



Rural Finance

Policy

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Abbreviations and acronyms

CGAP	Consultative Group to Assist the Poor
MFI	microfinance institution
MIX	Microfinance Information eXchange
RFP	Rural Finance Policy
SHG	self-help group
WFP	World Food Programme

IFAD Rural Finance Policy^a

Preface

Even with the well-known success of microfinance to date, formal financial services only reach about 10 per cent of rural areas, and the vast majority of poor men and women have no reliable, secure way to save money, protect and build their assets, or transfer funds. IFAD recognizes this challenge, as well as the vast potential to improve the livelihoods of rural men and women by increasing their access to a wide range of financial services and sound institutions.

This new IFAD Rural Finance Policy builds on, updates and supersedes the IFAD Rural Finance Policy of 2000, responding to the recommendations made in the corporate-level evaluation of 2006. It incorporates the major thrusts of the earlier policy and offers a framework for IFAD's rural finance portfolio. The new policy provides the guiding principles for rural finance operations at the three levels of intervention – micro, meso and macro – and gives further detail for IFAD's governing bodies, development partners and the broader public on the Fund's approach to rural finance. In addition, updated operational guidelines – the Decision Tools for Rural Finance – will also be provided to IFAD staff, consultants and partner institutions.

Through this updated policy, IFAD reconfirms its commitment to improved ways of supporting and developing rural finance systems. Having largely discarded the old paradigm of providing credit lines for targeted, subsidized lending, IFAD has shifted its focus in rural finance to the development of diverse, viable financial service providers that increase the long-term access of rural poor people to a wide range of financial services.

At the micro level, IFAD realizes that its support is most effective when directed at the productive potential of poor people and their organizations.^b It is also critical to reach the poorest through income transfers, safety nets, direct microenterprise promotion, graduation programmes and improved infrastructure, as well as targeted savings, remittances services and other innovative risk management tools.

a IFAD's engagement in rural finance is based on paragraph 17 of the annex of the Lending Policies and Criteria, which sets out the general policies and criteria of the Fund's financing operations.

b IFAD Policy on Targeting (EB 2006/88/R.2/Rev.1), pages 2, 12, 29.

At the meso level, IFAD interventions work to develop efficient financial-sector infrastructure by building both human and institutional capacity. The Fund is advocating financial transparency and promoting comprehensive consumer protection; it is also committed to investing in innovative technical solutions and financial mechanisms to maximize geographical and social outreach and impact. In the context of today's global financial and economic crises, and in view of the crises in Asia and the Americas in the 1990s, IFAD's work in developing strong, sustainable financial sectors that serve rural poor people is more critical than ever.

The full impact of rural finance is felt only when conducive national policies and strategies are in place, markets are functioning and complementary non-financial services are also available. Given the importance of the macro level of the financial sector, IFAD also works closely with Governments, development partners and the private sector to support this enabling framework for rural finance and development.

For IFAD, rural finance is one of several important areas for investment in poverty reduction through agricultural and rural livelihoods development. In addition, access to financial services can be instrumental in coping with income shocks such as severe weather events, increases in commodity prices and unexpected life events. While rural finance is not a panacea for poverty reduction, access to financial services plays an important role in empowering poor people to create their own pathways out of poverty.

A handwritten signature in black ink, appearing to read 'Kanayo F. Nwanze', with a large, sweeping flourish underneath.

KANAYO F. NWANZE
President

Executive summary

The IFAD Rural Finance Policy provides guidance to IFAD-supported rural financial services programmes and projects, and their components. Given its focus on women, young people, indigenous peoples and very poor households, IFAD concentrates on rural microfinance, with “micro” referring to the relative size of the financial transactions – including savings, remittances, leasing and risk management services – and “rural” reflecting the location of the entrepreneurs and small-scale agricultural and livestock producers that IFAD targets.

The provision of financial services to poor rural households faces many challenges, including weak infrastructure, the limited capacity of financial service providers and low levels of client education. In a changing global economy and in the context of the widening financial crisis, volatile food and agricultural commodity prices and the perils of climate change, **developing inclusive rural financial systems and fostering innovations to increase the access of poor and marginalized women and men to a wide range of financial services** is central to IFAD’s mandate. Given the many challenges inherent in remote, marginal areas, in conflict and post-conflict situations, and in areas recovering from natural disasters, the development of innovative products and delivery mechanisms is critical to meeting the needs of IFAD’s target group.

In building inclusive financial systems, IFAD applies **six guiding principles in its rural finance interventions**: (i) support access to a variety of financial services; (ii) promote a wide range of financial institutions, models and delivery channels; (iii) support demand-driven and innovative approaches; (iv) encourage – in collaboration with private-sector partners – market-based approaches that strengthen rural financial markets, avoid distortions in the financial sector and leverage IFAD’s resources; (v) develop and support long-term strategies focusing on sustainability and poverty outreach; and (vi) participate in policy dialogues that promote an enabling environment for rural finance. These binding principles will be applied at the micro level, working with retail rural finance institutions and beneficiaries; at the meso level, focusing on financial infrastructure, such as second-tier institutions, and technical service providers; and at the macro level, assessing the policy, legislative, regulatory and supervisory framework. Any deviation from these principles will require clear justification and approval by Management.

The updated rural finance policy offers **guidelines** to IFAD decision makers, consultants and partner organizations to ensure the development of a coherent and effective rural finance sector. The guidelines aim to assist in: building clients' skills to effectively participate in the ownership and oversight of local financial institutions; promoting financial literacy training; and supporting protective arrangements for savers, borrowers and lending institutions. They prescribe ways to strengthen the delivery capacity of financial service providers in rural areas and to achieve financial sustainability, help savings-based models of community-managed loan funds achieve promising results, and show how distortions of financial markets can be avoided. The policy prescriptions also provide clarity on interest rate subsidies, credit lines to retail and wholesale finance institutions, and professionally managed credit guarantees. IFAD's support to building stable, inclusive financial systems may include developing second-tier institutions such as industry associations and apexes, encouraging good governance and transparency in the sector, and assisting partner governments in promoting an enabling environment for market-oriented rural finance.

This policy is complemented by Decision Tools for Rural Finance, an IFAD manual that offers more specific guidance and background information for project design and implementation.

New challenges and opportunities

Challenges

In a changing global economy, development agencies engaged in rural poverty reduction are working to increase the impact of their interventions and reduce the vulnerability of people who risk being excluded from mainstream development processes.

Achieving these objectives is increasingly complex because of a number of global trends. The globalization of financial markets, trade liberalization, the volatility of food and agricultural commodity prices, the continuing transformation of the agricultural and rural sector, and greater climatic uncertainty have direct implications for IFAD's programme of work, including its rural finance interventions.

Rural finance is now recognized as an important tool in the fight to reduce poverty and enhance donors' development effectiveness agenda. As the rural finance sector has matured, the provision of financial services to poor people has moved beyond microcredit to microfinance, encompassing a wider range of financial services such as savings, remittances, leasing and insurance.

Nevertheless, the provision of financial services to poor rural households involves many challenges, including the weak infrastructure and low population density characteristics of rural areas. The capacity of financial service providers and the level of client education in rural communities can be quite limited. The overall financial market may be stunted and distorted from subsidized, targeted lending. In addition, financial institutions may be hesitant to serve the agricultural sector, given its seasonality and the inherent risks of farming. Rural finance may be made more complex in areas where clients, particularly women, have no access to due judicial process and lack property rights or secure land tenure, and therefore cannot offer the typical kinds of loan collateral. Taken together, these challenges increase the transaction costs and risks of serving rural areas and require continual attention and innovation.

The contemporary approach to rural finance focuses on building the sustainability of financial service providers, thinking beyond the short life cycle of donor-driven projects. Strong rural institutions and models present promising partnerships and business opportunities for commercial banks to become more involved in rural finance, thereby scaling down their services with products tailored to poor and marginalized households, often through a partnership with a community-based institution. More recent global developments in rural finance include the use of information and communication technologies such as cell phones to provide services and the growth in migrants' capital and remittances flows to rural areas.



As rural finance is part of the wider financial sector, at the macro level, governments should respond to weak financial markets or systemic crises with legislative and regulatory frameworks that comply with the Core Principles of Effective Banking Supervision issued by the Basel Committee on Banking Supervision. National governments also play a key role in establishing enabling policies, which lead to the reform of state banks and the establishment of many new rural finance institutions. Macroeconomic stability and transparency in the financial market are critical to creating a conducive environment for IFAD's efforts to develop sound rural finance systems that work for poor people over the long term and are integrated into the mainstream financial system.¹

Opportunities

Support for inclusive rural finance systems is central to IFAD's mandate. Over the years, IFAD has responded positively to the new challenges and the demands of its partner countries. Approximately 20 per cent of IFAD's investments are now focused on rural finance. IFAD also clearly recognizes that its target group² – poor, marginalized and vulnerable rural people – requires a wide range of financial services, not simply credit, and deserves robust standards of consumer protection.

The updated Rural Finance Policy (RFP) addresses the specific recommendations made in the agreement at completion point of the corporate-level evaluation of the earlier RFP.³ It is also aligned with changes in IFAD's operating modalities that have occurred since the inception of the RFP in 2000. These include systematic quality design of projects, with key issues deriving from the result-based country strategic opportunities programme and from quality enhancement and quality assurance processes; and improved implementation effectiveness through in-country presence, direct supervision and the strengthening of country programme managers' rural finance skills.

The promotion of knowledge sharing through the Rural Finance Thematic Group and through partnerships with centres of excellence and regional networks has enhanced IFAD's knowledge base on rural finance. With the increasing sophistication of IFAD and major institutions in the sector and an emphasis on partnerships, the Consultative Group to Assist the Poor (CGAP)⁴ has taken a leading role in building a consensus on good practices in microfinance, which are disseminated through rural finance networks such as the Rural Finance Learning Centre based at the Food and Agriculture Organization of the United Nations (FAO) and the regional agricultural credit associations, of which IFAD is an active partner. IFAD's systematic approach to institutional partnerships and regional knowledge management networks is regularly reported as part of the annual portfolio review.

1 Donor and development agencies concur that the overarching goal should be expressed as helping to build financial systems that work for the poor. See: Brigit Helms (2006). Access for All – Building Inclusive Financial Systems. Washington, D.C.: Consultative Group to Assist the Poor. http://www.cgap.org/gm/document-1.9.2715/Book_AccessforAll.pdf.

2 IFAD's target group includes small farmers and landless herders, artisanal fishers, small-scale rural off-farm entrepreneurs and indigenous peoples, among them poor women in particular.

3 "Action 2: **clarify the RFP standards and supporting instruments:** IFAD [PMD] will prepare an Update to the RFP, which will summarize its current policy prescriptions, clarify areas that are insufficiently prescriptive, and add more recent best practice standards."

4 The 33 members of CGAP include public and private funding organizations, bilateral and multilateral development agencies, private foundations and international financial institutions.

The changing landscape of rural finance – which includes new types of financial service providers and innovative technologies – has also sparked new partnerships between IFAD and a range of public, social and commercial investors. In 2005, IFAD established a demand-driven funding facility to promote innovative approaches to remittances in rural areas. This multi-donor facility provides seed funding to pilot innovative delivery mechanisms and money transfer products in rural areas. In addition, IFAD and the World Food Programme (WFP) are exploring innovative ways of responding to the needs and challenges of risk management among rural poor people. With support in the planning phase from the Bill & Melinda Gates Foundation, this IFAD-WFP collaboration aims to improve smallholders' access to weather index-based insurance and a range of other financial services.⁵ Access to finance for risk-prevention measures is also the subject of intensified cooperation among the three Rome-based United Nations organizations – FAO, WFP and IFAD – as part of the Rome Partnership on Integrated Disaster Risk Management.

⁵ IFAD hosts two dedicated facilities, one addressing the development issues of remittances (the multi-donor supported Financing Facility for Remittances) and one index-based weather insurance (IFAD-WFP Weather Risk Management Facility).

Defining rural finance

The term **rural finance** refers to the financial transactions related to both agricultural and non-agricultural activities that take place among households and institutions in rural areas. In some cases, rural finance has been wrongly equated with agricultural credit, based on the assumption that credit is the binding constraint to achieving project objectives related to agriculture. A more effective and comprehensive view of rural finance encompasses the full range of financial services that farmers and rural households require, not just credit.

Microfinance refers to financial services that focus on people with low incomes and small-scale business operators, whether they are located in rural or urban areas. Rural finance and microfinance are different though overlapping subsectors of the overall financial sector.

Given IFAD's focus on women, young people, indigenous peoples and very poor households, its activities could be characterized as focusing on **rural microfinance**, "micro" referring to the provision of financial services to people with low incomes in rural areas for both farm and off-farm activities, and "rural" to the location of the person who accesses the services. The range of products and services covers smallholder farmers' investments in livestock, stables, machinery, tools, warehouses, along with providing working capital and financing risk prevention measures.

Financial service providers in rural areas include commercial and development banks, non-bank financial institutions, cooperatives, microfinance institutions (MFIs) and semi-formal or non-formal organizations – such as savings and credit cooperatives, self-help groups (SHGs), village savings and loan associations, and financial service associations – as well as input supply traders and agroprocessing companies.⁶ While commercial banks may not serve IFAD's target group directly, they could still play an important role as part of a linkage strategy, serving the target group through an intermediary institution.

In this RFP, the term **rural finance institution** refers to both rural finance institutions and rural microfinance institutions.

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⁶ There are various overlapping definitions, e.g.: "MFIs are defined as licensed and unlicensed financial institutions that include non-governmental organizations (NGOs); commercial banks, credit unions and cooperatives; and agricultural, development, and postal savings banks. They range from specialized microfinance providers to programs within larger, multipurpose development organizations." – Consultative Group to Assist the Poor (2008). Appraisal Guide for Microfinance Institutions. Washington, D.C.: CGAP), p. xiii.

Objectives of the Rural Finance Policy

3

Among the multiple causes of rural poverty, the lack of access to formal and adequate financial services remains a major impediment to the socio-economic choices of rural poor people and smallholder farmers. IFAD's target group includes small-scale producers who are engaged in on- and off-farm activities and live in rural areas of varying potential. As such, IFAD's goal is to increase the access of poor rural women and men to the rural financial services they require to meet their productive and household needs and mitigate risk.

Built on the 2000 RFP, this updated RFP reflects the challenges and opportunities that have emerged in recent years and includes some added strategic dimensions and clarifications. The strategic emphasis of the earlier RFP was on **strengthening the capacity of rural finance institutions to mobilize savings, cover their costs, collect loans and make a profit in order to increase their sustainability and outreach**. Three major areas of work were also mentioned in the 2000 policy: (i) to assure the participation of all stakeholders for effective project planning and implementation; (ii) to build differentiated rural financial infrastructure; and (iii) to foster conducive policy and regulatory environments.

With the updated RFP, IFAD reconfirms its commitment to continually seek more effective ways of enhancing the access of rural poor people and smallholder farmers to a wide variety of financial services on an ongoing basis so that they can create a sustainable means of livelihood for themselves. IFAD emphasizes a market orientation and business approach in supporting the expansion of rural financial services, and focuses on meeting the demand of poor rural women and men with a diverse range of responsive and relevant financial services. This approach is derived from the IFAD Strategic Framework 2007-2010, as it relates to the importance of **developing inclusive financial systems and fostering innovations to increase rural poor people's access to a wide variety of financial services, including savings, investment and working capital loans, insurance and remittances**. The approach also has origins in other major corporate policies.⁷

Building on its experience, IFAD is also committed to exploring ways to successfully overcome key constraints in agricultural finance for smallholders.⁸ Recent developments in agricultural microfinance include the use of risk transfer mechanisms to support rural livelihoods and technology among remote and dispersed populations. Given the many challenges inherent in rural areas, innovative products and delivery mechanisms will be critical for meeting the varied needs of IFAD's target group, including women, young people and indigenous peoples living in remote areas. Providing a full range of financial services to poor families who live in

7 See the IFAD Strategic Framework 2007-2010 (<http://www.ifad.org/sf/>), the IFAD Strategy for Knowledge Management (EB 2007/90/R.4), the IFAD Innovation Strategy (EB 2007/91/R.3/Rev.1), IFAD's Private-Sector Development and Partnership Strategy (EB 2005/84/R.4/Rev.1), and the IFAD Policy on Targeting (EB 2006/88/R.2/Rev.1).

8 See IFAD/CGAP (2006): Managing risks and designing products for agricultural microfinance – Features of an emerging model, p. 12 ff, <http://www.ifad.org/ruralfinance/pub/risks.pdf>; and IFAD/CGAP (2006). Emerging lessons in agricultural microfinance – Selected case studies, http://www.ifad.org/ruralfinance/pub/case_studies.pdf.

degraded areas may, for example, support natural resource management practices and alternative livelihoods that are less harmful to the ecosystem. Partner countries in conflict and post-conflict situations, and areas recovering from natural disasters, also require workable responses to re-establishing and strengthening rural finance institutions, bridging the gap between emergency relief, rehabilitation and sustainable development.

In its approach to rural finance, IFAD also focuses on addressing cross-cutting issues such as gender and the environment in its rural finance interventions.⁹ Mainstreaming gender equality and women's empowerment and considering natural resource management are integral to effective approaches to rural financial services. IFAD-supported rural financial services programmes and projects also address specific conflict and economic recovery issues in conflict-impacted countries.

In order to promote inclusive rural finance systems in partner countries, IFAD's objectives are reflected in its interventions at different levels of the financial sector (RFP guidelines for each level are provided in section 5):

- **At the micro level:** Enhancing the sustainability of financial service providers while facilitating transparent information sharing on their financial and social performance management, including the provision of transparent information on terms and conditions, particularly the effective interest charges. With respect to its clients, IFAD aims to make clients "bankable" by enabling them to participate in the design of viable business undertakings and by enhancing their understanding of services and products through financial literacy training.

- **At the level of financial infrastructure:** Supporting second-tier organizations such as associations and apex institutions so that they can provide professional and cost-efficient financial and technical services to retail financial institutions and improve market transparency (e.g. credit bureaux, microfinance rating agencies).
- **At the policy and regulatory level:** Improving enabling framework conditions for a range of financial service providers to reach clients with low incomes with appropriate products and services, and to protect rural poor people's savings and deposits.

The RFP acknowledges the complexity and cost implications of a multi-level approach to building inclusive financial systems. Cooperation and partnerships with other development agencies in the field of financial system development are therefore critical to maximize complementarity and synergy among actors in the sector. Capacity-building of human resources, institutional development and macro-level interventions may require a significant allocation of resources in rural finance projects or project components, depending on the scope of these interventions, which vary from country to country.

9 See forthcoming IFAD guides for practitioners "Gender and rural microfinance: Reaching and empowering women. Guide for practitioners" by Linda Mayoux and "Poverty Alleviation, Sustainable Natural Resource Management, and Access to Finance: A common sense approach" by Robert Peck Christen and Consuelo Munoz Araya.

Guiding principles

Building on IFAD's experience in rural finance and the good practices developed over time within the sector, six guiding principles are at the core of IFAD's approach and support to rural finance. These guiding principles derive from the challenges and opportunities specific to the provision of microfinance services to poor rural households and should be reflected in each rural finance intervention that IFAD undertakes.

4

Throughout its interventions in rural finance, IFAD works to:

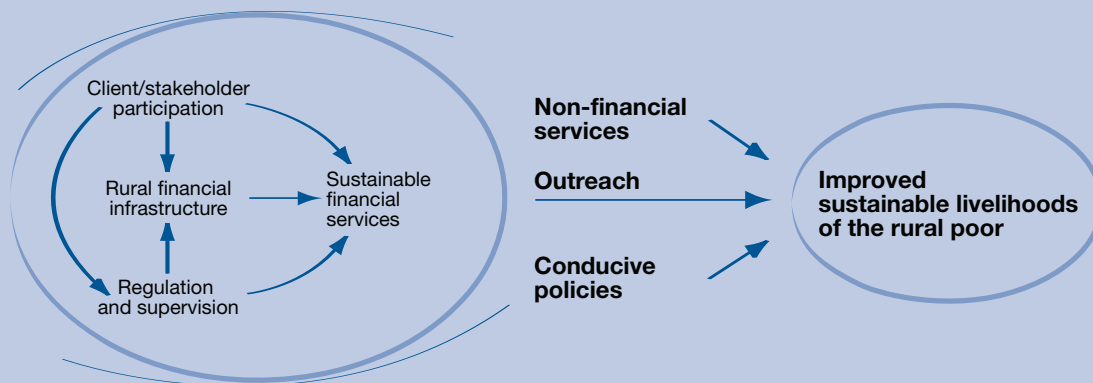
- **Support access to a variety of financial services, including savings, credit, remittances and insurance**, recognizing that rural poor people require a wide range of financial services;
- **Promote a wide range of financial institutions, models and delivery channels**, tailoring each intervention to the given location and target group;
- **Support demand-driven and innovative approaches** with the potential to expand the frontiers of rural finance;
- **Encourage – in collaboration with private-sector partners – market-based approaches** that strengthen rural financial markets, avoid distortions in the financial sector and leverage IFAD's resources;
- **Develop and support long-term strategies focusing on sustainability and poverty outreach**, given that rural finance institutions need to be competitive and cost-effective to reach scale and responsibly serve their clients; and
- **Participate in policy dialogues that promote an enabling environment for rural finance**, recognizing the role of governments in promoting a conducive environment for pro-poor rural finance.

These guiding principles can be applied at all three levels of intervention:

- **Micro level:** retail rural finance institutions and the ultimate beneficiaries of IFAD-supported projects and programmes, including poor rural households, women, young people and indigenous peoples;
- **Meso level:** financial infrastructure, including second-tier institutions and technical service providers; and
- **Macro level:** policy, legislative, regulatory and supervisory framework.

IFAD may support solutions on one or several levels of rural financial systems. The interlinkages among these levels are illustrated in the graph below.

The incorporation of these guiding principles into project design and activities will generate better results for IFAD partner countries and rural poor people. The application of these principles is binding on IFAD country programme managers, project staff and consultants in IFAD-supported projects working in rural finance. Any deviation from these principles will require clear justification and approval by Management.



Guidelines

5

The RFP offers guidelines to IFAD decision makers, consultants and partner organizations to ensure the development of coherent and effective rural financial systems. The guidelines are based on IFAD's own experience and on the key lessons learned by the international community in rural finance. The financial sector of a partner country comprises all individual and institutional actors, on both the demand and supply sides, along with the financial sector's legislative, regulatory and supervisory framework and its support infrastructure. IFAD's strategy is to support its partners at the different levels to build the sustainability of institutions and models, and increase outreach to remote rural areas and marginalized poor people.

The micro level – Demand side

The financial realities of poor rural women and men need to be understood in order for the promotion of rural finance to succeed. Credit is not always the answer. A loan is an obligation, and thus a risk, for the borrower, and rural poor people may have very limited, if any, debt service capacity. Other kinds of support such as safety nets, asset transfers or non-financial services may be more appropriate for the very poor, and some needs may be met by other services with which clients may be less familiar, such as insurance.¹⁰

Savings are often more important to clients than other financial services. They enable poor households to withstand shocks to their income and mitigate the effect of emergencies and crises. Access to secure savings services also promotes financial discipline. Regular savers are more likely to service their loans on a timely basis and build equity for their own investment purposes.

Customer education and protection are critical to successful IFAD rural finance investments. Savings should be adequately protected and any risks clearly explained. Financial literacy training can also help clients understand the benefits and risks of financial products and their specific terms (e.g. interest rates, premiums). Transparency on performance and innovative lending methodologies can increase the efficiency of financial service providers, enhance competition among institutions and thus reduce interest rates.

Participation of clients and stakeholders is fundamental. The effective planning and implementation of IFAD-supported operations requires the active participation of clients and stakeholders, including rural women and men, empowering them as users or user-owners of membership-based local financial institutions. Participation patterns may be culture-bound and variously determined by sex, social stratification or group affiliation. Where conflict arises, the stakeholders themselves must determine the balance between their social and economic concerns.

¹⁰ Studies such as the 2005 Financial Diaries by FinMark Trust, the Ford Foundation and the Micro Finance Regulatory Council have fully described the complex relationship between poor clients and financial services.

Monitoring client satisfaction is good business practice. An increasing number of financial institutions have introduced “social performance management” in their core operations to further understanding of the preferences and needs of clients, which allows them to track the profiles of their clients, their satisfaction with services offered, the impact of products and services on their lives, and drop-out rates.

Guidance for micro-level interventions – Demand side

- **Assess the demand for financial services,** the supply from existing financial institutions, and the gaps between demand and supply. Consider the variety of possible financial and non-financial services that could improve the livelihoods of the targeted clientele, without assuming that credit is always a binding constraint for rural households. Savings, income transfers and graduation models, or welfare activities, may be better suited to their needs;
- **Strengthen the access of both women and men to financial services and build their skills to effectively participate in the ownership and oversight** of local financial institutions;
- **Emphasize deposit collection** as a service to clients and an instrument for mobilizing capital for onlending purposes;
- **Promote financial literacy training** to help clients gain a better understanding of the functions and terms and conditions of financial services.
- **Support protective arrangements for savers, borrowers and lending institutions,** including transparency and auditing requirements, deposit insurance, life insurance and other insurance for loan protection, and access to liquidity exchange; and
- **Encourage partner MFIs to endorse the Client Protection Principles in Microfinance,**¹¹ that describe the minimum that microfinance clients should be able to expect from providers.

The micro level – Supply side

Institutional sustainability is fundamental for a financial institution’s growth beyond the period of initial donor or investor support. Sustainability hinges on profitability, outreach, resource mobilization and the appropriate legal status of operations. As a prerequisite for support, an institution’s measures and milestones towards sustainability should be clearly defined in a business plan.

The performance of a financial institution determines the extent to which it can reach poor rural households and provide long-term access to financial services. Service delivery differs greatly depending on an institution’s systems and procedures, the quality of management and skills levels, and incentives in place for staff.

Donor support is required mainly to strengthen the delivery capacity of financial service providers in rural areas and to upgrade non-formal institutions to higher legal forms as necessary. The provision of training and consultancy services, improvement of professional standards, and purchase of operating assets all constitute forms of subsidies. While IFAD supports a wide range of capacity development for rural finance institutions, interventions should not reinforce aid dependency but instead lead to the autonomy of an institution.

There is only limited scope for lines of credit¹² to retail institutions. IFAD’s experience shows that, in most cases, credit lines do not adequately respond to building an institution’s sustainability and may also undercut the market, alienating other donors and stakeholders and blocking the entry of other relevant service providers in rural areas.

11 IFAD declared its full support of and endorsed the Client Protection Principles in Microfinance on 22 October 2008. See: <http://www.cgap.org/p/site/c/template.rc/1.26.4943/>.

12 Key lessons are shared with the World Bank’s Guidance of Microfinance Credit Lines. See: <http://siteresources.worldbank.org/INTCDD/Resources/mf1.pdf>.

Support to community-managed loan funds, often as components of larger projects and programmes, can be an attractive alternative for remote or sparsely populated areas and poor rural households that formal rural MFIs would find prohibitively expensive to reach. Savings-based models have experienced promising results, but financing community-managed loan funds with external capital at the outset (e.g. revolving loan funds) often leads to poor repayment rates and the collapse of the fund. Savings and credit SHGs usually begin using only members' savings. After a period of successfully lending and collecting their own resources, SHGs may be coached to approach a commercial lender for a loan to leverage internally generated funds (i.e. linkage banking approach).

Credit guarantees can support pro-poor financial transactions under certain conditions by offering the partial coverage of lending risks. Credit guarantees are only effective when fully integrated into the existing financial market and managed by finance professionals who know the market well. Governments or publicly owned special-purpose vehicles for risk management have had very limited success in effectively managing guarantees. Furthermore, the full costs of guarantees to the financial intermediary and the client need to be assessed adequately.

Innovation is instrumental in expanding the frontiers of rural finance. IFAD is in the forefront in piloting new approaches and delivery mechanisms to provide financial services in remote rural areas. It promotes innovation through dialogue with international agencies and strategic partnerships with leading institutions such as CGAP, the United Nations Capital Development Fund, WFP and centres of excellence. Innovations require an experimental phase, which allows the testing and adjustments required to prepare the ground for scaling up and adoption by other institutions and in other areas.

Guidance for micro-level interventions – supply side

- **Prioritize supporting healthy financial institutions** that are embedded in existing market and institutional structures. There is no single best type of delivery channel for every rural area; the most appropriate model (private, cooperative, community, local or national government) will depend on the given sociocultural factors and legal framework;
- **Support the reform of promising institutions**, capitalizing on the experience of a growing number of reformed banks and rural MFIs. Base support to institutions on the results of a professional appraisal (due diligence) and seek the participation of potential partner institutions early in the process;¹³
- **Design institutional development programmes with incentives to build internal capacity and reduce dependency**, and encourage the inclusion of training and technical assistance costs in the institution's budget over time;
- External support constitutes an intervention in local market structures and constitutes an implicit subsidy. Therefore, **offer support to financial institutions on a competitive basis and develop performance-based contracts** that include clear performance benchmarks based on a business plan and exit scenarios;
- **Do not subsidize interest rates** at client level or support the establishment of interest rate caps or other mechanisms that distort markets. Refrain from interfering in the operations of participating financial institutions;
- **Promote social performance ratings of partner MFIs**, the collection and monitoring of relevant financial and outreach indicators, and the development of appropriate management information systems, so that performance information is used as a management tool. **All IFAD-supported financial service providers – except small member-based institutions – should participate in the Microfinance Information eXchange (MIX) Market, to**

¹³ Operational guidance regarding project design steps and updating during implementation is provided in the updated Decision Tools for Rural Finance.

promote transparency in the sector and allow IFAD to monitor its rural finance portfolio.

Institutions can also use the MIX Market to compare their performance with that of their peers:¹⁴

- **Offer lines of credit to retail or wholesale finance institutions only if** (i) the market demonstrates a clear lack of liquidity; (ii) private professional fund managers or institutions, and not the recipient government, manage the line of credit; (iii) loans to retail financial institutions are priced at commercial or near-commercial rates to avoid undermining their incentive to mobilize deposits or access other sources of capital; (iv) partner retail financial institutions are financially sound, independent from political interference and free to charge interest rates that allow cost recovery; (v) partner financial institutions have the capacity to efficiently and transparently absorb and manage the financial resources; (vi) opportunities exist to create linkages with other sources of refinancing that will continue after the project ends; and (vii) accountable reporting and supervision arrangements can be put in place until the line of credit is repaid;
- **Support savings-based SHGs** to develop solid track records of collecting and lending members' savings, and consider **promoting linkages with banks** to provide community-based MFIs with more capital than their accumulated savings, rather than providing external capital up front; and
- **Extend credit guarantees only if** (i) a measurable, quantifiable demand has been demonstrated; (ii) the guarantee is professionally managed by an independent, specialized financial institution; (iii) a significant part of the default risk stays with the retail institution to avoid moral hazard and adverse selection; and (iv) adequate technical assistance is available to mitigate the other constraints and risks involved in serving the target group (e.g. appropriate products and delivery mechanisms, trained staff, risk management systems). International good practices should be followed regarding leverage of guarantee funds and incentives for correct claim and settlement.

The meso level

The sound infrastructure of financial markets

is essential to an inclusive financial system. Meso-level interventions aim to reduce transaction costs, improve sector information and market transparency, increase outreach and access to refinancing for member institutions, and enhance skills across the sector. IFAD strengthens a broad range of market players, including networks, associations and apex organizations of rural finance institutions, domestic rating agencies, credit information bureaux, payment systems, training and technical service providers, and professional certification institutes.

Developing second-tier institutions such as industry associations and apexes

requires a long-term commitment, often going beyond the typical length of an IFAD-supported project. Successful associations and apexes are driven by the goals of nurturing the development of sustainable member institutions, assessing market potential, basing onlending decisions on criteria tailored to the cash-flow pattern, and monitoring and enforcing performance targets. Business operations of professionally managed apexes should be conducted without political interference, observing good governance and sound technical principles. Financial and technical support to apexes may include industry marketing, product development, treasury operations, supervision of member institutions, and the integration of rural finance institutions into national payment systems, including the gateway for remittances, cheque clearing, computerization of member institutions, and donor linkages. Non-financial services may be provided by subsidiaries.

¹⁴ The MIX Market is a public, web-based information platform providing data on MFIs worldwide as well as on public and private funds that invest in microfinance, microfinance networks, raters, advisory firms, and governmental and regulatory agencies.

Guidance for meso-level interventions

- **Conduct market and impact assessments to gain a better understanding of the constraints and opportunities at the meso level;**
- **Coordinate closely with other development agencies** that have more experience at the meso level and represent the issues and concerns of rural poor people;
- **Include state authorities**, as appropriate, in initiatives focused on technology, capacity-building and human resource development, where they can play a promotional role in developing rural finance infrastructure;
- **Ensure that apex institutions develop robust operational and financial projections, employ good governance and are politically independent;**
- **Assist second-tier institutions in improving their outreach, capacity and tools to measure the portfolio quality** of retail institutions and the supervision functions (including delegated supervision) of member institutions, and the sustainability of their operations; and
- **Encourage and support transparency in the sector** and the use of standardized reporting tools on financial and outreach performance, such as the MIX Market.

The macro level

An enabling and conducive policy environment is a prerequisite for an efficient financial system and effective rural development and poverty reduction. At the macro level, a number of factors are particularly important for preventing systemic risk. These include the development of a national microfinance or rural finance policy or strategy, deregulation of interest and exchange rates, liberalization of agricultural prices and foreign trade, establishment of a legal system that protects property and land-use rights and ensures due legal process, and support of autonomous financial institutions and regulatory authorities.

The prudential regulation and supervision of financial institutions is crucial for the evolution and stability of financial systems.¹⁵ Without properly regulated local financial institutions, which mobilize deposits and attract private capital, there can be no sustainable rural development. The appropriate level of regulation and supervision depends on the type of financial institution and, in particular, on the level of savings it mobilizes from the public. It is important to adopt appropriate legal forms for cooperatively and privately owned local financial institutions, build the capacity of self-regulating industry networks under the central financial supervisory authority, and enforce appropriate prudential norms.

Effective supervision of IFAD-supported rural finance projects requires regulated participating financial institutions. Institutions outside the purview of the regulator may also be included in a project provided they are making clear progress towards institutional sustainability. Support to non-regulated and non-supervised savings and credit SHGs and other non-formal local institutions, and establishing linkages between them and regulated financial institutions may also be included in a project, and should include mechanisms to ensure the functioning of local oversight such as annual auditing of

¹⁵ Prudential regulation and supervision refers to the structuring of financial institutions' actions according to a set of rules and norms that ensure the protection of depositors' money, a safe and sound financial system, and a competitive financial market structure. For further information, see: Food and Agriculture Organization of the United Nations and German Agency for Technical Cooperation (2001). Prudential Regulation and Supervision for Agricultural Finance. *Agricultural Finance Revisited*, No. 5.

savings and credit cooperatives. Effective performance measurement, adequate internal controls and annual audits of MFIs are essential elements in effective direct project supervision.

Regulatory and supervisory authorities need to be supported in strengthening financial markets and avoiding market distortions, while enhancing the good governance of their partner institutions and their regulatory and supervisory agencies. Strategic partnerships with development partners can give stronger voice to the concerns of IFAD's target group. Defining the role of governments and central banks in the context of rural finance and IFAD-supported projects is essential, particularly when selecting the most appropriate government partner. Rural finance support activities operate best under the auspices of government counterparts specialized in financial-sector operations.

Guidance for macro-level interventions

- **Support rural finance policy and sector strategy formulation and pro-poor measures taken by partner government agencies with a view to building an inclusive financial system;**
- **Support financial-sector assessment in terms of outreach to rural poor households;**
- **Participate in policy dialogues on creating an enabling environment for market-oriented rural finance**, addressing key issues such as a legal framework for regulated local financial institutions, the reform of state banks and credit cooperatives, the liberalization of interest rates, and the facilitation of deposit-taking for member clients or public customers;

- **Help partner governments develop policies and strategies in line with international good practices for rural finance and the stability of the financial system**, and that set appropriate legal, regulatory and supervisory frameworks to protect savers and create a level playing field among deposit-taking institutions; and
- **Assist partner governments in establishing institutional capacities to provide vital regulation, supervision and oversight functions for the rural finance sector.**

Implementing the Rural Finance Policy

– Implications for IFAD

IFAD's application and compliance with this RFP ultimately rests on its internal capacity and systems. For the guiding principles contained in the RFP to translate into programmes on the ground, IFAD will need to invest further in the areas discussed below.

Monitoring for results

Mechanisms are needed to assure that all rural finance interventions, whether stand-alone projects or components, are identified and monitored. Performance monitoring is fundamental for ensuring that IFAD policies and procedures are implemented and are generating concrete results. Monitoring indicators to measure the performance of participating rural finance institutions need to be included in the project design document¹⁶ and in contracts with participating rural finance institutions. These indicators should include standard financial indicators and outreach measures such as portfolio at risk (PAR>30 days), operational self-sufficiency, and the numbers of borrowers and savers, all of which are tracked on the MIX Market and in the Results and Impact Management System (RIMS), IFAD's comprehensive system for results-based monitoring. Contracts with partners should be performance-based and detail an exit strategy if targets are not achieved.

At the client level, project beneficiaries need to be involved in defining targets for success. Efforts must be made to measure the impact of access to financial services, taking into consideration the challenges of attribution and the fungibility of money. At the institutional level, outcomes may not be immediately measurable, depending on the functioning of markets.

Indicators should be updated regularly¹⁷ and the interpretation of the results should consider emerging international practices on rural finance monitoring indicators at different intervention levels, qualitative feedback from clients, and calibration of indicators as a result of new instruments or pilot initiatives with additional performance measurement requirements.

Strengthening and documenting IFAD's rural finance capacities and knowledge

IFAD's varied experience in rural finance is one of its core assets and comparative advantages. IFAD's corporate quest for quality enhancement and quality assurance includes rural and agricultural finance operations as a key area. This particular competence and sector knowledge requires systematic documentation, synthesis and dissemination. The Rural Finance Thematic Group (RFTG) plays an active role as a conduit for disseminating knowledge within IFAD and sharing information and experience within and beyond the Fund's boundaries. The RFTG assisted in updating the RFP and will also be actively involved in disseminating the policy through adequate communication plans that include decentralized staff and external partners.

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16 See IFAD Decision Tools for Rural Finance (2008) (www.ifad.org/RURALFINANCE/DT/INDEX.htm) (3.1 "Assessing FSPs for Potential Partnership" and 3.3 "Establishing the Monitoring and Evaluation System"); and technical fact sheets on monitoring financial performance.

17 IFAD's RIMS indicators are collected annually, but project management units collect operational information more frequently.

The multiple-level approach to developing inclusive rural financial systems has human resource implications within IFAD and in partner organizations. In line with its vision statement on knowledge management, IFAD will strengthen its capacity in and knowledge about rural finance, first, by learning systematically and collectively from its own projects, good practices and the experience of its partners.¹⁸ In addition, engagement with strategic partners will help IFAD improve the quality and impact of its projects and strengthen its capacity to promote learning, knowledge sharing and innovation. To facilitate these exchanges, staff development plans should include in-house training, exposure study tours, internships, and clear strategies for collecting and disseminating information.

Experimenting with innovative finance instruments

In the past decade, major innovations in instruments and funding modalities have been introduced in rural finance, including the entry of social and commercial investors in the market, as well as insurers, re-insurers, leasing and hire-purchase companies, and capital market development agencies. As the field continues to evolve, IFAD needs to sharpen its focus and define its areas of engagement in rural finance. IFAD's participation in the launching of targeted facilities appears the most feasible short-term approach. These funds could be directed to making public-private partnerships operational and providing an operating framework for innovations in payment systems, remittances, branchless banking and other important areas.

It is also critical to develop risk management products that target smallholders (e.g. weather index-based insurance, health and life insurance) and create linkages among smallholder farmers, rural financial service providers and the formal financial sector. IFAD is making sizeable investments in many new-generation value chain development

programmes. Innovative products could target actors throughout the agricultural value chains, such as warehouse receipts and production packages from agroprocessors that include financial services (e.g. credit and insurance). In addition, access to medium-term credit and leasing services could facilitate farm-level investments in assets such as equipment and livestock.

To meet the more fundamental challenges of expanding IFAD's instruments for partnering with rural finance institutions, amendments to IFAD's founding documents may be required to enable the Fund to engage directly with rural finance institutions and the private sector. Equity investments in rural finance institutions could avoid some of the pitfalls of credit lines. They strengthen these institutions' capital basis and leverage the mobilization of additional domestic resources in the form of savings deposits or borrowings. In preparing for other new financial instruments, IFAD could consider strategic partnerships with equity investors as an option in the near future. IFAD Management may also consider increasing the share of grant funding allocated to rural finance and clarifying the flexibility available in using IFAD's instruments.¹⁹ Interaction with and guidance from partner countries and technical centres of excellence, other donors and the private sector would be important to optimize these new funding instruments.

Providing supporting documents

This RFP is complemented by the IFAD Decision Tools for Rural Finance,²⁰ a manual that offers more specific guidance and background information for project design and implementation.

18 IFAD Strategy for Knowledge Management (EB 2007/90/R.4), p. 7.

19 See recommendations by Aid Effectiveness Initiative, Note to Management, IFAD Peer Review Check-up, October 2005, p. 10.

20 See <http://www.ifad.org/ruralfinance/dt/full/index.htm>.

Annex

IFAD's lessons learned with regard to rural finance

Further to the Board's request for the addition of an annex on IFAD's lessons learned with regard to rural finance (Decisions and deliberations of the ninety-sixth session of the Executive Board), reference should be made to

- (i) The corporate-level evaluation (CLE) of the IFAD Rural Finance Policy undertaken in 2006 (published in September 2007), which resulted in the decision by Management to "prepare an Update to the RFP" (Agreement at Completion Point, Action 2, #13 http://www.ifad.org/evaluation/public_html/eksyst/doc/agreement/corporate/rural.htm). This agreed recommendation was based on an analysis of IFAD's experience by region, captured in six regional working papers. The main report systematically organizes lessons learned from project performance and impact, design and implementation performance issues, and corporate arrangements supporting rural finance activities (http://www.ifad.org/evaluation/public_html/eksyst/doc/corporate/rural.pdf). The summary of the CLE's main report can be found on http://www.ifad.org/evaluation/public_html/eksyst/doc/agreement/corporate/rural.htm.
- (ii) The publications *Assessing and Managing Social Performance in Microfinance* (<http://www.ifad.org/ruralfinance/pub/performance.pdf>) and *Emerging Lessons in Agricultural Microfinance - Selected case studies* (http://www.ifad.org/ruralfinance/pub/case_studies.pdf).
- (iii) The Consultative Group to Assist the Poor (CGAP) SmartAid for Microfinance Index (see: <http://www.cgap.org/p/site/c/template.rc/1.26.3302/>) in which IFAD participated in 2009. The independent appraisal results of IFAD's aid effectiveness in rural finance is now available. Another external source of information is the CGAP 2008 Microfinance Funder Survey. IFAD has just provided the relevant data for the 2009 Funder Survey.



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