Discussion paper

WaterAid

The true cost of concessional loans:

On-lending practices at the Asian Development Bank

This discussion paper examines the practice and impact of re-lending concessional loans at increasing interest rates.

March 2007

WaterAid/Marco Betti

Headlines

- Concessional loans for water supply and sanitation projects are being lent and re-lent by intermediaries at increasing interest rates and reach end borrowers at relatively high rates of interest
- In order to make them financially viable, projects are designed with sharp, unrealistic and unaffordable increases in tariffs
- Poor users cannot afford to connect to services and end borrowers are struggling to repay loans

WaterAid's mission is to overcome poverty by enabling the world's poorest people to gain access to safe water, sanitation and hygiene education.

What is on-lending in Asian Development Bank projects?

In 2005 WaterAid conducted a study of the Asian Development Bank (ADB) water supply and sanitation projects in Bangladesh, India and Nepal. Part of the study examined the financial implications of ADB project lending at the national, state, and local levels.

The ADB lends money to central governments, normally to the Ministry of Finance, public and private enterprises. In order to pass on loans to the institution requiring funding for a project or programme central government 'on-lends' these funds to other institutions, such as lower tiers of government or specialised urban development funds. In turn these intermediaries again on-lend the money to a lower level of government or to users. Typically loans are on-lent twice before they reach the final borrower. Each time loans are on-lent, the interest rates on the loans are raised and the period for repayment is reduced. The rates that a final borrower is required to repay are far from concessional and hence steep, unrealistic and sometimes unaffordable tariff increases and built into project designs. This means that poor users cannot afford to connect to services and end borrowers are struggling to repay loans. This discussion paper aims to explain the process of on-lending and its impact and make recommendations on how the practice can be changed so that concessional lending actually benefits the poor.

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What are the terms of ADB lending to national governments?

Most ADB lending for water supply and sanitation projects is from the Ordinary Capital Resources (OCR) and the Asian Development Fund (ADF). In 2005, total ADB lending for 32 loans comprising $4.4 billion was from Ordinary Capital Resources (76% of lending) and 40 loans comprising $1.4 billion from the Asian Development Fund (24% of lending) (Asian Development Bank, 2006).

Loans from OCR are only made to comparatively "more-developed" countries, able to repay the debt. These loans are not concessional and interest rates are set by the market based on the LIBOR plus a fixed spread (currently at 0.6%), which is reset every six months. LIBOR is the London Interbank Offered Rate and is the interest rate offered by a specific group of London banks for US dollar deposits of a stated maturity. For example, the 1 year LIBOR rate on 14 July, 2006, was at 5.66% (www.interestonlyloans.com). LIBOR-based loans have a floating interest rate until the borrower requests for fixing. The loans are payable over a 15 to 25 year period. ADB loans to India are from the OCR.

ADF loans are made to the 24 "poorest" member countries with low debt repayment capacity at concessional rates (1 to 1.5% interest) with long grace periods (often 8 years) and long repayment periods (they have a 32 year maturity period). ADB loans to Nepal are from the ADF.

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At what terms are these loans on-lent by governments?

Governments and other intermediaries on-lending these loans typically increase interest rates by 3 to 6.5%. They also reduce repayment periods and grace periods. Table 1 illustrates how this works in water supply and sanitation projects in Bangladesh, India and Nepal.

Table 1: On-lending of ADB loans at increasing interest rates

Country	ADB Project	Step 1	Step 2	Step 3
India	Urban Water Supply and Environment Improvement Project in Madhya Pradesh - case of Ratlam	ADB to Government of India (GoI) at LIBOR + 0.60% (OCR - 25 year loan with 5 year grace period)	GoI to Special Purpose Vehicle Madhya Pradesh (SPVMP)	SPVMP to Town Municipality at 12%
Nepal	Small Towns Water Supply and Sanitation Sector Project	ADB to HMGN at 1.5% (ADF - 32 year loan, 8 year grace period)	HMGN to Town Development Fund (TDF) at 5% (20 year loan with 5 year grace period)	TDF to Water Users and Sanitation Committee at 8% (for 12 years with 3 year grace period)
Bangladesh	Second Water Supply and Sanitation Sector Project	ADB to GoB at 1.0% (ADF - 40 year loan, 10 year grace period)	GoB to Paurashava at 7.5% (20 year loan with 5 year grace period)	Paurashava to poor residents at 14% (market rate, through NGOs)

Source: WaterAid, 2006

Why do intermediaries increase interest rates when on-lending?

There are a number of reasons why intermediary borrowers increase interest rates:

- To cover the risk and cost of currency devaluation
- To cover the risk and cost of loan defaulters. Loans must be repaid to ADB. However intermediaries know that not all end borrowers (for example, municipalities) will be able to or choose to repay loans. Therefore intermediaries try to collect more money from those that do pay to cover these anticipated losses
- To cover their overhead costs. For example in Nepal the Town Development Fund (TDF) is a special organisation established to channel grant and loan resources to municipalities. It must cover all its running costs from repayments it receives from borrowers and therefore adds a 3% spread to its loans

While these causes might be reasonable, the result is perverse. Concessional loans designed to alleviate poverty end up burdening cities, towns and individuals with unpayable debt.

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Why do borrowers agree to the terms of the loan?

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Given that the interest on loans is relatively high for the end borrower, it is important to understand why institutions actually agree to the loans. Some of the reasons are:

- The water and sanitation situation in towns is deplorable and there is a perception that large-scale financing is needed to address the problem, for example to bring water from a distant source. Municipalities are unable to raise enough revenue to cover the costs of the infrastructure and central government grants are not available. Hence small towns have no option but to take loans for expensive, infrastructure-heavy projects, designed at state or central levels. Often cheaper water and sanitation solutions could be designed, such as upgrading distribution systems and fixing leaks, which would remove the need for large financing

- Although not as concessional as the loan made by ADB to central government, on-lent loans are still cheaper than commercial loans available to local governments. Furthermore many of the towns covered by these projects are not attractive investment destinations; hence alternative financing is not available

- In some cases the end borrowers are unaware of the terms and conditions of the loans. In one Municipality visited in Nepal, the officials in the Municipality were not even aware that the Municipality was a guarantor for a loan taken by the local users committee under an ADB financed project. In India, repayments are made to ADB by central government and information regarding the amount of outstanding loans is not available with the end borrower

- Borrowers know that they will be bailed out by state or central government if they are unable to repay loans and are therefore not very concerned about the terms and conditions

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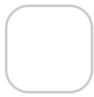
What is the impact of on-lending on users and end borrowers?

Tariff hikes to make projects financially viable

In order to be approved by the ADB Board of Directors, proposed projects must be financially viable, based on a calculation of the Financial Internal Rate of Return (FIRR). ADB projects are often designed centrally, by consultants, and not at the local level. This results in expensive projects due to over-designing of infrastructure, the cost of consultants and the interest rates on the loans. To make such projects appear financially viable designs include huge increases in tariffs. These tariff increases are built into loan agreements as conditions. In the case of the town of Ratlam under the Urban Water Supply and Environmental Improvement Project in Madhya Pradesh, India, water tariffs were projected to increase by 8.4 times over a 16-year period. Often these increases in tariffs are included in loan documents without any agreement from the local government that is responsible for implementing the increases.



Contributions sought from water supply users are unaffordable for the poor

Some projects are designed in such a way that part of the burden of loan repayment is passed to the users through up-front cash and in-kind contributions. For the poorer residents in these towns this contribution is unaffordable and means that they are unable to connect to the new water supplies, undermining the aim of delivering access to services for poorer communities. Box 1 below is an example of how this works from a project in Nepal. In some cases residents were found to be mortgaging property and taking multiple loans in order to pay the up-front cash contribution. The time taken to raise these contributions also results in delays in project implementation. Since the loans have already been taken, these delays also eat into the time available for generating revenues for loan repayment.

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Box 1: Cost sharing for water supply component in the Small Towns Water Supply and Sanitation Sector Project, Nepal

50%	Grant from central government
5%	Up-front cash contribution from users
15%	Cash or in-kind contribution from users (collected in cash in most towns)
30%	Loan taken by users (at 8% annual interest rate)

The 50% user contribution equates to US$270 and US$190 per household in the two small towns studied, Birendranagar and Ratnanagar, excluding interest on the loan. This is equivalent to ten and seven months' income of a poor household.

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Difficulty in paying back the loans

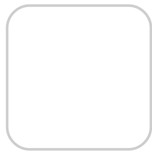
End borrowers are concerned about and in some cases struggling to repay loans. In the oldest project covered in the study, the Karnataka Urban Infrastructure Development Project, four towns who took loans under the project in 1995 are falling behind on their repayments.

Table 2: Towns struggling to repay loans in Karnataka (Indian Cr Rupees)

Town	Size of loan	Annual repayment	Repaid so far (since 2001)	% repaid so far (since 2001)
Mysore	195.47	26.64	46.48	24%
Channapatna	17.09	2.68	0	0%
Ramnagara	44.88	6.48	0	0%
Tumkur	66.02	9.7	2.01	3%
Total	323.46	45.5	48.49	15%

Source: Celestine, 2006

A number of towns in India and Nepal have done their own analysis of the debt burden that would result from projects and decided to opt out of the projects.



National and state level debt situation – the bigger picture

While on-lending is increasing debt at local levels, this is symptomatic of a worsening debt scenario at national and state levels.

National level external debt varies considerably in the three countries studied equating to 18% (2004), 33% (2003) and 63% (2003) of GDP in India, Bangladesh and Nepal respectively. While the national level debt burden in India is decreasing, it is increasing in Nepal where the annual increase in debt servicing outstrips revenue growth and Nepal is now eligible for debt relief under the Heavily Indebted Poor Country (HIPC) initiative.

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While loans for water and sanitation services alone are not responsible for a debt burden at the national level, total outstanding debt to the ADB in Nepal and Bangladesh is significant. In Nepal, around 38% of the country's outstanding external debt is owed to the ADB (WaterAid Nepal, 2006), with this figure standing at 27% for Bangladesh (WaterAid Bangladesh, 2006). In India, where ADB loans are exclusively from the more expensive Ordinary Capital Resources, ADB lending is on the increase, with India now the largest borrower of all ADB's Developing Member Countries, and a priority country under ADB's recently launched Water Financing Initiative.

In India, while national level debt indicators have improved in recent years, state government debt is accumulating. In 2004 state debt had reached 29% of GDP and debt repayments had reached 25% of revenue receipts (WaterAid India, 2006). This is higher than the 18% threshold considered sustainable in the medium term, and pushes states into a vicious circle of deficit, debt and interest payments. In the state of Madhya Pradesh, state debt as a proportion of Gross State Domestic Product increased from 38% in 2002/03 to 53% in 2003/04 (WaterAid India, 2006).

Recommendations

In India some action has already been taken by the government to address this issue. In 2005 the Government made changes which mean that Multilateral Development Bank loans are available to states at the same terms as Government itself receives from the Banks. While this makes financing available at lower rates of interest it also exposes states to the risk of foreign exchange fluctuation, previously a risk borne by the central government.

The ADB and governments should review on-lending practices for affordability to end users. Some initial specific recommendations on what the ADB and governments should do to address this issue are given below. These recommendations should be informed by further research into the practice of on-lending by the ADB and other development banks and its impacts.

Promote prudent debt management

1. Governments and the ADB should promote prudent debt management with regards to new borrowing, based on the principles of affordability, transparency and subsidiarity over decision-making. This requires both using debt sustainability assessments and putting in place appropriate institutional checks and balances to manage borrowing and to ensure that the finance reaches intended beneficiaries and is affordable.

Increase transparency on debt profiles and lending terms and implications

2. Governments and the ADB should make publicly available information on the debt profile of clients and end borrowers, including states and cites/towns, and on changes in concessionality of lending rates and costs to end borrowers. Local, regional and national legislators should be made fully aware of the volume of borrowing, terms and conditions, the implications for aggregate debt stocks and the implications of failing to repay loans (this may include reduction in development grants in future years).

3. In its Report and Recommendations to the President documents (the loan proposals to the ADB Board) the ADB should clearly state the cost of loans to the end user. These documents should also make a comparison of this cost versus the cost of available commercial loans.

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Ensure local government and citizens' participation in decision on borrowing and tariffs

4. The ADB and central government should ensure that local governments and the public are involved in deciding tariff increases and loan repayment schedules. Open debates on the volume, terms and conditions, including levels of conditionality, with locally elected representatives and organisations representing the poor should be held. Local governments should then sign-off on the conditions and these should be publicly displayed.

Build capacity of local governments to design local projects

5. Central government and the ADB should build the capacity of local governments to design and plan their own projects to meet local needs and fit with their financial and management capabilities.

Initiate debt relief on ADB loans

6. The ADB should coordinate its policy on debt relief policy in line with the Heavily Indebted Poor Country and 2005 Multilateral Debt Relief Initiatives where creditors, including the regional African Development Bank, have agreed to write off debts as means of mobilizing additional resources to help to achieve the MDGs.

Stop turning grants into loans

7. Bilateral donors should review the appropriateness of their grant financing to Multilateral Development Banks being turned into loans and debts. This practice means that it is Multilateral Development Banks rather than the poor that benefit from these grants.