DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

MEXICO

BANOBRAS SUBNATIONAL CREDIT LINE FOR INFRASTRUCTURE, PUBLIC SERVICES, AND INSTITUTION-STRENGTHENING

(ME-X1002)

AND

FIRST OPERATION FOR SUBNATIONAL CREDIT FOR INFRASTRUCTURE, PUBLIC SERVICES, AND INSTITUTION-STRENGTHENING

(ME-L1017)

LOAN PROPOSAL

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Technical documents in electronic format		**Subjects addressed**	**Hyperlink / Preparation status**
Mandatory			
Procurement plan			http://idbdocs.iadb.org/WSDocs/getdocument.aspx?DOCNUM=1713982
Annual work plan		N/A	
Monitoring and evaluation provisions		N/A	
Environmental and social management report[1]		N/A	
Safeguard Screening Form and Safeguard Policy Filter		http://idbdocs.iadb.org/WSDocs/getdocument.aspx?DOCNUM=1380078 http://idbdocs.iadb.org/WSDocs/getdocument.aspx?DOCNUM=1380087	
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ABBREVIATIONS

BANOBRAS	Banco Nacional de Obras y Servicios Públicos, S.N.C.
CCLIP	Conditional credit line for investment projects
FISM	Fondo para Infraestructura Social Municipal [Municipal Social Infrastructure Fund]
FORTEM	Program for the Institutional and Financial Strengthening of States and Municipalities
ICAS	Institutional Capacity Assessment System
ICB	International competitive bidding
INEGI	Instituto Nacional de Estadística y Geografía e Informática [National Institute for Statistical and Geographic Information Systems]
MDG	Millennium Development Goal
Mex$	Mexican pesos
NCB	National competitive bidding
PND	Plan Nacional de Desarrollo [National Development Plan]
PNI	Programa Nacional de Infraestructura [National Infrastructure Program]
PSPs	Public service providers
SHCP	Department of Finance

PROJECT SUMMARY

BANOBRAS SUBNATIONAL CREDIT LINE FOR INFRASTRUCTURE, PUBLIC SERVICES, AND INSTITUTION-STRENGTHENING (ME-X1002)

AND

FIRST OPERATION FOR SUBNATIONAL CREDIT FOR INFRASTRUCTURE, PUBLIC SERVICES, AND INSTITUTION-STRENGTHENING (ME-L1017)

<table>
<tr><th colspan="4">Financial Terms and Conditions[1]</th></tr>
<tr><td colspan="2" rowspan="3">Borrower and executing agency:
Banco Nacional de Obras y Servicios Públicos, S.N.C. (BANOBRAS)</td><td>Amortization period for the first program:</td><td>20 years</td></tr>
<tr><td>Grace period for the first program:</td><td>5 years</td></tr>
<tr><td>Disbursement period:</td><td>CCLIP: 10 years
Program: 5 years</td></tr>
<tr><td>Source</td><td>Amount</td><td>Inspection and supervision fee:</td><td>*</td></tr>
<tr><td>IDB (Ordinary Capital)</td><td>CCLIP: US$1.2 billion
First program: US$350 million</td><td>Interest rate:</td><td>LIBOR</td></tr>
<tr><td>Cofinancing</td><td>0</td><td>Credit fee:</td><td>*</td></tr>
<tr><td>Local</td><td>0</td><td>Currency:</td><td>U.S. dollars from the Single Currency Facility</td></tr>
<tr><td>Total</td><td>CCLIP: US$1.2 billion
First program: US$350 million</td><td>Conversion to Mexican pesos:</td><td>Local Currency Facility</td></tr>
</table>

Project at a glance

Objectives and description:

The general objective of the proposed credit line and program is to improve public services and strengthen the institutional capacity of subnational governments and public service providers (PSPs). The purpose of the first program is to support implementation of BANOBRAS' strategic plan and the National Development Plan through the following activities: (i) sustainably expand access to investment financing by subnational governments and PSPs; (ii) expand and diversify BANOBRAS' range of products according to the needs of different market segments; (iii) finance priority investments identified in the subnational governments' and PSPs' development plans; and (iv) increase the number of identified, structured subnational projects offering high economic and social returns.

Special contractual conditions:

As a condition precedent to the first disbursement, the borrower will demonstrate to the Bank's satisfaction that the BANOBRAS board of directors has approved the program Operating Regulations.

Exceptions to Bank policy:

(i) Waiver of procurement policies for Public-Sector Portfolio Rediscount (see paragraph 3.13); (ii) the CCLIP concept, applicable exclusively to loans, is extended to the use of guarantees; and (iii) the service fee for the guarantee would be equal to the credit fee for the loan.

Project consistent with country strategy: Yes [X] No [ ]

Project qualifies as: SEQ [ ] PTI [ ] Sector [ ] Geographic [ ] Headcount [ ]

Environmental and social review: 27 January 2008

Procurement: N/A

* The credit fee and inspection and supervision fee will be established periodically by the Board of Executive Directors as part of its review of the Bank's lending charges, in accordance with the applicable provisions of the Bank's policy on lending rate methodology for Ordinary Capital loans. In no case will the credit fee exceed 0.75% or the inspection and supervision fee exceed, in a given six-month period, the amount that would result from applying 1% to the loan amount divided by the number of six-month periods included in the original disbursement period.

I. DESCRIPTION AND RESULTS MONITORING

A. Background, problem, and rationale

1.1 **Macroeconomic framework.** In recent years, Mexico's macroeconomic situation has been stable with positive growth, budget equilibrium, growing net external debt reduction, and a favorable external position. In 2007, due to the financial and liquidity crisis in the industrialized economies—primarily the United States—the country faced some economic challenges including a deceleration in growth and unexpected increase in inflation slightly above the target rate. Growth declined to 3.5% in 2007, although it made an unexpected fourth-quarter recovery, driven by transportation and services (Link 1).

1.2 Projections for 2008 are more uncertain due to the economic slowdown in the United States and turbulence in international financial markets. This uncertainty is due to progressive losses in U.S. mortgage portfolios, among other factors. Growth estimates from Banco de Mexico's most recent Survey on Expectations of Private-sector Economists (Link 2) are 2.6% for the first half of 2008, an average of 2.7% for the year, and 3.4% for 2009. Despite this, Mexico is in a strong position to face a less favorable international environment, with a solid fiscal position, international reserves of close to US$70 billion, and a well-capitalized, solvent banking system. Government authorities have also announced a series of measures including: (i) a countercyclical fiscal policy; (ii) an increase in financing from development banks; and (iii) a significant increase in financing for infrastructure and the Program to Promote Economic Activity, Investment, and Job Creation.

1.3 **Financial sector developments**. Mexico's macrofinancial situation has improved considerably in recent years in terms of both the vulnerability of the Mexican financial system and access to financial services. The cornerstone of reforms has been an ongoing effort to correct macroeconomic imbalances. This effort has been supplemented by legal, regulatory, and operational reforms in the financial sector aimed at boosting the confidence of financial service users, reducing transaction costs, expanding access, and promoting efficiency in intermediation. These advances have helped provide Mexico with a well-capitalized financial system, prepared to intermediate resources to promote the country's economic development. Although they start from a modest base, growth rates in lending are high, sustained by lower interest rates, an increase in the number of bank branch offices, and the use of new technologies. However, significant gaps persist in the subnational governments' access to financing.[1]

1.4 **Fiscal decentralization framework in Mexico.** The structure of intergovernmental fiscal relations in Mexico is complex, reflecting the prolonged process of negotiating and formulating agreements between the various levels of government. There is currently a marked imbalance in these relations. According to Ehtisham

[1] As used in this document, "subnational governments" refers to the states and municipios. The term "public service providers" (PSPs) refers to public and private entities, trust funds, and structured financing geared toward infrastructure projects and public services.

Ahmad, the states received nearly 90% of their receipts from federal transfers in 2006, while the figure for municipios was 65%.[2] Transfers from the federal government to subnational governments have been increasing significantly, driven by changes in the rules defining them as well as increased nonrecurring oil revenue. The principal sources of subnational government funds include: (i) *participaciones* or unconditional transfers from the federal government to the subnational governments; (ii) *aportaciones*, or conditional transfers, used for the purposes defined in applicable laws and rules; (iii) shared taxes and federal taxes, collected and administered by the states; and (iv) surplus oil revenue. (Link 3). Although fiscal dependence is widespread among subnational governments, the dependence of the 1,957 rural municipios is more marked than that of the states and the 482 urban and metropolitan municipios. One of the principal objectives of the fiscal reform passed in 2007 is to strengthen the fiscal federalism framework. The reform is expected to provide subnational governments with more resources and stronger incentives to collect and use the revenue sources within their authority (Link 4). The challenge remains to create structures enabling subnational governments to diversify the sources of guarantee and payment in order to obtain financing.

1.5 **Public services infrastructure.** Mexico currently has significant unmet needs in terms of infrastructure for providing public services. One of the highest priorities of the administration is to improve the quality and competitiveness of infrastructure and basic services. To this end, it plans to significantly increase the relatively modest infrastructure spending, which accounted for only 3.2% of GDP in 2006.[3] As detailed in the 2007-2012 Plan Nacional de Desarrollo [National Development Plan] (PND), reducing the gap in infrastructure investment relative to comparable countries will require mobilizing resources from the private sector as well as subnational governments.

1.6 The 2007-2012 National Infrastructure Program (PNI) provides for investment of 2.5 trillion Mexican pesos (Mex$) in the next six years, almost a 50% increase in real terms over the previous administration. The PNI emphasizes the need to increase infrastructure financing and recognizes the central role of improving the quality of project design to ensure not only efficient use of public resources but also high economic and social returns. Therefore, timely allocation of resources is essential to preparing well-designed projects and strengthening the subnational governments' capacity to manage higher levels of investment.

1.7 The PNI also provides for greater participation by state governments in financing basic infrastructure services such as water, sanitation, and irrigation. Of the 52 program projects in these areas for a total of Mex$122.3 billion (close to US$11 billion), 26 are expected to be financed in part by the states, representing

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[2] Ehtisham Ahmad et al., "Why Focus on Spending Needs Factors? The Political Economy of Fiscal Transfer Reforms in Mexico" (IMF WP/07/252, 2007).

[3] The World Economic Forum currently ranks Mexico's infrastructure as 64th in its classification of 125 countries, and 7th in Latin America.

Mex$67.8 billion (US$6.3 billion). Significant gaps in basic infrastructure quality and coverage at the municipal level also exist, particularly in rural areas, requiring significant investment by municipal governments. Recent studies show that while 94% of the urban population has access to treated water, only 76% has access in rural areas, and this percentage drops to just 42% in the poorest areas.[4] Estimates of the necessary subnational investment vary considerably, but represent orders of magnitude greater than the subnational governments' debt stock. In brief, Mexico has significantly underinvested in infrastructure and the provision of public services, most which will have to be financed and/or provided by the subnational governments.

1.8 **Dependence on federal revenue-sharing transfers.** In practice, subnational government financing is provided almost exclusively through unconditional revenue-sharing transfers (*participaciones*) (paragraph 1.4). Given the pressing needs for financing, Mexican states have pledged close to half of their annual revenue from such transfers to pay their financial obligations. This reduces their fiscal headroom for other expenditures and, because of differences in revenue-sharing income, creates a marked disparity among subnational governments in capital expenditures. An analogous situation exists among municipios, where federal transfers represent close to 80% of revenue. Barely 20% of municipios have access to project financing, and they rely almost exclusively on revenue-sharing transfers. For the remaining municipios, the Fondo de Inversión Social Municipal [Municipal Social Investment Fund] (FISM) is the only source of investment funds. However, except for one pilot test that this program aims to replicate, the transaction costs associated with leveraging those funds have prevented their use as a source of payment for subnational government financing. In light of these restrictions, it is imperative that other sources of payment be identified to support subnational financing. BANOBRAS has initiated a program to leverage FISM transfers (Link 5), creating a structure that lends to more than half of the municipios in Michoacán. This program will support the replication of that structure for municipios that currently lack access to funding.

1.9 **Subnational government investment.** According to estimates, subnational governments generally devote relatively modest resources to investment. Mexico's Department of Finance (SHCP) estimates that in 2005, the states allocated 13.2% of total outlays to capital expenditures. Capital expenditures as a proportion of state GDP varied widely from state to state ranging from 6.8% for Chiapas to 0.3% in Yucatan in 2005. Although little information is available for municipios, they appear to make higher capital expenditures as a percentage of their budgets, even though the figures in absolute terms are small. In 2004 (the most recent year for which there are data), municipios' total capital expenditures were Mex$44.9 billion (close to US$3.8 billion)—a figure close to US$50 per capita and quite low in proportion to the unmet needs for access to public services (Link 6).

[4] A. Wellenstein, et al. (2006), "Infrastructure for Human Welfare and Economic Growth," World Bank.

Public Debt of States and Municipios (December 2006)
(in Mex$ millions)

Total	State government	Municipal debt	Autonomous entities	Public offerings	Debt with own source of payment
160,093.50	103,108.20	14,621.90	23,850.10	28,370.50	17,717.20

1.10 **Developments in the subnational debt market**. Subnational debt markets have been developing in recent years, supported by regulatory innovations to strengthen market discipline (Link 7), resulting in a modest increase in access to financing. According to SHCP figures, the subnational governments' total debt in constant pesos grew from Mex$123 billion in 1994 to Mex$160 billion in 2006 (30.2% in real terms). Nevertheless, Mexico's subnational governments have relatively low levels of debt. Since 1994, their debt has not exceeded 2% of GDP, and in 2006 it represented 1.8% of GDP.[5] Although they have developed in recent years, subnational debt markets remain highly concentrated—the top five states accounted for 67% of subnational debt at the end of 2006, while most subnational governments (80%) had no access to financing. Total municipal debt, in turn, represented only 9.1% of the subnational governments' debt at the end of 2006.[6] Although municipal debt has increased in recent years, from Mex$4 billion in 2000 to Mex$14.6 billion at the end of 2006, over 40% of this total is concentrated in municipios in the states of Jalisco, Mexico, Nuevo León, and Sonora. With respect to terms and conditions, 92.2% of the states' debt was contracted at nominal rates (in pesos) for an average term of 11.4 years at the end of 2006, up from 6.6 years in 1994. At the end of 2006, the weighted average rate of the debt in real terms (in rate per unit of investment) was 7.8%, while the debt in current pesos was at 11.2%.

1.11 **Challenges for increased capital expenditure by subnational governments.** As noted earlier, most Mexican states and nearly all of the municipios must overcome significant institutional challenges before they can increase their investments in public services and basic infrastructure. These include strengthening: (i) their finances, particularly in terms of increasing their own resources and improving management of expenditures and liabilities; (ii) their capacity to design and execute projects; and (iii) the institutional regulatory framework. All of these institution-strengthening efforts presume significant investment in training, reengineering processes, and information technology infrastructure that could require financing. The technical and capacity limitations in developing projects, combined with geographic dispersion that increases transaction and construction costs, serve to exclude most subnational governments from access to credit. This limits their capacity to finance projects geared toward improving public services and

[5] The figure is 6.4% in France, 9.2% in Spain, and 16% in the United States.

[6] This figure includes direct debt with and without backing by the state governments.

institution-strengthening. To summarize, despite the existence of a new framework for decentralization in Mexico and unmet public investment needs, subnational governments do not invest sufficiently in infrastructure and public services. This is due to lack of capacity to formulate projects, lack of access to financing for the majority of subnational governments, and the difficulty in creating structures to leverage resources apart from pool financing.

1.12 **BANOBRAS: Mission and financial situation.** BANOBRAS is a national credit institution established in 1933 to improve the well-being of Mexican citizens, make national production more competitive and generally improve development opportunities in Mexico through solutions promoting infrastructure and the delivery of public services. To fulfill its mission, BANOBRAS offers financing, guarantees, and technical assistance to subnational governments, including the Federal District, government-controlled public entities, and concessionaires of public services.[7] The priority sectors include: (i) water and sanitation; (ii) roads, highways, bridges, and urban development works; (iii) land acquisition and improvement; (iv) urban facilities and image; (v) power generation and conservation; (vii) land records and public property and business records; and (viii) collection, disposal and treatment of waste and industrial residues.

1.13 BANOBRAS is well capitalized, professionally managed, has significant franchise value, and is profitable. At the close of fiscal year 2007, it had assets of Mex$121.7 billion, a loan portfolio of Mex$100 billion, and past-due loans of 0.98%, provisioned at 500%. In terms of earnings, due to payment of a Mex$3.6 billion *aprovechamiento* (surcharge) to the treasury and reduction of Mex$97 million from recognition of interest on subordinate obligations from prior years, BANOBRAS recorded a loss of Mex$2.14 billion at the close of 2007, in contrast with profits seen in recent years. In late 2007, BANOBRAS' equity capital stood at Mex$13.728 billion with an overall capitalization index (credit and market) of 26% (Link 8).

1.14 **Strategic plan**. BANOBRAS recently approved a new strategic plan aimed at serving the population in priority sectors identified in the National Development Plan as underserved by the private financial sector. The plan proposes to: (i) increase lending to strategic sectors with limited access to financing; (ii) strengthen credit flows by releasing funds currently channeled to subnational governments with access to the financial market; and (iii) promoting mechanisms for financial guarantees. The targets identified by the plan are: (i) increasing the municipios' portfolio by 50%; (ii) doubling the total number of BANOBRAS borrowers; (iii) deepening the subnational debt market by providing guarantees of more than Mex$3 billion; and (iv) supplementing the structured financing market by increasing its lending by 50%.

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7 BANOBRAS has served as financial agent for loans contracted by the federal government, but this line of activity has been scaled back significantly.

1.15 **Strategic partnership.** The relationship with BANOBRAS is of central importance to the Bank and will enable the two institutions to leverage their individual strengths and more effectively coordinate programs to improve public services through institution-strengthening and financing for subnational government projects with high economic returns. This will serve to expand coverage as well as access on the part of underserved sectors. The proposed CCLIP is expected to finance this relationship, establishing a framework to strengthen the two institutions' capacity to create value for subnational governments through a combination of financial access, long-term financing, technical assistance in structuring operations, and diversification of sources of payment. As explained above, the challenges faced by subnational governments and their need for increased access to financing are critical. These efforts are of central importance to the government and consistent with its current policy in response to the economic slowdown (paragraphs 1.2-1.7). The Bank, in turn, has made subnational operations a priority, particularly those including technical assistance. As the subnational governments assume greater responsibility in providing public services and infrastructure financing, the Bank's activities directed toward these entities will become more important. Therefore BANOBRAS—the only channel through which the Bank can serve subnational governments in Mexico—is a strategic partner.

1.16 **Institutional capacity**. BANOBRAS has successfully executed 23 Bank-financed projects and is currently executing two others.[8] The Country Office in Mexico conducted an institutional capacity and risk evaluation that indicated satisfactory development results and low risk. BANOBRAS has demonstrated a high level of institutionalization, with solid systems and documented, audited processes. The project team can affirm that BANOBRAS fully complies with the criteria for executing agencies under the CCLIP policies (Link 9).

1.17 **Previous programs**. The Program for the Institutional and Financial Strengthening of States and Municipalities (FORTEM) was designed to support Mexico's decentralization process by improving subnational governments' management capacities and financing technical assistance and investment projects with high social returns. While the program has had a significant impact, investing close to US$900 million since 2000 (Link 10), the pace of execution has slowed recently, due in part to its operating mechanisms and transaction costs. Accordingly, a decision was made to design a more flexible mechanism to finance operations for the more marginalized subnational governments and help structure them with technical assistance funds, incorporating preparation and implementation periods compatible with the subnational administrations' terms of office (six years for states and three years for municipios). In order to provide sufficient financing to complete projects started under FORTEM, it is possible under the CCLIP for up to 20% of the financing (US$240 million) to be disbursed in accordance with the terms and conditions agreed on in that program.

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8 FORTEM I and II (loans 1383/OC-ME and 1744/OC-ME), for an approved total of US$500 million.

1.18 **Rationale for the credit line and first program.** The proposed credit line and first program will provide medium- and long-term financing for eligible projects presented by subnational governments and public service providers (PSPs) that currently face difficulties in preparing strategic projects and accessing financing. The funding will be supplemented with technical assistance for structuring projects with high social and economic returns, employing innovative tools to expand the universe of subnational governments that can receive financing. In this way, small-scale projects unlikely to be directly financed by the Bank can gain access to financing over appropriate terms. This mechanism is expected to extend the average term of subnational governments' loans and improve access to financing on a sustainable basis. The credit line and first program will also have a positive impact for BANOBRAS by providing long-term funding and improving its tools to measure the impact of its operations with subnational governments and PSPs.

1.19 Given the nature and structure of the target groups' demand for credit, a global multisector credit was chosen for the first operation. This is consistent with the financial products offered by BANOBRAS and will provide a flexible means of meeting subnational governments' financing needs.

1.20 The credit line and first program are consistent with the Bank's country strategy with Mexico. The proposed operation, by providing financing together with technical assistance for investments to strengthen subnational governments' capacity to provide quality public services, is consistent with the vectors of integration, improves private-sector productivity, and contributes to modernization of the State. The operation is also in line with the initial assertions of the new 2008–2011 strategy, which emphasize the Bank's focus on subnational issues and is consistent with the National Infrastructure Program and the measures taken by the SHCP to address the macroeconomic situation (paragraphs 1.2-1.7).

1.21 **Dimensioning of the credit line and first program.** The CCLIP is expected to be used for a broad range of sector and multisector projects. The flow of the portfolio generated by BANOBRAS is sufficient to justify the pace of disbursements expected under the CCLIP. Depending on market conditions, the pace of commitments is expected to be between US$200 million and US$400 million per year, of which a significant portion would be for small projects in marginalized municipios (Link 11).

B. Objectives and components

1.22 The general objective of the expanded credit line[9] and proposed program is to improve public services and build the institutional capacity of subnational governments and PSPs.[10] The purpose of the first program is to support the implementation of BANOBRAS' strategic plan and the National Development Plan

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[9] A CCLIP is typically limited to credit, while the expanded line also includes the use of guarantees.

[10] This term includes both for-profit public entities (water companies) and private concessionaires of public service projects.

through the following activities: (i) sustainably expanding access to investment financing for subnational governments and PSPs; (ii) expanding and diversifying BANOBRAS' range of products according to the needs of different market segments; (iii) financing priority investments identified in the subnational governments' and PSPs' development plans; and (iv) increasing the number of subnational projects offering high economic and social returns that are identified and structured. The first program includes two components to be financed by the CCLIP, a financing component and a technical assistance component. Funding for the technical assistance component may be supplemented with contributions from trust funds administered by the Bank, to be identified at the appropriate time.

1.23 **Financing component (US$347 million).** This component will provide financing to subnational governments that have identified eligible investment projects in accordance with the provisions of the program Operating Regulations, the key elements of which are described below. These regulations have been adapted to BANOBRAS' existing operating manuals for placement of funds and incorporate the fiduciary-management provisions stipulated in those paragraphs (3.1-3.14).

1.24 **Technical assistance component (US$3 million)**. This component will finance technical assistance to eligible borrowers under the CCLIP. The effort to increase the number of subnational borrowers is expected to require significant technical assistance resources to support them in the task of identifying and structuring projects. The program funds will be used both for feasibility and design evaluations and to support the municipios in preparing development plans. Program resources will be supplemented by funds from the Bank's trust funds and resources allocated from the National Infrastructure Fund (FONADIN) (Link 12). The technical assistance will be executed in accordance with basic principles to ensure their additionality and identify and structure projects with high social and economic returns. Resources will be focused on prefeasibility and feasibility studies and final project designs agreed on by BANOBRAS, the IDB, and the subnational governments, in order to generate investment projects to be financed under the credit line (Link 13).

1.25 **Subsequent credit line programs.** The CCLIP will enable financing and technical assistance needs with different risk profiles to be addressed gradually and in a flexible manner at the subnational level and can be implemented through loan or guarantee operations.

C. Cost, currency, and financing

1.26 Funds from the US$1.2 billion credit line will be applied under the multisector global credit modality to the three programs under the CCLIP. Each individual program can utilize the different investment project financing modalities provided for in the Bank's policies.

Table 2
Cost of Credit Line by Source of Financing (in US$ millions)

Investment component	IDB	Local counterpart	Total	%
CCLIP:				
Financing (loans and/or guarantees)	1,191.0	-	1,191.0	99.0
Technical assistance	9.0	-	9.0	1.0
Total	**1,200.0**	**-**	**1,200.0**	**100.0**
First program:				
Financing	347.0	-	347.0	99.0
Technical assistance	3.0	-	3.0	1.0
Total	**350.0**		**350.0**	**100.0**

1.27 **Currency and term.** The CCLIP will be financed through the Single Currency Facility in dollars from the Ordinary Capital, and will provide for the use of the Local Currency Facility (document GN-2365-6). The credit line can be used over a term of 10 years and will be implemented through successive multisector or sector programs, depending on demand. The first program will have a disbursement period of five years and amortization period of 20 years. The service fee for the guarantee will be equivalent to the credit fee for the loan.

D. Key indicators in the results matrix

1.28 The results matrix for the credit line (Annex I) has been designed to monitor the primary specific objectives of the first program: (i) expansion and diversification of the product range will be measured by the increase in structured operations or operations using sources other than revenue-sharing transfers as guarantees; (ii) the number of subnational governments/PSPs with access to financing will be expanded by increasing the number of municipal governments gaining access to financing and the number of subnational governments/PSPs receiving technical assistance to improve their performance and prepare projects; and (iii) financing of projects with a high social and economic impact will be achieved by targeting a significant portion of financing to subnational governments with poverty indicators above the national average.

1.29 **Methodology for compiling outcomes.** Since the CCLIP will continue the Bank's work with subnational governments in Mexico, data collection and measurement of outcomes will be based on the same monitoring systems already implemented at BANOBRAS. Measurement of indicators for product diversification and expansion of the client base (paragraph 1.22) will use the BANOBRAS system for operations programming and portfolio monitoring. The social and economic impact will be assessed based on specific sector indicators, and social and economic returns will be analyzed from a sample of projects financed.

1.30 **Expected outcomes**. Completion of the first program is expected to achieve the following outcomes: (i) expansion and diversification of the financial instruments

offered to subnational governments/PSPs; (ii) expansion of the subnational government/PSP market; and (iii) investments with high social and economic impact. In the context of institutional strategies, substantial progress will be made in consolidating the institutional partnership between BANOBRAS and the IDB.

II. FINANCING STRUCTURE AND RISKS

A. Borrower, guarantor, executing agency, and contractual conditions

2.1 The borrower and executing agency will be Banco Nacional de Obras y Servicios Públicos, S.N.C. (BANOBRAS). The guarantor will be the United Mexican States.

2.2 **Special contractual conditions.** As a special condition precedent to the first disbursement, the borrower will demonstrate to the Bank's satisfaction that the BANOBRAS board of directors has approved the program credit regulations and annual work plan. Drafts of these documents are provided in the annexes.

B. Risks and mitigating factors for the CCLIP and the first program

2.3 **Fiduciary risk**. The operation is considered to have limited fiduciary risk. BANOBRAS has recognized institutional capacity, as demonstrated in an evaluation conducted by the Bank. That evaluation found that all processes, systems, and procedures are properly documented and audited. BANOBRAS has a AAA local rating (Fitch) and is supervised by the Comisión Nacional Bancaria y de Valores [National Banking and Securities Commission] (CNBV), the Civil Service Department and its deconcentrated entities, and an external audit firm of recognized standing. During preparation of the operation, an institutional assessment was conducted using the Institutional Capacity Assessment System (ICAS) and yielded satisfactory results. BANOBRAS has satisfactorily executed 23 previous operations with the Bank. Lastly, as indicated in Mexico's Fiduciary Supervision Framework, Mexico—and its development banks in particular—has proven, rigorous fiduciary control systems.

2.4 **Environmental and social risks**. The Program's Environmental and Social Strategy consisted of an environmental and social assessment focused on analyzing BANOBRAS' environmental and social management capacity and defining an environmental management system in accordance with national standards and applicable Bank policies (operational policy OP-703). Based on the results of that strategy, the following environmental and social management mechanisms for the CCLIP were agreed on with BANOBRAS: (i) application of a list of activities not eligible for financing, as detailed in the Operating Regulations; and (ii) processing of financing requests from sub-borrowers in a manner that complies with Mexican environmental and social legislation and the relevant Bank policies. Using the filter for distinguishing between project categories, the program will comply with Bank policies. The regular supervision procedures planned by the Bank incorporate a review of compliance with the environmental and social management requirements

agreed on for the program. In addition, the final report of the CCLIP will include an environmental and social review of the line.

2.5 **Other risks** identified are: (i) an abrupt change in macroeconomic aggregates that may impact the federal and subnational governments' ability to invest; (ii) timely availability of technical assistance resources; (iii) lack of priority ascribed to program elements by BANOBRAS and/or its clients; (iv) market changes impacting the expected demand for products offered by BANOBRAS; (v) change in infrastructure investment policies as new subnational administrations take office; (vi) incompatibility of borrower procurement policies with Bank policies; and (vii) currency mismatch. The planned mitigating actions are described in the risk evaluation (Link 14).

III. EXECUTION MECHANISM AND MONITORING

A. Execution mechanism

3.1 BANOBRAS will execute this operation under its current organizational structure. The Promotion and Technical Assistance Division, in close coordination with the Credit and Finance Divisions, will have primary responsibility for executing programs under the credit line. The operational provisions governing program execution are defined in the Operating Regulations agreed to by the Bank and BANOBRAS. That document is consistent with the standards and policies of BANOBRAS and the Bank.

3.2 **Eligibility criteria for subnational governments and PSPs.** Subnational governments and PSPs that meet the eligibility requirements established in the BANOBRAS founding act and its implementing regulations can receive program-financed loans. As stipulated in its applicable manuals, BANOBRAS will ensure that borrowers are legally established in Mexico and have the administrative, technical, financial, legal, and environmental capacity to execute the projects financed. For certain operations geared toward subnational governments and PSPs, the Fondo Nacional de Infraestructura [National Infrastructure Fund] (FONADIN) may be an eligible borrower.

3.3 **Disbursements and execution schedule.** Program funds will be committed for a term of 48 months from the effective date of the loan contract and should be disbursed over a period of no more than 60 months from the same date. Financing provided by BANOBRAS will be recognized under terms substantially analogous to those described in this document beginning 18 months before signature of the loan contract.

B. Disbursement mechanisms

3.4 Summarized below are the three disbursement mechanisms for the first program.

3.5 **Disbursements based on physical and financial progress—Option 1.** This mechanism provides for disbursement of funds as the end borrowers request partial disbursements. Considering that the financing is for subnational governments'

investment plans, the execution mechanism should be responsive and flexible. Accordingly, the sub-borrowers will have access to up to 50% of the loan upon signing a contract with BANOBRAS. The subnational government will have access to the remaining amount as evidence of physical and financial progress of the project is presented, as prescribed in the respective loan contract between BANOBRAS and the subnational government. Each disbursement will be made through a specific conversion recorded as an individual loan.

3.6 **Advance disbursements—Option 2.** This mechanism provides for disbursement of funds to BANOBRAS at the time it receives the borrower's financial commitment through signature of a loan contract. The funds, which are a disbursement of the loan, will be used exclusively to finance the specific project specified in the loan contract with the subnational borrower. This mechanism will enable BANOBRAS to fix the level of funding received from the Bank, which is subject to variation due to the volatility of the derivatives (swaps) market. BANOBRAS will submit to the Bank expenditure reports and reports certifying the physical and financial progress of each project that will be used to justify the use of resources.

3.7 **Portfolio rediscount—Option 3.** This mechanism is designed for small projects executed by subnational governments, and does not contemplate the use of international competitive bidding (ICB) for works or goods. In order to be able to serve the majority of subnational governments that lack access to financing (paragraph 1.10), this option will rediscount the portfolio originated by BANOBRAS. This mechanism will enable the Bank to take part in financing small projects for drinking water, drainage systems, and street lighting; build markets, cemeteries, and slaughterhouses; and provide paved roads, parks and gardens, etc. As described in paragraph 3.12, a cap would be put on the maximum amount for each rediscountable operation. For projects involving amounts under the ICB threshold, the IDB will conduct ex post controls and verifications based on sampling.

3.8 **Formalization of access to the credit line.** Access to the credit line to finance investment plans under Options 1 and 2 will be formalized through a loan contract between BANOBRAS and the subnational government concerned that will include: (i) an approved investment plan; and (ii) a procurement plan, among other documents.

C. Procurement

3.9 The procurement procedures used in this operation match the different characteristics of BANOBRAS' sub-borrowers and the disbursement mechanisms designed for them. Except as described in paragraph 3.12, goods and works will be procured in accordance with the Bank's policies in document GN-2349-7 (Policies for Procurement of Works and Goods Financed by the Inter-American Development Bank). International competitive bidding will be mandatory for works estimated to cost over US$15 million equivalent per contract, and for goods

estimated to cost over US$500,000 equivalent per contract. National competitive bidding (NCB) will be mandatory for works estimated to cost over US$500,000 equivalent per contract, and for goods estimated to cost over US$100,000 equivalent per contract. Procurements under these thresholds will use price comparison. Mexico has standard procurement documents agreed to by the Bank, the Civil Service Department, and the World Bank, which will facilitate application of the Bank's policies and procedures.

3.10 Consultants for public sub-borrowers will be selected and contracted in accordance with the provisions of the Policies for the Selection and Contracting of Consultants Financed by the Inter-American Development Bank (document GN-2350-7). Mexico already has standard procurement documents that were agreed on by the IDB, the Civil Service Department, and the World Bank, which will facilitate implementation of IDB policies and procedures in this area. For the purpose of paragraph 2.7 of the policy on consultants, the shortlist for contracts estimated to cost less than US$500,000 equivalent may consist entirely of national consultants.

3.11 For operations with private or public borrowers that are autonomous public service providers, goods and works will be selected and procured in accordance with the Bank's policies set forth in Appendix 4 of document GN-2349-7. Private-sector sub-borrowers, regardless of the disbursement modality to be used (paragraph 3.5), will use procurement procedures tailored to market practices for the private or business sector that are acceptable to the Bank. These procedures must result in competitive market prices for goods and services.

3.12 **Rediscount of public-sector portfolio (Option 3)**. In accordance with the Bank's procurement policies, procurements under loans of less than US$5 million, financing of which is governed by the portfolio rediscount mechanism, can use NCB or other methods provided for in the policies. Local legislation can also be followed, if justification is provided that the works being financed with this rediscount mechanism are small[11] and are aimed at financing for social infrastructure and basic services such as providing drinking water, drainage systems, and street lighting; building markets, cemeteries, and slaughterhouses; and providing paved roads, parks and gardens, etc. Such works are performed based on demand, making procurement planning unfeasible. Procurements and contracts financed under this mechanism must meet the principles of economy, efficiency, and transparency as stipulated in the Bank's procurement policies.

3.13 The advantage of identifying investments for this lending option lies in the fact that when the portfolio amount to be rediscounted with the Bank is identified, the information available to BANOBRAS as a lending institution is based on units of credit, not contracts for works. However, the use of the funds is verified by the control desk within a maximum of 120 days following the BANOBRAS disbursement and after the close and completion of the work. The BANOBRAS

[11] Works amounting to approximately US$120,000 per contract.

control desk has a comprehensive warning system to monitor compliance with contractual obligations, which includes verification of the final use of resources.

3.14 As subloan operations are formalized, they will be incorporated into the procurement plans for Options 1 and 2 (except as described in paragraphs 3.11 and 3.12). Private-sector rediscount operations cannot be incorporated. The IDB and BANOBRAS will conduct ex ante review of procurement by subnational governments of goods, works, and consulting services over the ICB thresholds for Options 1 and 2. To this end, BANOBRAS has demonstrated that it has the procurement system and personnel required for this task. Lastly, it was agreed that for procurements under the ICB thresholds, the Bank will conduct ex post reviews based on sampling.

D. Monitoring and supervision

3.15 Monitoring and evaluation activities will be ongoing. In addition to semiannual progress reports to be presented by BANOBRAS, periodic meetings will be held with the IDB to evaluate aspects including: (i) structured, approved, and committed operations; (ii) progress on disbursements; and (iii) the subnational governments' investments. A midterm review will also be conducted in the first 24 months of execution or once 50% of the first operation under the credit line has been committed, and will evaluate progress on execution and fulfillment of program objectives. The project team will coordinate the necessary activities with BANOBRAS to ensure the technical quality of infrastructure and management strengthening projects. To this end, the IDB will receive the project proposals, which will be reviewed by sector specialists to ensure they meet the specific technical criteria.

BANOBRAS SUBNATIONAL CREDIT LINE FOR INFRASTRUCTURE, PUBLIC SERVICES, AND INSTITUTION-STRENGTHENING (ME-X1002)

AND

FIRST OPERATION FOR SUBNATIONAL CREDIT FOR INFRASTRUCTURE, PUBLIC SERVICES, AND INSTITUTION-STRENGTHENING (ME-L1017)

Objectives of the CCLIP
The general objective of the credit line and first program is to help improve public services and strengthen the management capacity of subnational governments and public service providers (PSPs).
The purpose of the first program is to support implementation of BANOBRAS' strategic plan and the National Development Plan through the following activities: (i) increase the number of subnational governments and PSPs with access to financing; (ii) expand and diversify the range of products according to the characteristics and needs of different market segments; (iii) finance operations identified in the subnational governments' and PSPs' development plans with high social and economic returns; and (iv) increase the number of subnational projects with a high economic and social return that are identified and structured.

RESULTS MATRIX FOR THE FIRST PROGRAM
TABLE OF INDICATORS

	Baseline	End of Year 1	End of Year 2	End of Year 3	End of Year 4		Comments
Specific objective 1: Increase the number of subnational governments and PSPs with access to financing.							
Outcome 1: Expand the portfolio of operations with municipios (total portfolio balance)	Mex$7.999 billion	Mex$8.3 billion	Mex$8.7 billion	Mex$9.2 billion	Mex$9.6 billion		Setting specific portfolio balance targets requires not only finding new borrowers but also maintaining current ones. These indicators are consistent with BANOBRAS' objective of expanding its portfolio with municipios by nearly 50% by the end of the government's current six-year term in office.
Number of subnational governments that have received technical assistance	20	25	30	35	40		

	Baseline	End of Year 1	End of Year 2	End of Year 3	End of Year 4		Comments
Specific objective 2: Expand and diversify the range of products according to the characteristics and needs of different market segments							
Outcome 2: Amount of operations with own source of payment	Mex$12 billion	Mex$13 billion	Mex$14 billion	Mex$15 billion	Mex$16 billion		These operations correspond to projects with PSPs.
Amount of operations with subnational governments and PSPs with a source of payment other than revenue-sharing transfers.	Mex$1 billion	Mex$1.5 billion	Mex$2 billion	Mex$2.5 billion	Mex$3 billion		The use of sources of payment other than revenue-sharing transfers is associated with the development of new financial products.
Specific objective 3: Finance operations identified in subnational governments' and PSPs' development plans with high social and economic returns.							
Outcome 3: Number of municipios where water and/or sanitation activities are conducted	100	100	50	100	100		In 2004, 21% of the population did not have access to drainage and 13% of the rural population did not have access to drinking water.
Amount of financing in municipios for water and/or sanitation activities	Mex$500 million	Mex$500 million	Mex$250 million	Mex$500 million	Mex$500 million		In 2006, Banobras allocated 32% of the portfolio to municipios with a high or very high degree of marginalization (as defined by INEGI).
Number of municipios with a high or very high degree of marginalization where water and/or sanitation activities are conducted	60	60	30	60	60		
Amount of financing in municipios with a high or very high degree of marginalization for water and/or sanitation activities	Mex$300 million	Mex$300 million	Mex$150 million	Mex$300 million	Mex$300 million		

FIRST OPERATION FOR SUBNATIONAL CREDIT FOR INFRASTRUCTURE, PUBLIC SERVICES, AND INSTITUTION-STRENGTHENING (ME-L1017)

SUMMARY PROCUREMENT PLAN

Due to the nature of the **First Operation for Subnational Credit for Infrastructure, Public Services, and Institution-strengthening (ME-L1017)**, a procurement plan can not be prepared in advance. The beneficiaries of subloans will prepare and present an initial procurement plan covering at least the first 18 months of execution of each subproject, as an eligibility requirement for Bank financing to BANOBRAS,[1] except for small municipios in accordance with the waiver mentioned in the loan proposal. The plans will be presented in accordance with the program Operating Regulations.

[1] As of the subproject's elegibility date.

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE- ___/08

Mexico. ME-X1002. BANOBRAS Subnational Credit Line
for Infrastructure, Public Services and
Institution-strengthening

The Board of Executive Directors

RESOLVES:

1. That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank to enter into such agreement or agreements as may be necessary with Banco Nacional de Obras y Servicios Públicos, S.N.C. (BANOBRAS), as Borrower, to establish a Subnational Credit Line for Infrastructure, Public Services and Institution-strengthening (the "Credit Line") for up to the sum of US$1,200,000,000, chargeable to the resources of the Single Currency Facility of the Bank's Ordinary Capital.

2. That the establishment and utilization of resources under the Credit Line shall be carried out in accordance with: (a) the objectives and regulations of the Conditional Credit Line for Investment Projects established by Resolution DE-58/03 of July 16, 2003 as amended by Resolution DE-10/07 of January 31, 2007; and (b) the specific provisions set forth in document GN-2246-4.

3. That the amounts authorized to finance individual operations chargeable to the Credit Line shall be granted as individual operations subject to the usual financial terms and conditions applicable to financing from the resources of the Single Currency Facility of the Bank's Ordinary Capital, in force at the time that each individual operation is approved. Such terms and conditions shall be specified in the executive summary of the corresponding loan proposal.

4. That the effectiveness of the agreement or agreements executed by the Bank with the Banco Nacional de Obras y Servicios Públicos, S.N.C. (BANOBRAS) to grant financing for each individual operation shall be subject to the effectiveness and validity of the cooperation agreement for the establishment of the Credit Line.

(Adopted on __ _________ 2008)

LEG/SGO/CID/IDBDOCS#1710684
ME-X1002

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE-__/08

Mexico. Loan ____/OC-ME to Banco Nacional de Obras y Servicios Públicos, S.N.C.,
First Operation for Subnational Credit for Infrastructure,
Public Services and Institution-strengthening

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with Banco Nacional de Obras y Servicios Públicos, S.N.C. (BANOBRAS), as Borrower, and the United Mexican States, as Guarantor, for the purpose of granting it a financing to cooperate in the execution of the first operation for subnational credit for infrastructure, public services and institution-strengthening, under the Subnational Credit Line for Infrastructure, Public Services, and Institution-strengthening approved by Resolution DE-__/__. Such financing will be for the amount of up to US$350,000,000, from the resources of the Single Currency Facility of the Bank's Ordinary Capital, and will be subject to the Financial Terms and Conditions and the Special Contractual Conditions of the Executive Summary of the Loan Proposal.

(Adopted on ___ _________ 2008)

LEG/SGO/CID/IDBDOCS#1710843
ME-L1017