and APL instruments

Sector-Wide Approaches (SWAps) leverage Bank funds by disbursing against large, priority client program expenditures. For instance, if the Bank approves of a country’s rural health program, it may choose to implement a SWAp, disbursing the Bank loan at a rate of 10-20 percent of the annual client rural health expenditures each year.

SWAps originated in Africa and South Asia in the mid-1990s, and were used mostly to support social sector objectives. SWAps meet demands for flexibility and harmonization with Bank Country Assistance Strategies (CASs) and client strategies. SWAps also minimize transaction costs associated with more traditional Bank approaches, such as the need to detail loan components, procure goods and services, and then account for them through statement of expenses, supervision missions, and audits. Using client systems also can simplify the process.

Expected Development Benefits of SWAps derive from their being vehicles for strengthening governance and implementation capacity by encouraging:
- Stronger country ownership
- Coordinated and open policy dialogue
- Rational resource allocation based upon priority programs
- Scaling-up of program benefits throughout the country
- Sector-wide accountability and strengthening of fiduciary and environmental/social safeguards
- Upgrade of client capacity, systems and institutions
- Reduction in unnecessary bureaucracy and transactions costs
- Greater results focus.

An Adaptable Program Loan (APL) provides phased support for long-term development programs. The APL requires Bank-client agreement on (i) the phased, long-term sector development program supported by the loan; (ii) development priorities for sector investments and recurrent expenditures within the sector; and (iii) the evolution of sector policies in each APL phase. APLs have triggers, or conditions that define when the next sequential loan can initiate operations. APLs are used when sustained changes in institutions, organizations, and client behavior are essential to successfully implementing a program. Such reforms generally take a long time to implement, requiring sequenced activities, specifically investments, institutional strengthening, policy reforms and constituency building. The APL provides incentives along the way, through staggered disbursements, for clients to implement such long run programs.

Key advantages for clients include:
- Reform realism: Arbitrary front-loading of policy conditionality is replaced by realistic phasing of reforms.
- Continuity: Long-term planning and sustainable institution-building are supported by bridging electoral cycles and administration changes.
- Financial Charges: Commitment fees are reduced.
fifth disbursements. Other ‘global’ conditionalities included completion of prototype sector strategic plans, primary surplus targets and satisfactory performance by the Bank’s other three loans to Ceará (two were rated unsatisfactory at the time the SWAPL was prepared).

4. Nine Eligible Expenditure Programs (EEP) --SWAps disburse against program expenditures--were selected from among the five line sectors’ most important budget programs that were also linked to benchmarks. Annual budgets were projected for each of the EEP, and a condition was established that disbursement against sector indicators would take place only if 70 percent of the projected expenditures had been spent in the relevant period. In this way, sectors were assured of receiving resources required to carry out the EEP.

5. EEP expenditures were pooled for the purposes of calculating loan disbursement. A loan disbursement percentage of up to 35 percent was used, meaning that if the client projected $100 million of pooled expenditures in a six-month period, the Bank could disburse up to $35 million. Five disbursements were projected at roughly six-month intervals – four of these against projected expenditures. Each disbursement was capped at an amount that would not jeopardize the primary surplus, while providing an incentive to meet benchmarks.

6. The SWAPL forged collaboration between line and central secretaries, replacing the contention and irregular funding that resulted from central secretaries’ weekly decisions on how to allocate scarce budget resources. The State Secretaries now receive program funds to meet SWAPL benchmarks thereby assuring the flow of loan proceeds to the State Treasury.

Reliance on country systems and procedures. An important element of SWAps is the use of client organizations and systems wherever possible. Consequently, a small Project Implementation Unit (PIU) of full-time staff was established under the immediate supervision of the head of the Secretary of Planning’s Research Institute (IPECE)—the same unit that took the lead in loan preparation.

Bank fiduciary oversight also relied upon Ceará’s financial systems and reports, once they had been approved by financial management specialists. This is a first for a sub-national government. The Bank is doing the equivalent of CPARs (Country Procurement Assessment Report) and CFAAs (Country Financial and Accounting Assessment) in Brazilian states, and both were conducted in Ceará. Findings supported the decision to rely on client systems. The State Procurement Assessment Report (SPAR) resulted in the SWAPL funding ongoing procurement reform initiatives in its technical assistance component. The State Financial and Accounting Assessment (SFAA) identified some weaknesses in the State’s audit capacity, which were addressed in a large technical assistance component during project preparation. The component was subsequently funded by an Inter-American Development Bank (IDB) nationwide loan, designed to strengthen sub-national audit capacity.

Technical assistance component. The loan provided for a substantial technical assistance (TA) component supporting sector objectives. The TA emphasized results-based management and strengthened fiscal and fiduciary control mechanisms and systems, and institutional strengthening of the Controller and procurement.

Strong Monitoring and Evaluation (M&E) framework. The SWAPL has been cited as a best practice in terms of its managing-for-results focus and M&E design. The indicators and disbursement conditionalities were developed collaboratively, and with them, the M&E framework. And because the indicators came out of the Government’s development agenda, ownership was assured. The Ceará Government rightly takes pride in what it has helped to create. M&E is simplified for the Bank, as the Government is obliged to present evidence of fulfillment of conditions of disbursement in order to receive loan funds. It is noteworthy to mention that one 2005 health indicator will not be met. When this fact became apparent, Ceará formed a multi-sector commission to investigate the causes. The result was the development of an action plan of reforms that will have much broader consequences for the State.

Lessons Learned/Challenges

Overview. It is de riguer at the Bank to extol the virtues of simplifying and focusing: Hence, ‘Christmas tree’ loan design, which include numerous different sector objectives, generally are avoided, disbursement conditionality is not done outside of adjustment loans and other forms of conditionality are minimized. Yet, in some circumstances, a ‘Christmas tree design’ with
conditionality is very likely the best way to minimize risk and ensure that ‘easy’, important and often interconnected reforms across multiple sectors are implemented.

During loan preparation the project design was roundly criticized for not limiting sectors and conditionality. But subsequent experience with the Ceará SWAPL has demonstrated that the design works. Hopefully future SWAPL’s will be easier to prepare. It is also instructive to note that this loan could never have been done had it not been for the ardent support of the Government of Ceará, which saw in the multi-sector conditionality a means of reaffirming its development agenda and commitment to its constituency.

**Number of sectors.** The team originally wanted to work in eight sectors, but was obliged to limit it to six, owing to the highly innovative, hence ‘risky’ nature of the SWAPL. Each sector component is the equivalent of a small, but important, sector loan in terms of goals and objectives to be achieved. Hence, one real advantage of this ‘Christmas tree’ approach is that the Bank and Ceará optimized the operation’s development impact, taking advantage of development synergies through integrated, cross-sectoral approaches. The inclusion of an umbrella PSM sector is also an innovation worthy of replication, as it included important results based management, fiduciary and fiscal initiatives that linked the line to the center sectors, ensuring comprehensive sectoral reforms.

A second justification for multi-sector operations is that a single sector SWAp program in some small countries and most sub-national entities may not be big enough to justify the necessary Bank disbursement, hence, aggregating programs across a number of sectors becomes a necessity.

**Number of indicators.** The advantage of this SWAP is that the ‘global’ and 13 sectoral indicators/conditions of disbursement (with price tags of about $2 million each) governing the fourth and fifth disbursements are also included in the loan agreement. Other than adjustment loans, conditions for disbursement rarely have been incorporated into Bank loans hence it is important that they support key client priorities. Finally, there are 17 APL triggers across the six sectors—also exceeding the Bank’s guidelines for well-focused APLs. Even so, the expectation is that most will be met or exceeded. It is noteworthy to recall that these indicators were the product of a joint Bank-client diagnostic of priority actions for each sector.

The sector diagnostics identified numerous sector indicators that were considered important by sector specialists but not sufficiently important to be either disbursement conditions or triggers. These other indicators were included in the Project Appraisal Document annex to support the Government of Ceará and sector managers in their efforts to spearhead a cultural change endorsing results-based management. For this administration, this has happened.

The SWAPL has a third tranche condition requiring the Government to produce six Bank-vetted Strategic Sector Plans with measurable indicators. These Plans are to be mainstreamed into priority setting, budgeting, budget execution, and M&E in a continuous cycle dovetailing with Multi-Year Budgeting Plans (PPA) and State systems and procedures. The State went much further, requiring every sector to develop, submit, and refine in an iterative process a results-based sector strategic plan. Whether this impressive initiative will withstand the rigors of regime change is yet to be seen, but phase two of the Ceará SWAPL is intended to support results based management initiatives.

**Risk aversion.** The Bank is generally risk averse and promotes simplification, focus, and minimizing or eliminating conditionalities. But this may not always be what is needed. Furthermore, the negotiating governments are also risk averse when it comes to disbursement conditionalities. Strong client support and ownership are critical remedies for overcoming risk aversion in SWAPLs.

**Conclusions**

An innovative SWAp variation has been approved that opens up numerous new possibilities to strengthen the design of SWAps and other loans in order to enhance loan impact. There is significant interest in Brazil and elsewhere in replicating the Ceará SWAPL. Project and reform implementation appear to be on track. Perhaps the most important conclusion is to understand that the Bank is sufficiently flexible to allow enterprising staff and clients to design the sorts of operations that will optimize development impact.