IFAD Decision Tools for Rural Finance

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Acronyms

ALR	annual loan loss rate
ASCAs	accumulated savings and credit associations
ATM	automatic teller machine
CGAP	Consultative Group to Assist the Poor
COSOP	country strategic opportunities programme/paper
CPM	country programme manager
CPMT	country programme management team
CRR	current recovery rate
FFR	Funding Facility for Remittances
FSA	financial service association
FSP	finance service provider
IFC	International Finance Corporation
ILO	International Labour Organization
KfW	Kreditanstalt für Wiederaufbau
LAR	loans at risk
M&E	monitoring and evaluation
MFI	microfinance institution
MIS	management information system
MIX	Microfinance Information eXchange
OSS	operational self-sufficiency
PAR	portfolio at risk
PEARLS	protection, effective financial structure, asset quality, ratios of return and costs, liquidity and signs of growth
PMU	programme/project management unit
PRSP	poverty reduction strategy process/paper
RB-COSOP	results-based country strategic opportunities programme/paper
RFP	IFAD Rural Finance Policy
ROSCA	rotational savings and credit association
SACCO	savings and credit cooperative organization
SEEP	Small Enterprise Education and Promotion
SHG	self-help group
SME	small and medium enterprise
TA	technical assistance
TSP	technical service provider
UNDP	United Nations Development Programme
USAID	United States Agency for International Development
VSLA	village savings and loan association
WOCCU	World Council of Credit Unions

Foreword

In the past 30 years, microfinance has revolutionized rural development. Groundbreaking institutions and models have emerged that are expanding financial services in new directions, using technology and innovations to serve more clients in increasingly remote communities, and offering them an ever-wider range of products.

But even with these dramatic gains, the vast majority of poor men and women still do not have reliable, secure ways to save money, protect and build assets, or transfer funds. In fact, the most basic formal financial services reach only about 10 per cent of rural communities.

IFAD recognizes this challenge, as well as the vast potential to improve the livelihoods of rural people by increasing their access to a wide range of financial services and sound institutions. With over 30 years of experience and more than US$900 million invested in rural finance initiatives, IFAD has the experience and partners to make significant strides in rural finance.

The Consultative Group to Assist the Poor (CGAP) is one of IFAD's core partners in this area. CGAP has led the global movement for pro-poor finance, working to outline good practice standards for financial service providers (FSPs) and to support donor effectiveness in building and expanding the sector. As a member of CGAP, IFAD reflects these standards in the *IFAD Rural Finance Policy*[1] and the present *Decision Tools for Rural Finance*, both of which were updated in 2009 to better reflect new challenges and opportunities for IFAD's interventions in rural finance.

Based on years of experimentation and innovation in the sector, a powerful set of good practices have been developed that can guide FSPs and their supporters in better serving poor rural men and women. These good practices are based on the commitment to support *sustainable* rural finance service provision for poor people, recognizing that ongoing access to a wide range of financial services is needed in order to impact rural poverty more effectively.

Rural finance is not the only answer in rural poverty reduction, but it is a key part of the response. IFAD will continue to invest in this important area of agricultural development and rural livelihoods support, applying the good practices learned from our own experience and that of our partners to this important challenge.

Kevin Cleaver
Associate Vice-President, Programmes,
Programme Management Department

[1] IFAD Rural Finance Policy website, www.ifad.org/ruralfinance/policy/index.htm.

Rationale and structure of the paper

The objective of *IFAD Decision Tools for Rural Finance* is to provide decision-making support for the IFAD country programme managers (CPMs), consultants, project staff and technical advisers who develop and implement rural finance projects. Built on the *IFAD Rural Finance Policy* (RFP) (IFAD 2009), as well as other good practice guides, this knowledge management tool is designed to help identify and answer the questions that arise in each rural finance project, provide background on key issues, define common terms, highlight risks and opportunities, and provide references for further investigation.

The paper is divided into five main sections, each with a specific objective:

Introduction – understanding the fundamentals. Review rural finance basics and IFAD's role in the sector

1. **Assessing the market**. Analyse the status of a financial sector and identify the gaps
2. **Designing a project**. Define the interventions in a rural finance project
3. **Assessing and selecting project implementation partners**. Assess and select project implementation partners through a transparent, competitive process
4. **Conducting performance monitoring and evaluation**. Effectively conduct ongoing and annual performance monitoring

The Decision Tools are not meant to comprehensively address all challenges and opportunities in contemporary rural finance. Instead, they provide country programme management teams with a basic set of principles to apply in the assessment, design, implementation and monitoring of IFAD-supported rural finance projects – principles that are consistent with both the RFP and widely-accepted good practices in the field.

This manual is a living document that will be continuously updated and improved over time to reflect the development of the industry, innovations, IFAD's increasing experience, and case studies of these good practices at work. Your comments and suggestions to improve the Decision tools are welcome at www.ifad.org/ruralfinance. In addition, the Decision Tools will be complemented by additional, detailed technical information on emerging topics and challenges in rural finance.

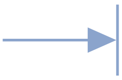
A note on the decision process, flow charts and decision trees

As with any decision-making process, use of these Decision Tools is not a strictly linear activity. However, for the sake of clarity, this document will address actions as if they were isolated steps in a procedure. The reader should nevertheless understand that there is a certain amount of fluidity in the process. For example, 'assessing the market' and 'identifying potential partners' are treated separately; but the skilled and prudent analyst will recognize that there is a great deal of overlap in these actions.

Flow charts and decision trees are used to assist systemic analysis. They provide a convenient check to ensure that a project is supported with an appropriate level of analysis, is consistent with good practice, and is compliant with IFAD principles and competencies. However, flow charts and decision trees cannot anticipate all the unique challenges of a given environment. In addition, they are not meant to dictate the direction of a project nor to limit the imagination or good sense of the analyst.

Table 1. Reading flow charts and decision trees

Flow charts are meant to be read from top to bottom in the direction of the arrows.

Symbol	Meaning
	Terminator: indicates the beginning or end of a process
	Action: indicates that an action is performed
	Decision point: indicates that a decision is to be made, typically with separate 'YES' and 'NO' paths
	**Direction arrow:** indicates the direction of the process

With this nomenclature in mind, this document presents the typical decision process as follows:

Initial project idea → Assess market → Design project → Assess & select partners → Monitor & evaluate performance → Replicate, scale up or terminate

Each of these actions is discussed in detail in the relevant chapter.

A note on the boxes

Throughout the text, boxes are used to highlight information. Some boxes serve as a quick reference guide to terms and concepts (Box A). Others provide additional information to consider in the decision-making process (Box B). While they stand apart from the main text, boxes should be considered essential to an understanding of the design process for a rural finance project.

Box A
Quick reference box

These boxes provide overview information for easy reference on key points.

Box B
Further information

These boxes provide additional detailed information on the topic, such as background, rationale, descriptions or further reading.

Introduction
Understanding the fundamentals

Introduction
Understanding the fundamentals

- **Action**: Review rural finance basics and IFAD's role in the sector.

Financial services in rural areas

Since the early 1980s, innovations in the delivery of financial services have enabled millions of people formerly excluded from the financial sector to gain access to these services on an ongoing basis. While there are overlaps in the financial sector among micro, rural and agricultural finance, it is important to understand how they differ and the various challenges they face:

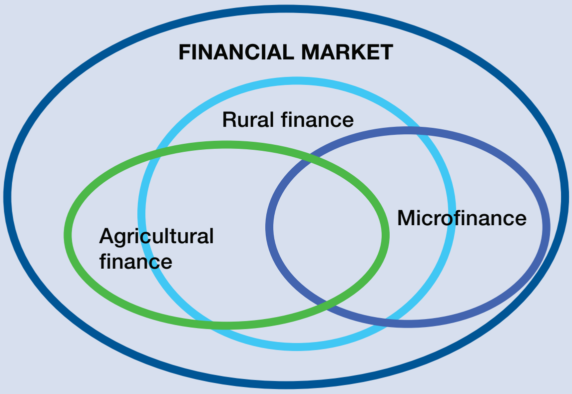
- **Microfinance**. Financial services that focus on low-income households and small-scale businesses in both rural and urban areas. Growing beyond microcredit, microfinance has blossomed since the early 2000s to include a range of financial services targeted to low-income clients, including savings, money transfer and insurance products.[2]
- **Rural finance**. Financial services that focus on households and businesses in rural areas, encompassing both agricultural and non-agricultural activities, and targeting poor and non-poor women and men. Rural finance encompasses the full range of financial services that farmers and rural households require.
- **Agricultural finance**. Financial services that focus on on-farm activities and agricultural businesses, without necessarily targeting poor people. Fresh thinking has identified some of the key features of successful agricultural microfinance, replacing the heavily subsidized, unsustainable and unsuccessful approaches of the past.
- **Rural microfinance**. Financial services that focus on relatively small-scale products and services targeted to poor clients in rural areas. Given its focus on women, youth, indigenous peoples and poor people in rural areas, this is IFAD's main area of focus.
- **Value chain finance**. Financial products and services that flow to or through any point in a value chain in order to increase the returns on investment, growth and competitiveness of that value chain. Value chain finance has a long history in many rural areas (often referred to more specifically as 'agricultural value chain finance'), given that food processors, input suppliers and large commercial farms may be the only source of credit available to their clients and suppliers. See Box 2 for additional information.
- **Financial service providers (FSPs)**. Institutions and community groups that offer financial services, including commercial and development banks,[3] non-bank financial institutions, cooperatives, savings and credit cooperative organizations (SACCOs), postal savings banks, self-help groups (SHGs), village savings and loan associations (VSLAs), financial service associations (FSAs), and even telecommunications providers (particularly in providing remittance services). Input suppliers, traders and agroprocessing companies can also provide financial services, such as credit for inputs and insurance to farmers through the value chain.

[2] For more information on the history of microfinance, see Helms (2006).

[3] Commercial banks may not directly serve IFAD's target group, though they could play an important role as part of a linkage strategy, reachng IFAD's target group through intermediary institutions.

Box 1
The financial market

- Microfinance: Financial services for poor and low-income people
- Rural finance: Financial services used in rural areas by people of all income levels
- Agricultural finance: Financing of agriculture-related activities, from production to marketing



Source: Adapted from CGAP (2006a).

Box 2
Value chain finance in agriculture

From farm to table, there are many points in an agricultural value chain at which financing is required. Farmers must pay for seeds and fertilizer at the beginning of a season, and other expenses related to production, storage, transportation and processing often require financing. Finance along the value chain can come from multiple sources: buyers, input suppliers, traders, farmers' groups and cooperatives, processors and producers. However, financing can be expensive for the borrower or only available on terms and conditions that are unfavourable to farmers and poor rural people.

Looking at supply and demand for financial services from a value chain perspective helps identify the range of actors offering financial services throughout the chain, including informal arrangements and interlinked transactions (e.g. inputs sold on credit, advance purchase of products). Understanding these actors and inputs can highlight ways to improve access to financial services along the value chain.

Pro-poor interventions in value chain finance have a number of advantages, given that they

- Build on current relationships and connections;
- Overcome information gaps due to familiarity and trust among actors;
- Embed repayment mechanisms more easily;
- Promote the provision of technical assistance to producers; and
- Focus on buyers, traders and inputs suppliers, who may be the only suppliers of credit in rural areas.

Value chain finance is an important aspect of rural development and financial services, but it is not the focus of the Decision Tools. For additional resources, see FAO (2009), USAID (2005a), and USAID (2009).

IFAD and rural finance

The development of inclusive rural financial systems and fostering innovations that increase poor peoples' access to a wide range of financial services are central to IFAD's mandate. These goals are especially relevant in the context of a changing global economy that is facing challenges linked to the financial crisis, volatile food and agricultural commodity prices, and the perils of climate change.

IFAD focuses on development of and support to diverse, viable financial service providers that increase the long-term access of poor rural people to a wide range of financial services. The *IFAD Rural Finance Policy* (RFP) (IFAD 2009) articulates six principles that guide IFAD's approach to rural finance:

- "**Support access to a variety of financial services**, including savings, credit, remittances and insurance, recognizing that poor rural 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 [to benefit poor rural people];
- **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 [by applying the CGAP Client Protection Principles in Microfinance (ACCION International 2008)];
- **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."

IFAD has two instruments for supporting rural finance: loans to governments and grants to non-profit organizations.

- Loans are used largely to develop the capacity of institutions in the rural finance sector and increase the outreach of services in rural areas.
- Grants are used largely to spark innovation and pilot new approaches that can later be expanded into the wider sector.

Box 3
Six guiding principles of IFAD rural finance interventions

- Support access to a variety of financial services
- Promote a wide range of financial institutions, models and delivery channels
- Support demand-driven and innovative approaches
- Encourage market-based approaches
- Develop and support long-term strategies focusing on sustainability and poverty outreach
- Participate in policy dialogues

Using these two instruments, IFAD country programme management teams (CPMTs) implement programmes designed to address specific issues within a target market.
IFAD works at the three levels of the financial market:[4]

- At the micro level, IFAD realizes that its support is most effective when directed at the productive potential of poor people and their organizations. It is critical to reach the poorest people through income transfers, safety nets, direct microenterprise promotion, graduation programmes and improved infrastructure, as well as through targeted savings, remittance services and other innovative risk management tools.
- At the meso level, IFAD interventions work to develop efficient financial-sector infrastructure by building both human and institutional capacity. IFAD promotes financial transparency and comprehensive consumer protection; it invests in innovative technical solutions and financial mechanisms to maximize geographical and social outreach and impact.
- At the macro level, 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 available. IFAD works closely with governments, development partners and the private sector to support this enabling framework for rural finance and development.

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 in rural finance is critical in meeting the needs of IFAD's target group.

[4] These three levels are defined and further examined in chapter 1.

1. Assessing the market

1. Assessing the market

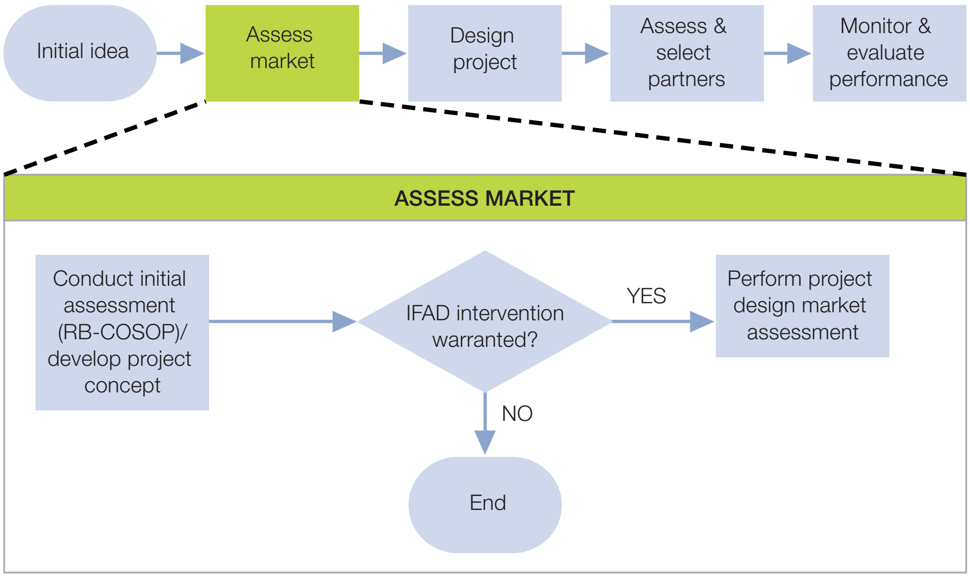
- **Action**: Analyse the status of a financial sector and identify the gaps.
- **Objective**: A clear understanding of the market and potential IFAD interventions in rural finance.
- **Key players**: Rural finance consultants, guided by country programme managers (CPMs) and country programme management teams (CPMTs).

Assessing the market for a potential IFAD intervention is usually a two-stage event, starting with an initial assessment that is broadly based and not necessarily too detailed. This assessment is used to better understand the market, the players and any active donors or ongoing projects. If this assessment has shown promise, the analysis is expanded and deepened to examine the market in detail and identify potential entry points for an IFAD rural finance intervention.

The three levels of the financial sector

In order to have a clear picture of the financial market, the analyst needs to examine each of its three levels. Using a framework developed by the Consultative Group to Assist the Poor (CGAP), the financial market can be divided into three levels: micro, meso and macro.[5] This approach allows IFAD to determine whether a rural finance intervention is warranted. It generates a number of possible interventions and guides IFAD in pursuing the best course of action given IFAD's current competencies and resources.

Figure 1. Decision tools flow chart: market assessment



Note: Although the initial assessment may suggest that no intervention is warranted, the collected data may be used for other purposes.

[5] Developed by CGAP, this three-level framework is used by analysts to understand how to best support pro-poor financial-sector development.

As with most donor organizations, IFAD does not have the resources, required capacity or expertise to implement a rural finance project that intervenes at all three levels of the financial sector at the same time. Acknowledging this limitation, it is useful to understand the objectives and activities of other donors, as this information can provide direction and open up opportunities for joint efforts. For example, market assessments, especially detailed ones, can absorb significant resources. So if another donor is similarly invested, a strategic approach would be to partner and jointly collect and analyse information about the financial sector.

Micro level

The micro level of the financial system consists of FSPs and their clients.

On the demand side, it includes the households and individuals (both poor and non-poor) served by FSPs.

On the supply side, it includes retail FSPs such as mainstream commercial banks, agricultural development banks, postal banks and postal savings banks, financial cooperatives, credit unions, NGOs that provide financial services, agricultural supply agents, and insurance and leasing companies, as well as highly decentralized, community-led approaches such as SHGs, FSAs and VSLAs.

An assessment at the micro level examines both the demand and supply of financial services.

Micro level: demand

Goal: Identify the financial products and services important to IFAD's target group in a specific region or country.

Types of clients and demand

In general there are three types of clients of financial services in rural areas. While all three types can be found within a single household, each has its own specific needs.

- **Individuals and families** need savings and consumer and housing loans, as well as access to money transfer services and insurance.
- **On-farm production enterprises** need production and asset loans, as well as business services such as leasing.
- **Off-farm enterprises** need working capital and asset loans, as well as business services such as leasing.

Other types of rural clients may include small formal businesses, cooperative and non-profit businesses, large commercial businesses, and larger commercial agricultural businesses.

Determining overall demand

Most analyses assess *overall demand* for rural financial services by estimating the number of economically active low-income people in a particular market and then multiplying this number by a minimum assumed credit need to arrive at a rough market estimate. This relatively crude method is minimally sufficient.

Market surveys provide a more accurate estimate of demand. FinScope, for example, has conducted extensive surveys and profiled the demand for financial services in several national rural finance markets.[6]

Issues to consider

It is easy to assume that 'poor people' are all the same. However, the needs of low-income peoples not only differ greatly across geography, but can even differ greatly within a single household. Keep the following issues in mind when assessing demand for financial services:

- **Target a market**. During project design, the target market of the project should be clearly identified (e.g. potential regions, areas, farm and off-farm activities) to better inform the market research process.
- **Make no assumptions about client demand**. Keep an open mind as to the kinds of financial services that households demand, particularly for loans. In the past, projects assumed that rural households only wanted credit, but it is now recognized that poor people, like everyone else, value a wide variety of financial services. Demand may vary among household members, diverse economic activities and across income levels, as well as for various formal and informal financial services.

Table 2. Assessment of the micro level: demand

Issue	Areas of interest	Sources of information
• What is the demand for financial services? Credit, savings, money transfers, leasing, other products? • What are the savings habits? The credit culture? • How do urban and rural needs differ? • What distinctions are visible between women and men in the demand for and use of financial products? • What are the sources of income for rural households? • What do agricultural households produce? How are they linked to a value chain? At what points in the agricultural production cycle would farming households want to use a financial product or service? • What are the most significant risks or income cycles impacting the target group (e.g. floods, droughts, agricultural cycles of planting and harvesting)? • What is the overall size of the market? • What are other donors doing at this level?	• Size of market • Evidence of demand for financial services • Penetration of existing services • Current use of formal and informal services • Profile of target group	**Key informants**: Clients, FSPs, network organization, donor country offices, bureau of statistics, local advocacy groups **Suggested documents**: • Demand surveys (donors, FSPs, government) • Rating reports often include a summary of demand • Some specialized surveys (FinScope) • Statistics on access to finance (www.doingbusiness.org)

6 FinScope website, www.finscope.co.za/index.asp.

Micro level: supply

Goal: Evaluate the strength of existing financial service providers and how well they meet (or could meet) demand in rural areas.

Issues to consider

IFAD recognizes that no one business model has the flexibility or capacity to meet the financial needs of every client. Given this, IFAD works with a wide range of formal and informal FSPs in rural areas, looking for the most relevant model to meet the needs of a project and serve its target group. When assessing the supply side of the micro level, be sure to evaluate the following aspects of FSPs:

- **Sustainability**. Institutional sustainability is fundamental if an FSP is to grow beyond initial donor or investor support. The sustainability of an FSP hinges on its profitability, outreach, resource mobilization and the appropriate legal status of operations. As a prerequisite for IFAD support, an institution should clearly define its milestones and measures of sustainability in a business plan.
- **Portfolio diversification**. Most financial institutions make a strategic choice not to concentrate their lending portfolio on poor farmers. This is entirely reasonable. Low-income clients may count as only a modest percentage of an FSP's business, as institutional sustainability requires a certain level of diversity of both clients and risk. Most sustainable, formal rural financial cooperatives, such as the Caja Popular Mexicana in Mexico and Kafo in Mali, serve clients across income levels. IFAD-supported projects are not required to find a single institution that will serve the target group, but instead to work with a wide range of partner FSPs to meet the diversity of financial needs with a range of appropriate services and delivery channels over the long term.
- **Poverty outreach**. When evaluating available products and services, consider how pro-poor they are. One way to do this is to determine minimum balances for basic deposit products and loan sizes for loan products. As an example, if the minimum amount required to open a savings account is US$25 at one FSP, while other FSPs require only US$10, then the first FSP may be targeting clients at a higher income level.
- **Potential for expansion**. As banking transaction technology improves, larger, well-established commercial service providers may consider expanding into peri-urban and larger rural towns. Some state banks also have the potential to provide services in rural areas.

Table 3. Assessment of the micro level: supply

Issue	Areas of interest	Sources of information
Financial service providers		
• What types of formal financial service providers cater to the low-income market? What is the role of informal FSPs (e.g. money lenders, rotational savings and credit associations [ROSCAs])? • What types of services do the various organizations offer (by provider type)? • How many service providers exist? • Where are they located? How much of the country is covered? • What are the different institutional models of FSPs? How do they fund themselves? • What FSPs are connected to ongoing donor or government initiatives in the financial sector? • What other delivery channels does the target group consider accessible and trustworthy (e.g. agricultural supply dealers, cellphone operators, shops with point-of-sale devices)? • Are there potential new entrants into the market? Or is there potential for existing institutions to expand? • How are other donors interacting with FSPs?	• Types of institutions and their locations and legal status • Number of branches or outlets • Outreach to the poor • Use of mobile phones and automated teller machines (ATMs) • Role of state-owned and postal banks • Role of commercial banks • Sources of capital • Role of informal providers (e.g. moneylenders, ROSCAs, supplier credit)	**Key informants**: Clients, retail institutions, FSP network, donor country offices, microfinance project offices, ministry of finance, ministry of cooperatives **Suggested documents**: • Central bank • Financial Sector Assessment Program country reports (www1.worldbank.org/finance/html/fsap.html) • World Bank access to finance reports • Microfinance studies (donors, networks, government) • FSP annual reports, websites • MIX Market/Microfinance institutions (www.mixmarket.org/en/demand/demand.quick.search.asp)
Products and services		
• What services are accessible and in what locations? • What gaps exist in the supply of financial services in rural areas (i.e. geographical, product, services)? • How appropriate (pro-poor) are the terms and conditions? • What is the volume of loans and savings? • What is the loans/savings ratio? • What is the breakdown by type of service provider? • What is the average loan size by type of provider?	• List of products and services • Term sheets • Portfolio reports • Industry statistics • Examples of linkages between institutions	**Key informants**: FSPs, network organization, donor country offices, ministry of finance, ministry of cooperatives **Suggested documents**: • MIX Market/Microfinance institutions (www.mixmarket.org/en/demand/demand.quick.search.asp) • Network statistics

Issue	Areas of interest	Sources of information
Outreach		
• What is the collective outreach for loans and savings? • To what extent are rural areas being served? • What types of service providers are reaching low-income households?	• Trends in number and volume of clients, loans and active savings accounts	**Key informants**: Central bank, all retail institutions (including postal, agriculture and state banks), networks **Suggested documents**: • Central bank reports and websites • National surveys on microfinance • Microfinance association reports/websites
Performance		
• How many institutions are sustainable? • Are the financial products sustainable (i.e. are interest rates set by the market, are they sufficient to cover costs, and are they not subsidized)? • What is the quality of the loan portfolios?	• Outreach • Depth of outreach • Portfolio quality • Financial sustainability • Efficiency	**Key informants**: FSPs, network organization, donor country offices Suggested documents: • MIX Market/Microfinance institutions (www.mixmarket.org/en/demand/demand.quick.search.asp) • FSP financial statements

Table 4. Key types of financial service providers

Financial service provider	Ownership	Regulatory status	Kinds of financial services offered
Government finance programmes or agencies for rural micro or small and medium enterprise (SME)	State-owned	Not regulated by banking authority	Wholesale or onlending funds to retail institutions and individuals
NGO FSPs	None	Usually not regulated by banking authority	Microfinance loans, rarely voluntary deposits, and possibly microleasing, Business Development Services, sub-agents for money transfer services
FSPs not licensed as banks	Varies	Usually not regulated by banking authority	Microfinance loans and rarely voluntary deposits
Membership-owned financial institutions (e.g. credit unions, FSAs, SACCOs)	Members	Regulated in many countries by department of cooperatives and other regulatory authorities	Savings and loans to members (and in some cases loans to nonmembers)
Informal savings and credit groups (e.g. SHGs, VSLAs, ROSCAs and accumulating savings and credit associations)	May be started or sponsored by an NGO, bank, or government programme, or be independent	Not regulated by banking authority	Savings and loans to members
Postal savings banks	State-owned	Usually not regulated by banking authority	Savings and money transfers
Rural banks	Private-sector investors or shareholders	Licensed or supervised by banking authority	Savings, loans and sometimes money transfers
Microfinance banks	Private-sector investors or shareholders	Licensed or supervised by banking authority	Savings, loans and sometimes money transfers
Commercial banks	Private-sector investors or shareholders or state-owned	Licensed or supervised by banking authority	Savings, loans, money transfers and foreign exchange
Insurers	Varies	Licensed or supervised by insurance/government authority	Insurance
Money transfer companies	Private-sector investors or shareholders	Licensed or monitored by government authority, though this varies by country	Money transfers

Meso level

Goal: Identify and evaluate the main actors and activities in the infrastructure of the financial system.

The meso level of the financial system consists of financial-sector infrastructure and support services. It includes domestic rating agencies, credit information bureaux, audit firms, deposit insurance agencies, training and technical service providers (TSPs), professional certification institutes, and the networks, associations and apex organizations of FSPs.

These actors work to reduce transaction costs, improve sector information and market transparency, increase access to refinancing and enhance skills across the sector. They facilitate activities in the financial sector, but do not themselves provide retail financial services.

Issues to consider

Increasingly, governments and donors are recognizing that the vitality of the meso level has significant implications for efforts to develop inclusive financial sectors. When performing an assessment, keep in mind the following aspects of meso-level institutions.

- **Sustainability**. Sustainable, commercially-driven bodies and institutions in the infrastructure are critical to the long-term provision of financial services. Assess the long-term viability of meso institutions.
- **Interconnectedness and reliance**. Weaknesses at the meso level could be linked to more general micro-level problems. At the micro level, for example, clients could face high levels of indebtedness, and FSPs could face high risk of portfolio delinquency, which may be linked to the non-existence or limited use of credit information bureaux at the meso level. Credit information bureaux help FSPs determine reasonable levels of client debt and calculate the loan repayment capacity of potential clients.

Box 4
Examples of meso-level financial infrastructure

- Institutional infrastructure: Networks, associations and apex organizations of retail financial service providers and other institutions engaged in advocacy and information dissemination.
- Information infrastructure: Credit bureaux, auditors and rating agencies that promote transparency in institutional performance and transactions.
- Technical support and training services: Technical service providers, research companies, consultants, technology firms and professional certification institutes.
- Financial infrastructure and markets: Wholesale or second-tier mechanisms such as apex lending facilities, guarantee banks, credit guarantee funds and payment clearing systems, as well as investment funds, bond issues and securitization mechanisms.

Table 5. Assessment of meso level

Issue	Areas of interest	Sources of information
Financial infrastructure		
• What institutions and actors make up the infrastructure of the financial sector? • Are any donor initiatives supporting capacity-building at the meso level? • **Payments and clearing system**: Are FSPs linked to the formal banking infrastructure (i.e. payment, information, clearing systems for settling accounts among banks)? • **Local capital markets**: What is the current state of bond issues, stock markets, securitization?	• Payments systems, ATM and short messaging service (SMS) technology, SWIFT, ACH, interbank networks and credit card companies • Previous securitization deals, if any	**Key informants**: Ministry of finance, central bank, FSPs, network, bankers' association **Suggested documents**: • CGAP Technology Program (www.cgap.org/p/site/c/tech/)
Information infrastructure and transparency		
• Are support services (e.g. auditing, rating, management information system (MIS) providers) available locally? • Are FSPs publishing their accounts and participating in benchmarking initiatives? • Have any FSPs been rated by a rating agency? • Are there mechanisms to manage risk, such as credit bureaux? Do they operate in rural areas?	• Existence and quality of local audit firms, MIS providers, rating agencies • Reporting to MIX or other benchmarking efforts • Existence of credit bureaux	**Key informants**: MIX Market and MicroBanking Bulletin, central bank, network, donor country offices, rating agencies, International Finance Corporation (IFC) regional office
Technical support services		
• What is needed and what is available in terms of specialized technical assistance and training in rural finance and microfinance? • Are there research companies offering local services in rural pro-poor finance market assessments, surveys, information gathering? • Are there local technology firms offering software and MIS development services geared towards pro-poor FSPs? • Is technology used for rural finance and microfinance (for example, mobile banking, smart cards, biometry)? Is it available to most FSPs? • Are there mechanisms to guarantee the quality of collateral, such as collateral registries?	• Existence and quality of microfinance consultants, training centres and title/collateral registries • ATM and SMS technology	**Key informants**: Ministry of finance, central bank, donor country offices, regional development bank, FSPs, network, bankers' association, local microfinance consultants, microfinance project offices, consumer protection agency **Suggested documents**: • Financial Sector Assessment Program country reports (www1.worldbank.org/finance/html/fsap.html) • Regional development bank financial-sector studies (www.ifitransparencyresource.org) • Financial Deepening Challenge Fund (www.financialdeepening.org) • Regional and bilateral donor reports • Credit Bureau IFC Knowledge Guide (www.ifc.org/ifcext/gfm.nsf/AttachmentsByTitle/FI-CB-KnowledgeGuide-E/$FILE/FI-CB-KnowledgeGuide-E.pdf)

<table>
<tr><th>Issue</th><th>Areas of interest</th><th>Sources of information</th></tr>
<tr><td colspan="3">Advocacy and information dissemination</td></tr>
<tr><td>• Is there an active, effective microfinance association?
• Does it promote sound policies and practices?
• Does it effectively represent its members?
• Does it promote or enforce standards? Transparency?</td><td>• Size/membership of networks
• Participation of variety of FSPs (NGOs, credit unions, banks)
• Quality of materials/services offered
• Credibility in sector</td><td>Key informants: Network, donor country offices
Suggested documents:
• Network websites
• Small Enterprise Education and Promotion (SEEP) Network (http://seepnetwork.org)</td></tr>
<tr><td colspan="3">Wholesale finance</td></tr>
<tr><td>• How do FSPs fund their growth?
• Refinancing:
- What role do local private sources play (e.g. commercial banks and private investors)?
- Are international investors/lenders (e.g. apex bodies, wholesale lending facilities, investment funds) refinancing local microfinance providers?
- Are sources in local currency? How accessible are they? How appropriate are terms and conditions?
- Are there apex refinancing facilities? Are they public or private? Are they efficient? Do they complement or duplicate local funding sources such as savings and commercial loans? Is there a sufficient number of strong retail FSPs to absorb this funding?[a] What mechanisms are in place to protect this apex fund from political pressure and interference?[b]</td><td>• Number, size and quality of wholesale lending facilities (restrictive conditions such as interest ceilings)
• Liquidity of the formal banking sector and deposit-matching regulatory rates
• Treasury bond rates
• Role of the government, stock market, local commercial banks and local investors in financing FSPs
• Role of foreign investment and loan funds</td><td>Key informants: Ministry of finance, donor country offices, regional development bank representatives, FSPs, network, microfinance project offices, local microfinance consultants
Suggested documents:
• Council of Microfinance Equity Funds (http://cmef.com/)
• MIX Market/Funders (www.mixmarket.org/en/supply/supply.quick.search.asp)
• International microfinance investor websites
• Local or regional studies
• Regional/bilateral donor reports or studies
• CGAP research on local wholesale facilities</td></tr>
</table>

[a] Apex funding and technical assistance can help good FSPs, but usually cannot create good FSPs, or turn bad ones into good ones. Apex project designers seldom do a careful study of the capacity of existing FSPs, and almost always overestimate such capacity.

[b] Most apex projects have not been very successful in contributing to the development of sustainable FSPs. Successful apex bodies usually have a management structure and oversight board in which the government has little or no representation, or where the government's influence is outweighed by the presence on the board of powerful private-sector, non-partisan individuals. Most apex project documents assert that the apex body will be independent of political interference. This assertion has little value unless that independence is built into the structure of apex governance.

Macro level

Goal: Identify all relevant contextual, policy and regulatory issues likely to affect the expansion of an inclusive rural finance sector.

The macro level of the financial system consists of the legislative and policy framework that is necessary to the reliability and sustainability of the financial system. Governments, and in particular central banks and ministries of finance, are clearly central to the macro level: they write financial laws, supervise financial institutions and enforce compliance. These actors shape the overall economic conditions that affect a country's financial system and impact private- and public-sector business development.

Governments also have indirect impacts on the financial system through their macroeconomic policies, particularly monetary policy, as well as their spending priorities and the regulatory regime for business. An assessment of the macro level will review whether the policy framework is adequate to allow rural finance and microfinance to flourish. For example, national policies on women's individual rights to property influence what women can offer as loan collateral; and a government's provisions for social protection affect consumer demand for savings and deposits, loans, insurance and pensions. These direct and indirect impacts strongly affect the strength of a financial sector and influence development potential in the country.

While not technically part of the macro-level assessment, the role that the country context plays in the financial sector cannot be overlooked. Regional factors such as recent history, type of government, average life expectancy, type of currency and condition of physical infrastructure (among many others) also play a role in the financial system. While it would be impossible to measure every factor that impacts a region's financial profile, any assessment must consider these variables (see Table 6 on page 26 and Table 7 on page 28 for details).

Issues to consider

- **Enabling policy environment**. A number of factors are particularly important in preventing systemic risk in the financial system. These include 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 to autonomous financial institutions and regulatory authorities. Given the potential impact of changes in the regulatory structure, a cautious approach is strongly recommended (CGAP 2008).
- **Prudential regulation and supervision**. Without properly regulated local financial institutions that 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, the capacity of supervisors and, most importantly, on the level of savings mobilized from the public.
- **Government partners**. 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. The ministry of finance is a natural partner for IFAD-supported rural finance projects.

Table 6. Assessment of macro level: country context

Issue	Areas of interest	Sources of information
Country history and political situation		
• What are the key recent historical events? • Who holds the balance of political and economic power? • What are the political, regional or ethnic divisions? • Are elections or other regime changes pending? Will the change be stable? • Is poverty a political issue? Is microfinance politicized? Which political entity has influence on microfinance?	• Historical background • Current political situation • Roles and power balance of executive and legislative bodies • Key policymakers at central, regional and local levels	**Key informants**: Government officials, parliamentarians, donor agency local offices, consultants **Suggested documents**: • Economist Intelligence Unit (EIU) country reports (countryanalysis.eiu.com/country_reports) • International and local press • General economic research (in French – www.cofacerating.fr) • World Bank country profiles (http://go.worldbank.org/1SF48T40L0)
Macroeconomic data		
• How stable are the economy and currency? • What is the level of real economic growth? Is growth concentrated in certain sectors? • What is the influence of donors in the national budget? Of remittances? • Is the budget balanced?	• Growth rates • Inflation (consumer price index) • Exchange rate • Economic structure (by sector) • Trade and current account information • Fiscal issues (national budget) • Hard currency reserves	**Key informants**: Central bank, ministry of finance, financial-sector consultants, donor country offices **Suggested documents**: • Central bank reports, website • Ministry of finance reports, website • World Bank country reports (http://worldbank.org/countries) • IMF country reports (www.imf.org/external/country/index.htm)
Physical infrastructure		
• Is the physical infrastructure (or lack thereof) an obstacle to doing business efficiently, both for entrepreneurs and for FSPs?	• Kilometres of paved roads • Number of telephone lines or mobile phone users • Percentage of households connected to running water • Electricity shortages • Number of large marketplaces	**Key informants**: Ministry of equipment, donor country offices **Suggested documents**: • Communication and transportation: CIA World Fact Book (https://www.cia.gov/library/publications/the-world-factbook/) • Infrastructure (www.doingbusiness.org/ExploreTopics/Infrastructure/) (under development)

Issue	Areas of interest	Sources of information
Population		
• What is the national poverty line? What percent of the population is poor? • What are the main constraints faced by women? What gender-disaggregated data is available? • How much of the population is economically active? • How young is the population? • What is the population density? • Is life expectancy low? Improving?	• Population • Gender • Age distribution • Number of households • Economic activity statistics • Poverty line • GNI per capita • Mortality rates • Urban versus rural population issues	**Key informants**: Donor country offices, International Labour Organization (ILO), United Nations agencies **Suggested documents**: • UNDP Human Development Reports (http://hdr.undp.org/) • National bureau of statistics • National census reports • Country poverty reduction strategy process (PRSP) (www.imf.org/external/np/prsp/prsp.asp) • International financial institution sector studies
Trends in banking and finance • How stable is the financial sector? • How many national banks are there? International banks? • What is the breadth and depth of financial services (credit and savings)? • How prevalent is the state in the banking sector? • How does credit volume compare with that of savings? • How large is the equity market? • How large is microfinance lending compared with total domestic credit?	• Economic and financial-sector reforms • 90-day treasury bill rate • Cash outside banks or currency in circulation • Savings in banks (or as percentage of GDP) • Domestic credit to private sector (or as percentage of GDP) • History and perception of microfinance • Proportion of small accounts in formal banking sector (loans and savings)	**Key informants**: Central bank, ministry of finance, financial-sector consultants, donor country offices **Suggested documents**: • Central bank reports, website • Ministry of finance reports, website • World Bank Country at a Glance (www.worldbank.org/data/countrydata/countrydata.html) • Financial Sector Assessment Program country reports (www1.worldbank.org/finance/html/fsap.html) • Other World Bank financial-sector studies • Regional development bank financial-sector studies (www.ifitransparencyresource.org/) • Financial Deepening Challenge Fund (www.financialdeepening.org/) • Bilateral donor agency reports on microfinance

Table 7. Assessment of macro level: policy, legal and regulatory framework

Issue	Areas of interest	Sources of information
Policies		
• Does the country have a national strategy for its financial sector and for microfinance? • Who makes key decisions in microfinance? • Is access to finance part of the PRSP? • Is the banking sector being privatized or restructured? • Are there specific tax treatments for different types of FSPs? • Are any donor groups working with policymakers?	• Financial-sector policies • National microfinance strategies, PRSPs and other sectoral policies that include references to microfinance • Ongoing financial-sector reforms • Fiscal regimes for different types of FSPs • Policy and targeted lending • Level of decentralization for policymaking	**Key informants**: Ministry of finance, UNDP, World Bank and regional banks **Suggested documents**: • PRSP • Speeches by key policymakers • Regional development bank financial-sector studies (www.ifitransparency resource.org) • National financial-sector strategies • Financial Sector Assessment Program country reports (www1.worldbank.org/ finance/html/fsap.html) • Microfinance Regulation and Supervision Resource Center (http://microfinancegateway. com/resource_centers/ reg_sup)
Laws, regulations		
• How do banking laws treat microfinance? • Is there a usury law, interest rate caps or other impediment to microfinance? • Is there a specialized law or regulation for microfinance? • Does the legal and regulatory environment encourage market entry and competition in the pro-poor financial services sector? • What types of institutions can lend and mobilize deposits? • Do minimum capital and reserve requirements inhibit microfinance? • Are there restrictions on the interest rates and fees that can be charged by pro-poor financial service providers? • How effective is the judiciary system? • How does government cover branchless banking regulations? • What is the consumer protection regime? Are there procedures or self-regulation in place to protect consumers (such as mandatory publication of certain information, consumer organizations)? • Are any ongoing donor programmes working to strengthen the legal and regulatory frameworks?	• Banking law, microfinance law or regulation, and laws on savings and credit co-ops • Legal feasibility of transformations (e.g. foreign NGO into local NGO, foreign NGO into local company, local NGO into company, and local NGO into licensed bank) • Usury or interest-rate laws • Minimum capital requirements, reserve requirements and prudential regulations • Regulations on branching, ATMs, branchless banking, anti-money laundering/ combating the financing of terrorism • Civil code for contracts, land title, collateral • Deposit insurance • Consumer protection code of conduct and watchdog or consumer protection organizations	**Key informants**: Central bank, ministry of finance, parliamentarians, bankers' association, network, World Bank and regional development banks, international investment funds, consumer associations **Suggested documents**: • Microfinance Regulation and Supervision Resource Center (http://microfinancegateway. com/resource_centers/reg_sup) • World Bank country reports (http://worldbank.org/countries) • IMF country reports (www.imf.org/external/country/ index.htm) • Laws • Gazetted regulations • Central bank regulations/rules • Civil code for collateral • Prudential regulations • CGAP policy diagnostics (www.cgap.org)

Issue	Areas of interest	Sources of information
Supervision capacity		
• How well are banks and other FSPs supervised? • Are supervisors focusing on appropriate things? Do they have enough capacity to supervise all regulated FSPs?	• Location and composition of supervision unit • Number of FSPs visited each year • Quality of FSPs reporting to supervision unit • Capacity of supervisors	**Key informants**: Central bank, ministry of finance **Suggested documents**: • Microfinance Regulation and Supervision Resource Center (http://microfinancegateway.com/resource_centers/reg_sup) • Central bank regulations/rules • CGAP policy diagnostics (www.cgap.org)
Other roles/interventions of government		
• What different roles does the government play as a promoter of microfinance and a protector of clients? • Is the government directly intervening in financial service delivery? Are there government-subsidized credit programmes providing credit at the retail level? What are the trends? • Does the government play a role in consumer protection? • Is the government involved in funding apex bodies (see meso level)? • How does the government promote microfinance? • Is there an understanding of the role of land registries and improvements?	• Extent of government's involvement in microcredit, savings and other financial services • Government ownership of institutions that serve poor people • Types of financial services provided by state banks • Promotion of transparency • Provision of market intelligence • Financial incentives for banks	**Key informants**: Central bank, ministry of finance and other ministries likely to be involved (e.g. agriculture, SME, social affairs), national apex bodies **Suggested documents**: • National financial-sector policies/strategies • Financial Sector Assessment Program country reports (www1.worldbank.org/finance/html/fsap.html) • World Bank and regional development bank reports • CGAP research on apex bodies

With a clear understanding of, demand for, and supply of rural financial services and of strengths, weaknesses and gaps at macro, meso and micro levels, project designers are well positioned to evaluate possible IFAD-supported interventions in rural finance, as detailed in the next section.

Market assessment

When initially considering a rural finance intervention, it is important to develop a good understanding of the market in order to evaluate whether an IFAD intervention is warranted and how it could possibly take shape (Box 5). This step may contribute to the results-based country strategic opportunities programme (RB-COSOP) (IFAD 2006).

If the initial assessment shows that an IFAD intervention is warranted, a much more detailed and rigorous market assessment is conducted, which will contribute to the project design. As with the initial assessment, the assessment for project design examines each of the distinct levels of the financial sector (micro, meso and macro) and then determines the outline of the potential IFAD-supported interventions (see chapter 2 for additional discussion of project design).

The market assessment for project design should

- Detail the existing strengths, weaknesses and gaps in the rural finance sector at macro, meso and micro levels;
- Demonstrate a clear understanding of government strategy and other donors' activities in rural finance;
- Clearly define the target group and outline its demand for and supply of rural financial services;
- Identify relevant stakeholders in the market;
- Identify potential partner FSPs and evaluate their capacity, using qualitative analysis, and quantitative outreach and performance indicators (e.g. number of borrowers and savers, gross loan portfolio, operational self-sufficiency, portfolio at risk – see chapter 4 on performance indicators);
- Identify TSPs and evaluate their potential capacity.

Box 5
Key concerns in an initial market assessment (RB-COSOP)

In the initial market assessment, a great deal of information can be gathered from other donors, government partners, FSPs, existing research and market information, NGOs, farmers' organizations, community groups, and so on. The goal of this research is to evaluate whether an IFAD rural finance (RF) intervention is warranted. Any potential intervention should be:

- Consistent with the *IFAD Rural Finance Policy* (IFAD 2009) and its six guiding principles (see Box 3 on page 13);[7]
- In line with international good practice in developing inclusive financial systems and fostering innovation;
- Consistent with national development policies and strategies to assist poor people;
- Complementary to other donor activities in RF (avoiding overlaps, while developing strategic partnerships);
- In line with key principles of ownership, alignment, harmonization, managing for results and mutual accountability;
- Supported by an understanding of the financial sector at macro, meso and micro levels, as well as demand for and supply of financial services;
- Located in areas in which IFAD has a clear comparative advantage in RF;
- Relevant to the policy and strategic objectives contained in the RB-COSOP;
- Inclusive of verifiable RF outcome and milestone indicators in the results management framework of the RB-COSOP;
- Achievable in light of the political and institutional context, IFAD experience and comparative advantage, resources, partnerships and time frame;
- Positioned to be later scaled up in order to enhance development impact.

Overall: Is IFAD's investment in RF warranted? And is the proposed strategy realistic and viable?

[7] IFAD Rural Finance Policy website, www.ifad.org/ruralfinance/policy/index.htm.

2. Designing a project

2. Designing a project

- **Action**: Define the interventions in a rural finance project.
- **Objective**: Detailed project design and a strong framework to facilitate implementation.
- **Key players**: The CPMT, with support from rural finance consultants.

Building on assessment of the market at each of the three levels, this chapter concentrates on deciding what possible activities to undertake in an IFAD-supported rural finance project.

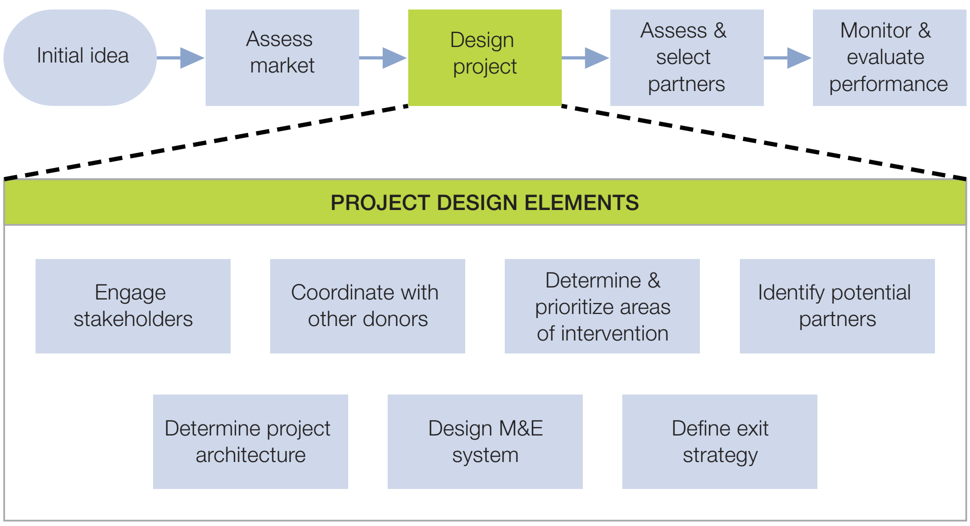
Project design: micro level

The decision to intervene at the micro level must be based on a solid match between the financial needs of low-income people and the ability of FSPs to address this demand on a sustainable basis. If the FSPs being considered are formal organizations, then competitive profit, risk and opportunity cost need to be factored into any calculation of sustainability. These calculations differ for commercial banks, non-bank FSPs and cooperatives. If the FSP is informal in nature – such as a self-help group – then the calculation will again be different, focusing instead on the ability and willingness of clients to participate in the management of service provision.

During the market assessment, the most relevant FSPs for an IFAD-supported project would have been identified, and their capacity and willingness to partner with IFAD would have been evaluated. If there is more than one potential partner FSP, then the project design should include criteria for an open, competitive selection process during implementation.

The criteria for FSP selection could include an institutional vision compatible with the *IFAD Rural Finance Policy*, sound financial performance indicators, experience in rural

Figure 2. Decision tools flow chart: project design



finance, access to finance, growth potential, and so on. A competitive process tests an institution's interest in the project's goals, as well as its overall commitment to rural finance and to IFAD's target group. The ownership and senior management of potential partner organizations must be convinced that the rural finance market is an attractive and viable opportunity if they are to commit to collaborating with IFAD and continuing to serve rural areas after the project ends.

It is also important that project designers assess the availability and capacity of potential national, regional and international TSPs. These institutions are key collaborators in supporting local activities and building the capacity of IFAD's partner FSPs. (Further information on the identification and selection of TSPs is found in chapter 3.)

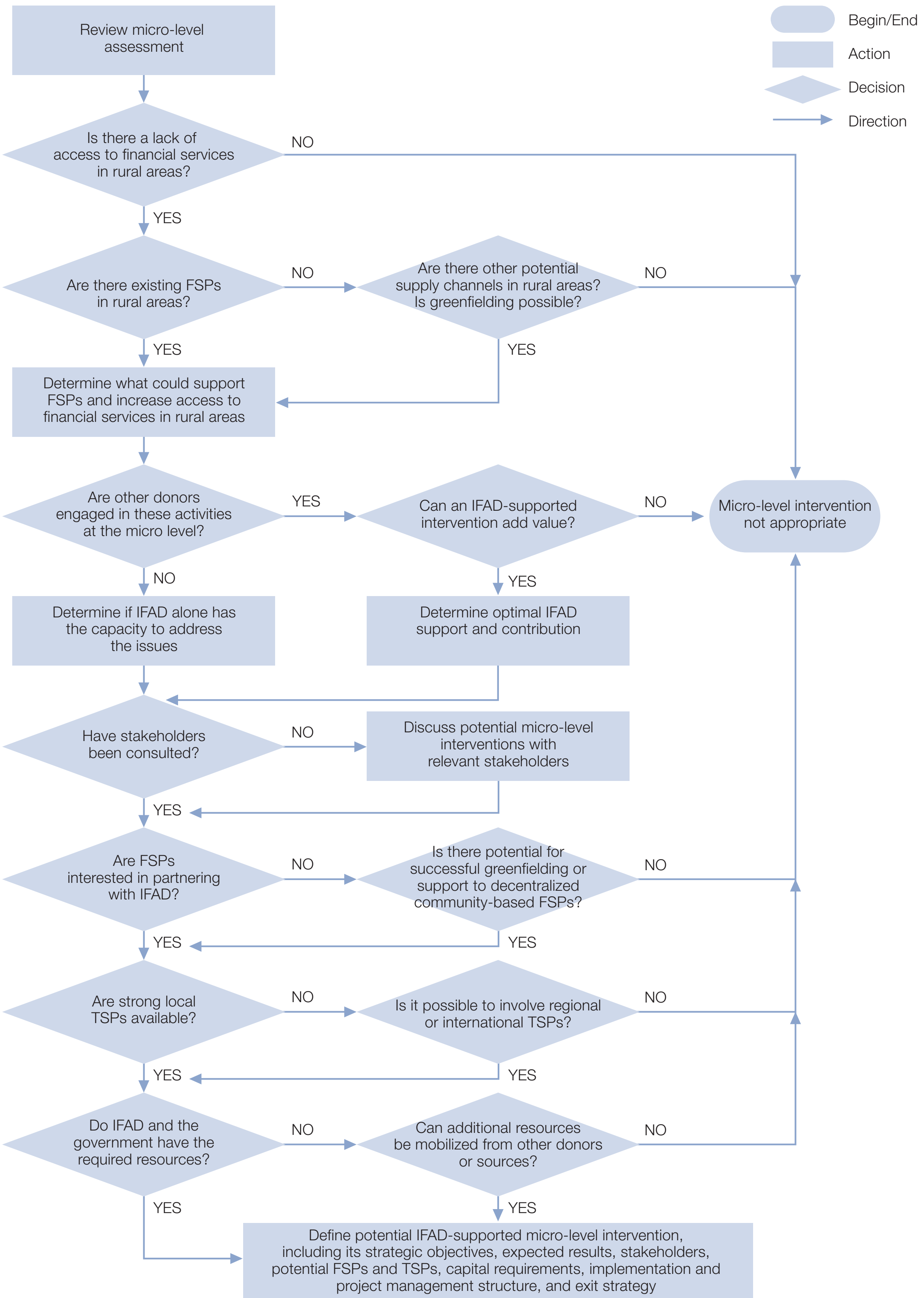
Issues to consider

- **Sustainability**. Financial sustainability is essential if FSPs are to reach significant numbers of poor people and realize long-term social returns. This means, among other things, charging interest rates that cover costs in order to ensure profitability and growth. Over time, competition, improved efficiency and increased accountability for results should drive costs down, and thus interest rates as well. Some FSPs take 5-10 years to become financially sustainable, though the time required to achieve sustainability depends on the country context, local market conditions, capital structure and the market segment served.
- **Efficiency**. Improving the efficiency of rural finance operations translates into higher-quality, lower-cost services for poor people. FSPs can achieve greater efficiencies, and thus reduce costs, by investing in quality management information systems, development of relevant products, technological improvements and well-trained staff.
- **Capacity-building**. FSPs often need capacity-building support more than loan capital. Tailored technical assistance can be important to strengthen their capacity, develop relevant products and deepen their outreach in rural areas, though institution-building requires a long-term commitment by donors and investors. This commitment should be balanced by a defined time limit for funding support.

Box 6
Key questions at the micro level

- What challenges and gaps has the market analysis identified in rural areas at the micro level?
- What possible IFAD-supported interventions could address the identified gaps in rural areas?
- What other donors and stakeholders are working on the issue and have strong technical capacity in this area? Why should IFAD be working on this as well?
- How strong are existing financial service providers – both formal and informal?
  - How strong is their outreach and financial performance? What are the trends over the last three years?
  - What are their strengths and weaknesses and capacity-building needs?
  - Do they have the potential to deepen their outreach in rural areas?
  - Would they be interested in partnering with an IFAD-supported project?
- Are there qualified TSPs to support partner FSPs?
- Is the government willing to invest in capacity-building activities?

Figure 3. Micro-level decision tree



- **Use of appropriate instruments**. If not applied properly, donor support for grants, loan capital and guarantees to FSPs can undermine or crowd out national or international commercial capital markets or domestic savers. For example, savings-based, community-managed loan funds have shown promise, but when donors infuse outside capital, they almost always fail due to poor repayment.

Possible areas of focus at the micro level

The following list is by no means exhaustive and is only meant to offer some ideas (as well as precautions) on possible IFAD-supported interventions in rural finance at the micro level:

- **Credit** helps households and small enterprises manage cash flows, cope with emergencies and take advantage of opportunities. The success of microcredit has shown that poor people are reliable customers who want and will pay for financial

Box 7
Good practice project-design principles – micro level

- **Focus on the FSP's own business goals**. Technical services should be driven by the FSP's own goals. IFAD should not design projects that try to push institutions in directions they do not want to go.
- **FSPs should set their own pricing policies and be sure that their interest rates cover their costs**. IFAD should not impose interest-rate ceilings or establish any other pricing policies. FSPs must establish transparent pricing policies that will guarantee their long-term sustainability.
- **Adapt the funding and support to the maturity of FSPs**. Newly established FSPs have different needs and strengths than growing or mature ones.
- **Use cost-sharing mechanisms**. When FSPs share the costs of expanding services or developing new products, this confirms their long-term interest in project objectives and reinforces performance incentives. More-mature institutions know the value of technical services as a recurring expense.
- **Engage partners in performance-based contracts**. Funding for FSPs and TSPs should be tied to operational improvements (e.g. increased target clients, reduced defaults, lower operating costs), not just activities or 'stats' (e.g. number of training events, new hires). Funding should be terminated when results on the agreed indicators are consistently poor.
- **Technical support should have a continuous local presence**. The selection of TSPs should be based on their rural finance experience and their capacity to stay involved with the project on a continuous basis. Consultants who drop in once or twice a year may be good for strategic discussions, but not for an institution's ongoing management consulting needs. High-quality, local TSPs should be used whenever possible, given their knowledge of the local market, proximity to partner FSPs and relatively lower cost structure. When local consultants are not available, good regional specialists or international-quality consulting firms with expertise in rural finance could be contracted to manage a project.
- **Coordinate and collaborate with others supporting the same institutions**. When several funding agencies are building capacity in the same institution or the same local market, coordination is the minimum requirement. Collaboration is a key to avoid duplicating efforts.
- **Make a long-term commitment**. Building retail capacity requires reliable access to technical services and training over at least five to seven years.

Source: Adapted from CGAP (2006a).

services. Though microcredit has helped millions of people in developing countries improve their lives, loans are not always the answer. A loan is an obligation – and thus a risk – for the borrower, and poor rural people may have very limited, if any, debt-service capacity. For the very poor, other kinds of support such as safety nets, asset transfers or non-financial services may be more appropriate.[8]

- **Savings** help people build assets, plan for life events (e.g. births, weddings, deaths) and respond to emergencies. Safe places to save are in high demand by poor households, valued more than even access to credit. Poor people already save money informally – investing in livestock or jewelry, or hiding their money at home – but they are looking for methods that are safer, easier and more affordable. For FSPs, accepting deposits can be a major challenge that may require more sophisticated systems and management, transformation to a different institutional type and new product development.
- **Community-managed loan funds and savings-based groups** in remote or sparsely populated areas have demonstrated promising results, but financing them with external capital at the outset (e.g. revolving loan funds) often leads to poor repayment rates and the collapse of the fund (CGAP 2006b). Savings and credit SHGs usually begin by using only members' savings. Then, after a period of successfully collecting and lending their own resources internally, they may be coached to approach commercial lenders for a loan to leverage internally generated funds (i.e. the linkage banking approach).
- **Remittances** – the portion of migrant workers' earnings sent home to their families – have been a critical means of financial support for generations. Today, the impact of remittances is recognized in all developing regions of the world, constituting an important flow of foreign currency to most countries and directly reaching millions of households. These funds are used primarily to meet immediate family needs, but a significant portion is also available for savings, credit mobilization and other forms of investment. Finding ways to improve access to affordable, easy-to-access money transfers and connecting them to other financial services is an important challenge.
- **Insurance** can assist poor, vulnerable households in not slipping further into poverty after an income shock. A range of microinsurance products have been developed – including health, personal accident, fire, crop and property coverage – to help poor people cope with life's unexpected events. In addition, weather index-based insurance can cover the impact on crops of severe weather events such as prolonged drought. As new products reach the market, it is also important that poor households understand what insurance does and does not cover and that they are well-positioned to make good financial decisions.
- **Financial education and financial literacy** empower poor households to make wise financial decisions, teaching people how to save more, spend less, borrow wisely and manage debt. They also help clients better understand the benefits and risks of different financial products and their specific terms (e.g. interest rates,

[8] Studies such as the *Financial diaries*, by FinMark Trust, the Ford Foundation and the Micro Finance Regulatory Council of South Africa (2005), have fully described the complex relationship between poor clients and financial services.

Box 8
IFAD-based Financing Facility for Remittances

Recognizing the increasing importance of remittances in rural areas around the world, IFAD hosts the US$15 million, multi-donor Financing Facility for Remittances (FFR). With funding support from the European Commission, the Inter-American Development Bank, CGAP, the Government of Luxembourg, the Ministry of Foreign Affairs and Cooperation of Spain and the United Nations Capital Development Fund, the FFR works to:

- Increase economic opportunities for poor rural people through support to and development of innovative, cost-effective and easily accessible remittance services;
- Support productive rural investment channels; and
- Foster an enabling environment for rural remittances.

To achieve these objectives, the FFR regularly launches competitive calls for proposals.

For more information, see www.ifad.org/remittances/ and www.remittancesgateway.org.

Box 9
Client Protection Principles in Microfinance

The CGAP Client Protection Principles in Microfinance (CPPM) describe the minimum protection that microfinance clients should expect from providers. Hundreds of FSPs, investors, donors, associations and individuals have endorsed these principles, including IFAD.

"Over the past several years, consensus has emerged that providers of financial services to low-income clients should adhere to the following six core principles:

1. **Avoidance of overindebtedness**. Providers will take reasonable steps to ensure that credit will be extended only if borrowers have demonstrated an adequate ability to repay and loans will not put the borrowers at significant risk of overindebtedness. Similarly, providers will take adequate care that non-credit financial products (such as insurance) extended to low-income clients are appropriate.
2. **Transparent pricing**. The pricing, terms and conditions of financial products (including interest charges, insurance premiums and all fees) will be transparent and will be adequately disclosed in a form understandable to clients.
3. **Appropriate collection practices**. Debt-collection practices of providers will not be abusive or coercive.
4. **Ethical staff behaviour**. Staff of financial service providers will comply with high ethical standards in their interaction with microfinance clients, and such providers will ensure that adequate safeguards are in place to detect and correct corruption or mistreatment of clients.
5. **Mechanisms for redress of grievances**. Providers will have timely and responsive mechanisms in place for complaints and problem resolution for their clients.
6. **Privacy of client data**. The privacy of individual client data will be respected, and such data cannot be used for other purposes without the express permission of the client (while recognizing that providers of financial services can play an important role in helping clients achieve the benefits of establishing credit histories).

These principles are distilled from the innovative work of providers, international networks and national microfinance associations to develop pro-consumer codes of conduct and practices. While the principles are universal, their meaningful and effective implementation will require careful attention to the diversity within the provider community and conditions in different markets and country contexts" (ACCION International 2008).

For more information and technical tools, see www.smartcampaign.org/tools-a-resources.

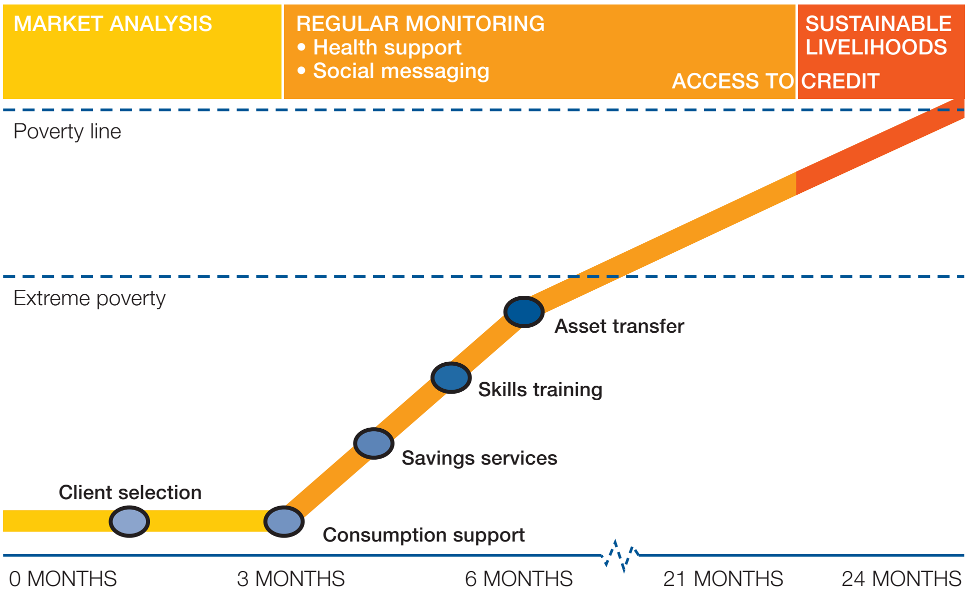
premiums). FSPs also have a role to play in treating their clients fairly. Hundreds have endorsed the Client Protection Principles in Microfinance, which commit FSPs to take concrete steps to protect their clients from potentially harmful financial products and ensure that they are treated fairly (CGAP 2009).

- **Social performance management** can help financial institutions achieve their pro-poor objectives.[9] This innovative approach to performance management allows FSPs 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. Adopting and using these qualitative and quantitative indicators, which go beyond standard financial and outreach indicators, helps institutions improve their products and maintain the poverty focus of their work (see Box 24 in chapter 4).
- **Graduation programmes**. Microfinance can be an excellent tool for poor people who have the stability and skills to operate a microenterprise, though people at the very bottom of the economic ladder may need a combination of several development services to facilitate their consumption stability before they can take advantage of other financial services such as credit. Graduation programmes use the targeting and transfer elements of safety net programmes and then introduce entrepreneurial activities through training, an asset grant and credit (see Figure 4). This process helps people develop income-generating activities and build assets in order to move out of extreme poverty.
- **Greenfielding** is the establishment of new microfinance institutions (MFIs). Such a project would be a significant challenge for IFAD, given the Fund's lack of experience in this highly technical field and the long-term investment required. Working through an international bidding process, IFAD could partner with an institution or donor or could hire a firm with significant greenfielding experience to start up a rural finance provider. International Finance Corporation and Kreditanstalt für Wiederaufbau (KfW) have a great deal of greenfielding funding experience and could be key partners in such a project.
- **Guarantee funds** and credit guarantees are financial contracts in which a lender (e.g. a local bank) extends credit to a borrower (e.g. an MFI), based on a promise by a guarantor (e.g. a donor) to absorb a specified portion of losses if the borrower fails to pay as promised. Guarantees can also be used to encourage lenders (e.g. a local bank) to make loans to specific types of borrowers (e.g. farmers' associations, SMEs). By reducing the lender's risk, the guarantor hopes to encourage the lender to make loans that the lender would otherwise have rejected as too risky. *IFAD only supports interventions using guarantee funds under very specific conditions* (Box 10).
- **A line of credit** is a loan to a financial institution that it will use to make many smaller loans to its individual customers.[10] *There is only limited scope for lines of credit in IFAD interventions* (Box 11).

[9] MIX Social Performance site, www.themix.org/standards/social-performance; SEEP Network Social Performance Working Group site, http://seepnetwork.org/Pages/SocialPerformance.aspx; and Microfinance Gateway resources on social performance, www.microfinancegateway.org/p/site/m/template.rc/1.11.48260/.

[10] Key lessons are found in Ritchie (2005).

Figure 4. Graduation model of microfinance



Source: CGAP graduation models, www.cgap.org/p/site/c/template.rc/1.11.1925/

Box 10
Interventions using guarantee funds

Credit guarantees are only effective when fully integrated into the mainstream financial market, managed by finance professionals who know the market well, and used as a catalyst to achieve longer-term objectives, such as developing products to serve a new market (Deelen and Molenaar 2004; ACCION International 2007).

Government agencies, publicly-owned mechanisms and IFAD-supported projects have had very limited success with guarantee funds. Only in a few cases have IFAD-supported guarantee funds been effective in opening access to credit among IFAD's target group. Most often, commercial banks do not lend to FSPs because of their weak performance, and the establishment of a guarantee fund alone will not overcome this problem. IFAD funds are often better used to build the capacity of FSPs to make them more attractive bank clients.

Given IFAD's weak experience with guarantee funds, a proposal to include such a mechanism in an IFAD intervention would need to be strongly supported by the results of a rigorous market assessment and a clear rationale. IFAD would consider supporting credit guarantees only under the following conditions:

- A measurable, quantifiable market demand has been demonstrated.
- The guarantee is professionally managed by an independent, specialized financial institution, and its functional modalities have been discussed and defined with the commercial banks and FSPs that would benefit.
- A significant part of the default risk stays with the retail institution to avoid moral hazard and adverse selection.
- Significant 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 for guarantee funds and setting incentives for correct claim and settlement are followed.[11]

[11] See www.rafad.org and www.rafad.org/en-2-1--OUR-SERVICES__Expertise-in-Guarantee-Funds.html for more information on guarantee funds.

Box 11
Interventions using lines of credit

IFAD typically avoids offering lines of credit. IFAD's experience has shown that, in most cases, credit lines fail to trigger the development of sustainable financial services. Lines of credit do not meet the longer-term needs of FSPs; they can cause considerable problems for FSPs, and they can even negatively impact the wider financial sector.

Some examples of problems with lines of credit include the following.

- Liquidity (i.e. access to loan capital) is not usually the main constraint that keeps FSPs from offering loans to poor people. More commonly, FSPs do not have the capacity, products or systems in place to serve poor clients. And some FSPs are simply not interested in serving this target group.
- Lines of credit can distort credit markets, undercutting and chasing out sustainable, unsubsidized competitors, and blocking the entry of new service providers, as well as alienating other donors and FSPs.
- Wholesale and retail FSPs may become less attentive to their lending practices with access to large amounts of low-cost capital. Wholesalers, for example, may feel pressure to disburse funds to weak institutions or in tranches too large to effectively manage, leading to increased defaults or overexpansion.
- The sustainability of the products financed by the credit line is often uncertain. When access to the credit line stops, financial service providers may go back to serving mainstream borrowers and stop serving the target group.
- Some FSPs rely too much on donors and lines of credit, and they lack a clear exit strategy to mainstream market-based credit. When projects end, FSPs must be strong and resourceful enough to fund their own loan portfolio (de Sousa-Shields and Frankiewicz 2004).
- Most FSPs need support for capacity-building more than credit and, as they improve operations, funding is usually less of a problem. Supporting institutional capacity development is a proven and integral part of integrating financial services for poor people into the formal financial sector.
- If credit lines are to be useful, then they must be made available with coordinated technical assistance and resources for capacity-building. If a project is working with an FSP on product development, for example, then the product should be researched, designed and ready to pilot before it can access capital for its launch and testing (assuming the agreed targets were met).

Because of these concerns, IFAD would consider offering a line of credit *only* under the following conditions:

- The market demonstrates a clear lack of liquidity, as shown by a rigorous market assessment.
- The line of credit will not undermine the initiatives of other donors or private-sector partners.
- 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.
- Partner FSPs
  - Use this capital as part of their own strategic plan to develop new products and/or serve new markets in rural areas;
  - Are financially sound and have the capacity to efficiently and transparently absorb and manage the credit line;
  - Are independent of political interference and free to charge interest rates that allow cost recovery;
  - Endorse the CGAP Client Protection Principles in Microfinance; and
  - Share performance and outreach information with the MIX Market on an annual basis and submit the required performance indicators to the PMU regularly during implementation and supervision.
- Private, professional fund managers or institutions, and not the recipient government, manage the line of credit.
- Resources are allocated for the capacity-building of partner institutions to successfully manage rural finance operations and effectively use the additional capital.
- A clear exit strategy develops linkages with other sources of refinancing and ensures that the target group will continue to access these services after the project ends.

Project design: meso level

Given the nature of interventions at the meso level, IFAD alone does not seem to be strategically positioned to promote interventions with these actors. The decision to proceed with a meso-level intervention should be based on how important any outcome would be to the expansion of retail rural financial services and on whether IFAD has the resources and capacities to ensure a sustainable outcome. In many instances, other donors will already be addressing the problem. If this is the case, IFAD may choose not to become involved or, as is often the case, an initiative may be better off with grant support.

Box 12
Key questions at the meso level

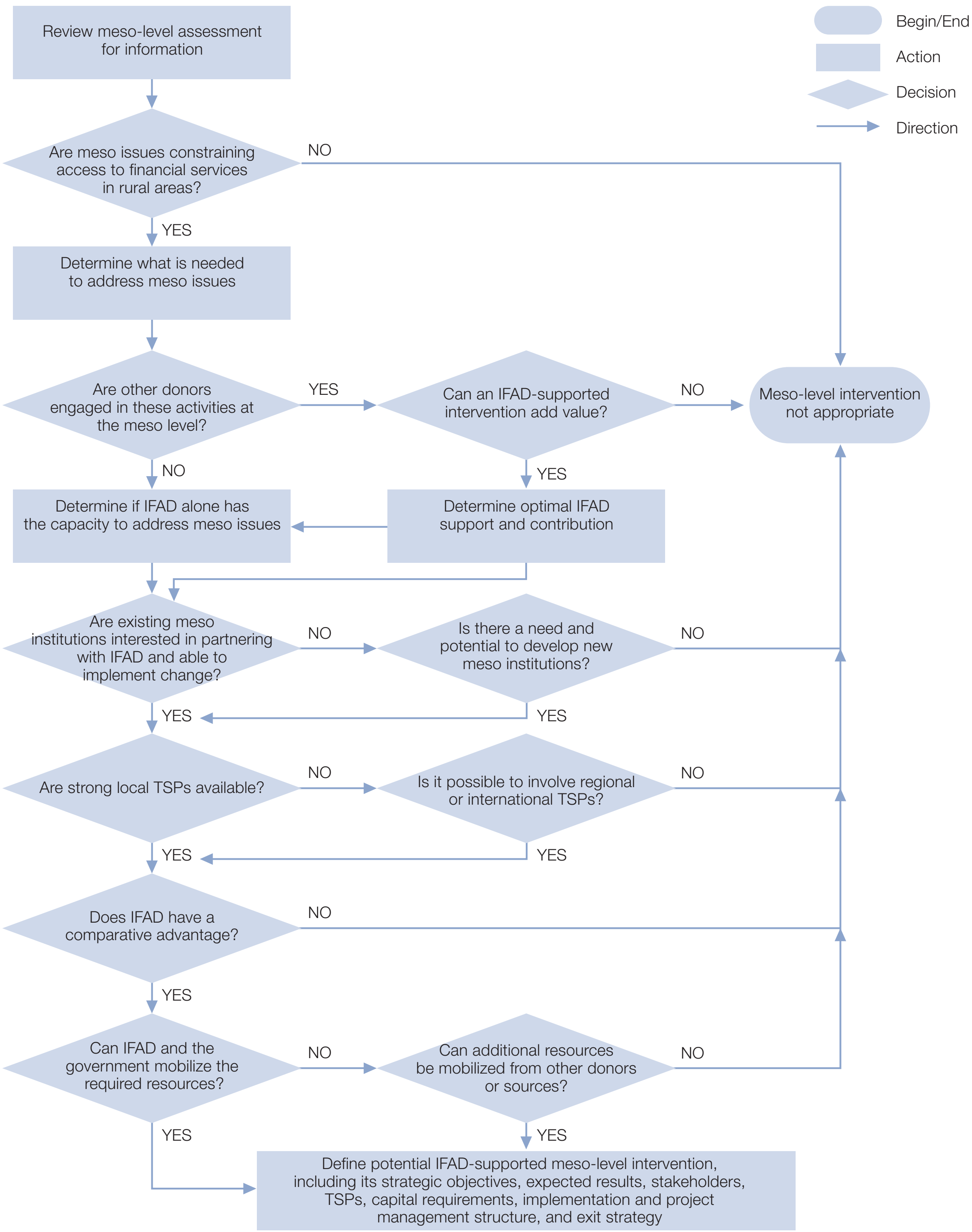
- What challenges and gaps has the market analysis identified in rural areas at the meso level?
- What possible IFAD-supported interventions could address the identified gaps in rural areas?
- What other donors and stakeholders are working on the issue and have strong technical capacity in this area? Why should IFAD be working on this as well?
- Does IFAD have the comparative advantage needed to provide the required support? Does it have the required resources and long-term commitment to support an intervention at the meso level?

Box 13
Good practice project-design principles – meso level

- **Work with existing service providers**, including mainstream organizations, at regional, national and international levels to build market-based, demand-driven service capacity. Avoid creating separate support structures that do not match the level of retail activity.
- **Before supporting onlending from apex institutions, ensure that retail capacity is sufficient** to absorb loan funds. Funding or creating apex lending institutions requires rigorous financial and operational analysis of both the apex institution and the potential recipients of its funds. Sound apex bodies have strong strategic focus, political independence and minimized disbursement pressure, as well as a clear governance structure, performance-based disbursement and leaders with financial management skills.
- **Do not create long-term disincentives for FSPs to mobilize savings and use commercial loans from banks and investors**. Supporting apex funds with capital for onlending in the market can in some situations be pivotal to jumpstarting the microfinance sector. Retail FSPs, however, should have a long-term strategy for accessing capital from the market or, when possible through savings mobilization, for working towards long-term sustainability.
- **Consider technical assistance** in institutional development and product development in meso-level organizations to ensure that sustainable capacity is built.

Source: Adapted from CGAP (2006a).

Figure 5. Meso-level decision tree



Issues to consider

- **Long-term commitment**. Developing second-tier institutions such as industry associations and apex bodies requires significant resources for capacity-building and institutional development, as well as a long-term commitment, often going beyond the typical length of an IFAD-supported project.
- **Sustainability**. Meso-level organizations serving retail FSPs often struggle with sustainability. Funding a specific objective with a clear exit strategy can help ensure that the association does not become dependent on IFAD funding. Long-term support through grants may be a better option for supporting these kinds of initiatives.
- **Technical capacity**. Careful planning is needed; non-FSP meso-level institutional support often requires a different skills set and network of contacts than does support to an FSP. It can also demand understanding of a different regulatory regime.
- **Role of government**. State authorities should be included, as appropriate, in initiatives focused on technology, capacity-building or human resource development, where they can play a promotional role in developing the infrastructure to support rural finance. At the same time, the potential for political interference should be minimized.

Possible areas of focus at the meso level

The following list is by no means exhaustive, and is only meant to offer some ideas (as well as some precautions) on possible IFAD-supported interventions in rural finance at the meso level:

- **Support country-level associations** in order to build the capacity of multiple financial service providers and to disseminate knowledge. All support should be contingent on proof that members value network services (e.g. cost-sharing and other means of supporting network services). Financial and technical support to apex bodies could be dedicated to industry marketing, product development, treasury operations, supervision of member institutions and the integration of rural finance institutions into national payments systems, including the gateway for remittances, cheque clearing, computerization of member institutions, and donor linkages.
- **Promote research and development on the use of technology** for points of service, transfer and payment mechanisms, credit bureaux and other mechanisms. Avoid duplicating the efforts of other donors and private-sector actors, and identify opportunities to collaborate on creating standards for sharing technology platforms and managing information.
- **Advocate increased transparency among financial service providers** in financial statements, performance and outreach on an industry platform. Note also that all IFAD-supported FSPs are required to participate in the MIX Market to the extent possible.
- **Support capacity-building** for local TSPs and establish certification programmes for rural finance practitioners. Improving the capacity of trainers, auditors, raters and certifiers builds fundamental capacity within the sector, making contributions that will continue long after IFAD-supported interventions end.

Project design: macro level

IFAD does not have extensive experience in intervening without partners at the macro level. Such interventions often require greater capacity and a longer-term commitment than IFAD can currently support. Similarly, they usually require the consistent presence of highly skilled TSPs.

Macro-level interventions also typically require the support of an influential public or private advocate to spearhead the reform. Advocates could come from the ministry of finance, central bank, domestic microfinance network, or people in positions of power and visibility such as successful entrepreneurs or elected officials. Successful advocates fully understand what regulatory reform entails, its potential effects, and whether it meets the needs of the rural finance sector. Advocates also have sufficient political authority within the government and financial sector to be influential agents of change (USAID 2005b).

The design team must determine whether an IFAD-supported intervention has the capacity to successfully address a project at the macro level.

Issues to consider

- **Coordination with other donors**. The design team must determine whether other stakeholders are likely to resolve macro issues. Because of IFAD's limited capacity and experience at the macro level, it is strongly recommended that any macro-level project be coordinated with other donors having strong experience and expertise at this level.
- **Importance of macro-level challenges**. Where macro-level intervention is critical to the expansion of rural financial services, IFAD may decide not to support a rural finance project until these critical issues are resolved. IFAD could also choose to support sector associations that work with regulators or policymakers. In more politically sensitive situations, IFAD could work through non-project, grant-based assistance. Whatever the case, such interventions would require at least medium-term support, as most regulatory change takes from three to five years to achieve, or, in the case of policy change, from two to three years.

Box 14
Key questions at the macro level

- What challenges and gaps has the market analysis identified in rural areas at the macro level?
- What possible IFAD-supported interventions could address the identified gaps in rural areas?
- What other donors and stakeholders are working on the issue or have strong technical capacity in this area? Why should IFAD be working on this as well?
- Does IFAD have the comparative advantage needed to provide the required support? Does it have the required resources and long-term commitment to support an intervention at the macro level?
- How great is the capacity of the authorities? Which ministry or institution has the capacity, mandate and power to make changes? Is the government willing to work on this project?

Possible areas of focus at the macro level

The following list is by no means exhaustive, and is only meant to offer some ideas (as well as some precautions) of possible IFAD-supported interventions in rural finance at the macro level:

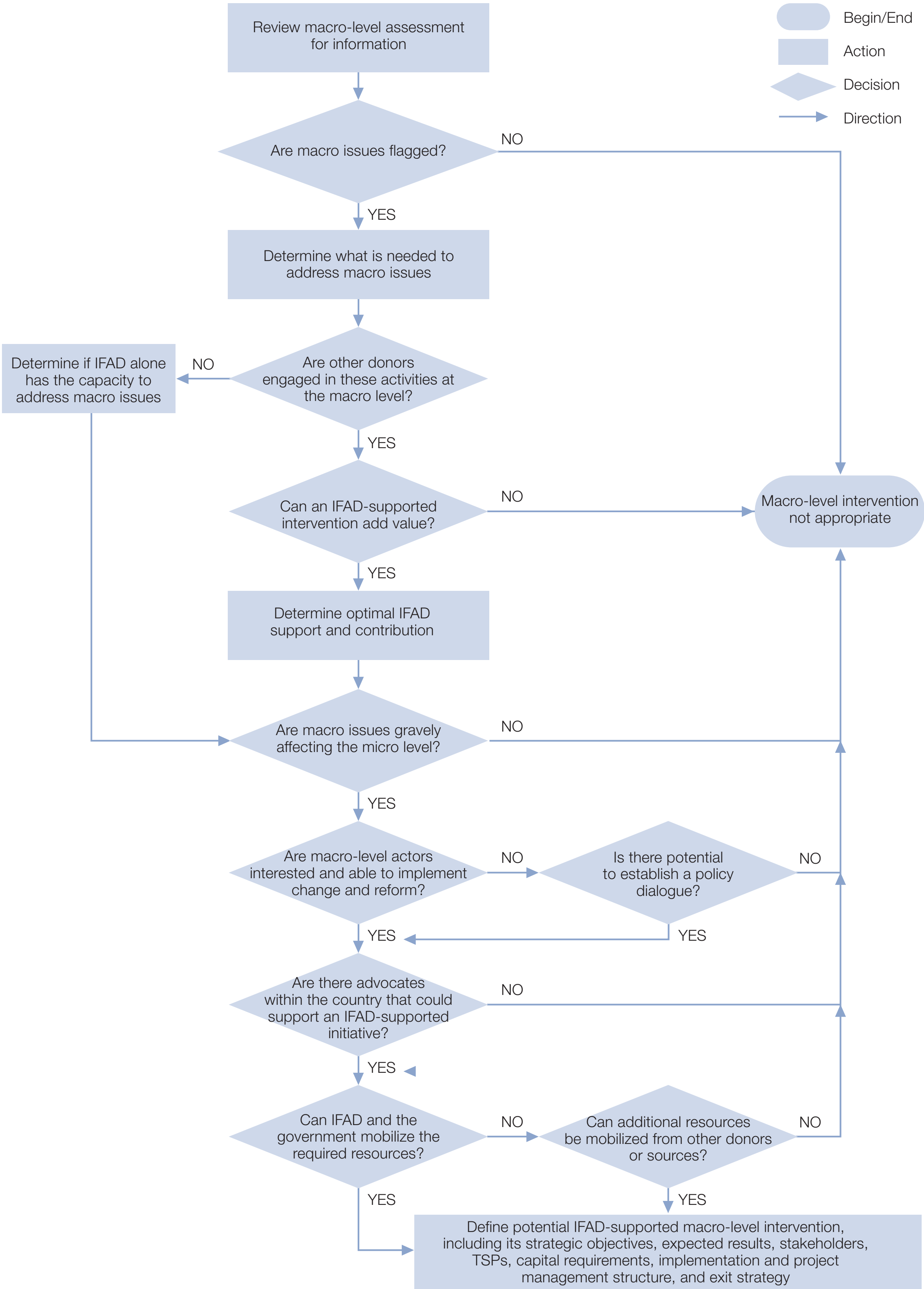
- **Participate in policy dialogues** on creating an enabling environment for rural finance, addressing market failures and key issues such as the legal framework for regulated local financial institutions, reform of state banks and credit cooperatives, liberalization of interest rates, and facilitation of deposit-taking for member clients or public customers.
- **Work with partner governments** in the development of policies and strategies – in line with international good practices for rural finance and the stability of the financial system – that establish the appropriate legal, regulatory and supervisory frameworks to protect savers and create a level playing field among deposit-taking institutions (Peck Christen, Lyman and Rosenberg 2003). Projects can also engage members of the government and civil service on important rural financial issues (e.g. cost recovery pricing) to inform and influence political decision-making (Duflos and Imboden 2004).
- **Build the capacity of key government staff** in ministries of finance and central banks, including supervisory capacity. IFAD-supported interventions can also assist

Box 15
Good practice project-design principles – macro level

- **Support consumer protection**, such as measures to promote transparency in loan costs to clients, consumer education, endorsement of the CGAP Client Protection Principles in Microfinance, and consumer complaint mechanisms, working in concert with similar efforts at the meso level (CGAP 2009).
- **Build on existing policy frameworks and dialogue** (e.g. financial-sector reforms) to promote the legitimacy of inclusive financial systems.
- **Reduce barriers to market entry for FSPs** in order to increase competition and, ultimately, improve the quality of services available to poor clients. Regulation should not prohibit market entry and development by, for instance, requiring a single legal structure for all licensed microfinance providers.
- **Encourage regulatory changes that allow credit-only institutions to lend** without prudential licenses or supervision, but with adequate consumer protection, in cases where non-bank institutions, such as NGOs, need explicit legal authorization in order to lend.
- **Support interest-rate liberalization** through education and advocacy, both directly and by working with stakeholder networks, while encouraging FSPs to work more efficiently in order to bring transaction costs and thus interest rates down.
- **Do not support the direct provision of credit services by governments**, such as government-mandated portfolio quotas, directed credit, borrower loan guarantees or operational subsidies. An exception may be considered in some cases for the provision of financing, subsidies or guarantees to well-run FSPs that are unable to obtain sufficient financing from local capital markets.
- **Do not 'rush to regulate' and 'only regulate what can be supervised'**, as the sayings go. Work with partner governments to adjust the regulatory and supervisory framework for deposit-taking institutions (e.g. cooperatives, postal banks), without pushing for premature or restrictive legislation. Before recommending prudential regulation, make sure that it is truly necessary to protect the safety of savings, there is a critical mass of retail institutions qualified for such regulation, and supervisory capacity exists to monitor and enforce the regulation. Rural finance policies should be integrated into broader financial-sector strategies.

For more technical guidance, see www.smartcampaign.org/tools-a-resources.

Figure 6. Macro-level decision tree



partner governments in establishing or improving the wider institutional capacities needed to provide vital regulation, supervision and oversight functions for the rural finance sector.

- **Support transparent, enforceable improvements in the legal framework** for collateral, taxation and registration. These important modifications can facilitate access to finance, particularly among women.
- **Work with the registrar of cooperatives** and other key players to improve the supervision of credit unions. This could involve improving the cooperative law to facilitate compliance with regulations, as well as the implementation of risk-based supervision. Technical assistance could include experts in cooperative-law policy formulation, as well as in credit union on-site monitoring and supervision.

Project design: cross-cutting issues at all levels

Issues to consider

- **Engage clients and stakeholders**. The effective design and implementation of an IFAD-supported intervention requires the active participation of clients and stakeholders, including rural women and men, as well as potential partner FSPs and TSPs. 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 (Box 18).
- **Coordinate with other donors and work to IFAD's comparative advantage**. Donor coordination is key in rural finance projects. Other donors may be supporting initiatives at the macro, meso and micro levels of the financial system, so it is crucial that initiatives work in coordination and without undermining each other.
  - Define IFAD's comparative advantage in rural finance in the given region;
  - Determine the comparative advantage of other donors in rural finance;
  - Whenever possible, jointly design, fund, implement and monitor rural finance projects with strong donor partners;
  - Harmonize reporting requirements with other donors;
  - Participate in any rural or microfinance donor committees and regularly communicate with other funders on programme design, progress and other developments.
- **Clearly define the target group**. The target market for a rural finance project must be clearly defined. This can be done using market data, and it should be consistent with the overall goals of the project. Evidence must also clearly indicate that the project has sufficient scale to support sustainable outcomes. On the other hand, the project development team should also be careful not to be too ambitious and overextend the scale of an intervention, given available resources and capacity.
- **Scale of the target market**. Defining the scale and scope of any intervention – national, regional or local – is an important step in determining the potential sustainability of a project. IFAD-supported projects typically focus on certain regions or districts. However, the specific target market has often proven too small to introduce sustainable financial services: FSPs would not break even facing such low volumes and high costs. Scale has been especially problematic in multifocus

projects where credit was used as an input to meet other agricultural development objectives. The volume of client demand must be large enough to attract a supplier willing to provide services on a sustainable basis. When determining the scale of the target market, keep in mind that the sustainable FSP is typically the one that serves a range of clients in different areas with a wide range of products.

- **Characteristics of the market**. The nature and scale of market demand is often defined by its geography or its predominant agricultural activities. These two considerations will strongly influence whether a financial service supplier is interested in serving a market and able to do so sustainably. If the market is too small, for example, or if the population density is too low to generate low transaction costs, then service providers may not be able to offer profitable and thus sustainable services. If there are major risks due to the climate or main commodity markets in an area, lenders may be hesitant to serve agricultural households in that market.
- **Design a stand-alone project whenever possible**. IFAD-supported rural finance interventions have either been stand-alone projects or smaller components within larger rural development projects (e.g. an agricultural development project that includes a small intervention on rural finance). According to IFAD's experience and general good practice, stand-alone rural finance projects have a much greater chance of success than multifocus projects (CGAP 2003). A recent corporate-level evaluation of the RFP (IFAD 2007a) found that projects that attempt to tackle many different development objectives tend to scatter programme resources and do not dedicate the required attention to rural finance. If, for example, the target group of an IFAD-supported project on agricultural technology needs credit to purchase crop inputs, then linking them to an existing FSP would be more effective and sustainable than trying to insert a rural finance component into the activities.
- **Focus on one level of the financial system**. Due to capacity constraints, it will rarely be a viable option for an IFAD-supported rural finance project to intervene alone on more than one level of the financial system, though the market assessment may suggest that interventions could be warranted at more than one level. Effective micro-level efforts, for example, often call for changes in the enabling environment to maximize their long-term impact and/or sustainability.
  For IFAD, engaging at the macro or meso level should be contingent on whether the intervention would be critical to the expansion of retail financial services. To maximize the impact of its interventions, IFAD must rely on strong donor coordination working at multiple levels of the financial system.
- **Work towards strong, independent institutions**. Donor support in rural finance is required mainly to strengthen the delivery capacity of FSPs in rural areas and to upgrade non-formal institutions to higher legal forms, as necessary. Provision of training and consultancy services, improvement of professional standards and purchase of operating assets all constitute forms of subsidy. While IFAD supports a wide range of capacity development for rural finance institutions, interventions should not reinforce aid dependency. Instead, they should lead to the autonomy of the partner institution.
- **Monitoring and evaluation**. Successful rural finance projects have a robust monitoring and evaluation (M&E) system that can track performance of FSPs and identify areas that need added attention. Though the M&E system will not be

operationalized until project implementation, its design should begin in the early phases of the overall project design (see chapter 4 for further details on M&E).

- **Define the exit strategy**. IFAD-supported projects should clearly define an exit strategy: a plan that allows the project to either replicate in other areas, scale up in the project area, or effectively disengage from partner implementing institutions, leaving them in a position to continue sustainable operations without further inputs from donors. In implementation, institutional development programmes should have incentives to build internal capacity and reduce dependency, while training and technical assistance costs become integrated into the institution's budget over time.

Box 16
Establish the project management unit

The team responsible for project management and implementation is the project management unit (PMU). When determining the most effective structure for the PMU, consider the following:

Location considerations

- Good practice shows that the ideal project management structure is competitively selected private-sector management, such as an NGO with high-quality project management capacity or a proven consulting company. The PMU would ideally have an independent legal structure, with a clear performance-based contract to guarantee accountability and a clear firewall against political pressure.
- Most PMUs are housed within or staffed by a particular government ministry. In most cases, however, close PMU association with or direction by a government ministry is against good practice. Direct government involvement in project management should be avoided.
- If housing the PMU outside the government is not possible, then the most relevant government ministry – typically the ministry of finance – should be selected to host the project. Usually this ministry has a firmer grasp of basic good practice in rural finance projects than does the ministry of agriculture, for example.

Staffing considerations

- PMU staff should be competitively selected. Clear criteria for identifying and selecting key rural finance project staff should be detailed in the project design document.
- IFAD should be involved in developing the terms of reference and recruiting staff for the PMU team. This participation will help avoid the politicization of the PMU and its personnel. If IFAD itself cannot be involved, then it should insist on a mutually agreeable and highly competent representative.
- For stand-alone rural finance projects, the programme manager selected to coordinate the PMU should be a rural finance expert with significant experience in project management, as well as the ability to interact with high-level government officials and a wide range of other stakeholders. At a minimum, managers must be familiar with reading the balance sheets and income statements of complex financial institutions and working with FSPs to improve their performance and outreach in rural areas.
- Ongoing staff training in rural finance is important, for those both with and without significant rural or microfinance experience.[12] This includes sensitivity to gender and ethnic issues in the delivery of financial services and awareness of when expert input might be needed on these and other issues.
- It is critical that the staff of the PMU be given authority to represent IFAD at national donor coordination events. This, too, may require training, but having strong in-country representatives is essential, particularly given that IFAD does not have a permanent field presence in most countries.

[12] The Boulder Institute of Microfinance, Frankfurt School of Finance and Management, School of Applied Microfinance, and MicroSave, among others, offer microfinance training programmes for practitioners, donors, managers and consultants.

Box 17
Establish a project steering committee

The project steering committee should include a range of stakeholders:

- Government officials from several departments (within the ministries of finance and agriculture), ideally with knowledge of the rural finance sector and few shared political interests;
- A strong complement of donors in rural finance, including IFAD;
- Expert external stakeholders, who can help mitigate possible government interference and contribute additional expertise;
- Expertise on gender and, as relevant, cultural and ethnic issues, given the importance of women as potential rural finance clients and the multiple constraints that women and ethnic groups continue to face in accessing financial services;
- The PMU usually reports to but does not sit on the committee. Decision-making and management of the committee should be transparent and the meeting minutes should be publicly available.

Box 18
Engaging stakeholders effectively

Since stakeholders provide a project its 'license to operate', the project development team needs to ensure that relevant stakeholders are included in the design process as appropriate. A structured approach to their engagement is critical early on. Understanding the expectations and potential influence of stakeholders will ensure that project design and implementation have the full benefit of incorporating these important considerations.

Each context requires analysts to consider who the intended beneficiaries are, who else will be affected, and who can exert influence and contribute to a project either directly or indirectly. Special emphasis should be placed on stakeholders normally marginalized from mainstream finance.

In some cases, the various stakeholders will be obvious (e.g. there may already be a list of target clients), though they may have different or even conflicting interests to consider. It is also important that women stakeholders are given the chance to articulate gender concerns, and that they are included as full members of other stakeholder categories (e.g. farmers, small business owners). Sometimes stakeholder interests will be difficult to define, especially if they are 'hidden', or in contradiction with the openly stated aims of the project or the organizations involved.

Analysts should recommend the appropriate level of participation for each stakeholder group in project design and implementation. Generally, stakeholders can have three levels of interaction. They can:

- Be consulted;
- Assist directly in the project; and
- Have decision-making participation.

Stakeholder engagement methods should be subject to accepted research practices, recognizing specific cultural adaptations and the need to take into account gender dimensions. In particular, analysts must take a representative or at least defensibly indicative sample of opinions from each stakeholder group.

If the project would support rural finance mechanisms that are owned by clients or user groups (e.g. SHGs, FSAs), then considerable time and effort should also be spent identifying the stakeholders that will assume leadership roles in the project. Rural finance projects in very low-population-density areas are often user-owned. The sustainability of these projects is very much tied to user buy-in to the model and their administrative capacity, as they will be responsible for managing the mechanism.

Box 19
Classic errors in rural finance

- Restricting FSPs to target markets that are not large enough to support sustainability, which makes interventions donor-driven and short-lived.
- Using finance as an input to achieve multiple and varied development aims, such as soil conservation or irrigation, which takes the focus away from providing demand-driven, sustainable financial services.
- Focusing on credit as the only financial service needed by poor people in rural areas, when their demand for financial services also includes savings, money transfers, insurance, and so on.
- Using donor-funded projects or revolving loan funds to try to deliver financial services, instead of working with financial service providers who have the mission, focus and capacity to successfully serve the target group over the long term.
- Mandating interest rates that are not high enough to motivate lending activity or to compensate for the risk and opportunity cost of capital, which in many cases leads to operating losses for FSPs and no improvement in access to credit and other financial services for the target group.
- Providing finance for on-farm improvements that make sense from a development perspective, but that do not make financial sense to farmers (i.e. the returns on the farmer's investment are not sufficient to pay the interest on the loan).

3. Assessing and selecting project implementation partners

3. Assessing and selecting project implementation partners

- **Action**: Assess and select project implementation partners through a transparent, competitive process.
- **Objective**: A strong network of partners to work towards achieving project objectives.
- **Key players**: CPMT, PMU, and CPM, with possible support from specialized rural finance consultants as necessary.

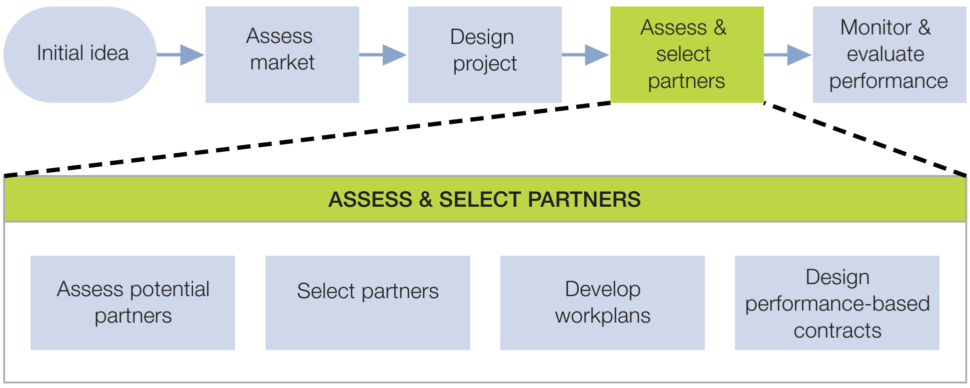
This section addresses critical issues related to the identification and assessment of project partners. It focuses on issues unique to rural finance. However, additional, more general elements are also important to consider (e.g. hiring of project staff, communications between headquarters and in-country staff, accounting and disbursement processes).

The issues discussed can arise at different moments in a project's development and implementation. The identification and *initial* assessment of partner FSPs, for example, should take place during project design, while the *detailed* assessment and selection process is somewhat fluid. Depending on the project and regional context, the process may occur entirely during project design, or may begin in the design phase with the development of the selection criteria and conclude in the initial phase of implementation, with the actual selection of FSPs. While the timing varies from project to project, all the issues will be considered.

Partner financial service providers

The assessment of an FSP must be conducted by a rural finance specialist with extensive experience in performing institutional diagnostics of these kinds of institutions. CGAP (2007) is a useful resource for these assessments (see also Spann 2008).

Figure 7. Assessment and selection phase



An institutional assessment tests an FSP's depth of interest and its capacity to provide sustainable rural financial services. The institutional assessment varies depending on the type of institution being analysed: institutions with a more-formal, centralized structure (e.g. a bank or financial cooperative) should be handled differently than those with a more-decentralized, community-based structure (e.g. SHGs or credit unions).

Assessing more-formal, centralized FSPs

A formal, centralized FSP should be evaluated based on the strength of its leadership, its profitability, the quality of its portfolio, its access to financial resources and the strength of its systems. In particular, the following areas should be assessed:

- Capacity
- Planning processes and risk management
- Organizational structure
- Market and services
- Management information systems (MIS)
- Financial management and administration
- Financial performance
- Social performance
- Internal controls and transparency

See Table 8 for additional details.

The assessment should also consider the FSP's business plan, which is an important part of organizational management and capacity-building. Partner FSPs should submit detailed information on their goals, strategy and plans to expand into rural finance markets.[13]

The business plan will identify the specific areas in which IFAD support is most needed. Once FSPs have been selected and their commitment established, their business plan should be modified as needed to incorporate the objectives of the IFAD-supported project. Effective business planning requires establishing practical and operational conditions for the project's implementation. This involves developing appropriate and detailed workplans not only for capacity-building and technical assistance, but also for operational support that could include human resources, equipment, monitoring and reporting.

Assessing decentralized, community-based FSPs

Compared with relatively more-formal FSPs, decentralized, community-based organizations are much smaller, have lower cost structures, different products, and diverse financial administration methods. Their members save, borrow and invest their returns in the association. Thus these groups can only survive by maintaining high levels of member participation and satisfaction.

The following questions can help evaluate the success of a community-based association:

- What is the demand for the financial services provided by these groups, and who benefits from them? How useful do group members find the products or services provided?

[13] The preparation of a business plan is not always feasible for community-based FSPs. However, their supporting institutions should have a vision or mission statement, a set of key activities and a clear sense of direction.

- What is the capacity and interest of group members in governing and participating in the groups?
- How well do the groups perform in terms of mobilizing savings, making sound loan decisions, encouraging timely repayment and sharing information? How has this changed over time?
- Are the groups linked to other FSPs that provide a wider range of services? Is this part of the long-term strategy?
- What is needed in terms of capacity-building? What TSPs are available to provide this support?

Effective tools for evaluating community-based FSPs include the following:

- *Ratio analysis of community-managed microfinance programs*, developed by SEEP (2008); and
- PEARLS – or *Protection, effective financial structure, asset quality, ratios of return and costs, liquidity, and signs of growth*, developed by the World Council of Credit Unions (WOCCU 2009). PEARLS is a financial performance-monitoring system designed

Table 8. Elements to examine in potential FSP partners

Planning	• Well-defined vision and mission • Thorough business planning • Comprehensive planning process • Appropriate monitoring mechanism(s)
Organizational structure	• Well-defined ownership structure • Well-defined legal structure • Adequate governance • Adequate senior management • Adequate organizational structure
Markets and services	• Defined target markets • Risk management tools for market risk assessment • Assessments of its competitive position • Competitive product offerings • Documented and updated credit policies and procedures
Management information systems	• Adequate data collection • Adequate record management and security • MIS components linked automatically • MIS applicable to FSP needs/requirements • Accurately generated reports
Financial management and administration	• Adequate accounting and policies and procedures manuals • Written portfolio management policies • Adequate asset/liability management • Appropriate cash and liquidity management
Financial performance	• Adequate sustainability and profitability indicators • Adequate asset/liability management indicators • Acceptable portfolio quality indicators • Adequate efficiency and productivity indicators
Internal controls	• External audit • Documented internal controls for all operational and credit processes

to offer management guidance to credit unions and other savings institutions. It comprises a set of indicators that can be used to compare and rank institutions and facilitate an analysis of their financial condition.

Selecting FSPs: Understanding their strengths and weaknesses

A competitive process evaluates an institution's interest in project participation and its long-term commitment to rural finance. Partnerships should not be established solely on the grounds of having an operational presence in the target markets, but rather on the basis of performance results that demonstrate the capacity to effectively deliver financial services to IFAD's target group.

Context, capacity and FSP interest govern how many FSPs should participate in an IFAD-supported project. Some IFAD-funded rural finance projects involve several FSPs, while others work with only one. Working with multiple FSPs in a project can stimulate performance and drive results, particularly when technical assistance funding is allocated on a competitive basis and linked to performance. Projects supporting multiple FSPs can also shift technical assistance resources from underperforming institutions to better-performing competitors.

In the absence of a sound rural FSP, it may be possible to find, attract and support qualified FSPs operating in urban and peri-urban areas in expanding into an IFAD project target market. This strategy is often more effective than working with an unqualified partner or starting a new FSP altogether.

If a project team considers working with an FSP that has a number of weaknesses, then these challenges must be accurately analysed. Projects with the goal of resurrecting or improving existing FSPs (particularly state agricultural development banks) are valid, but can reduce short-term client impact.

- If the weaknesses of an FSP reflect poor management and a lack of leadership or commitment, then IFAD should not partner with the institution.
- If the weaknesses are linked to poor systems and limited capacity, but the management is committed to change, then there could be potential for successful partnership and reform. A capacity-building plan that includes jointly established performance milestones and indicators should be negotiated with the FSP. Funding should be disbursed in tranches as each successive set of targets is met.
- If there are weaknesses in the social or gender dimensions of operations, then a decision must be made as to whether it will be possible to address these through a social and gender audit, followed by capacity-building. If the FSP does not seem committed to addressing these concerns, then IFAD could either choose not to partner with the institution or design the project with a set of strict social performance-management and performance-based targets, based on short- and long-term objectives. Funding should be disbursed in tranches as each successive target is met.

Ultimately, any project must squarely intersect with the strategic interests of the FSP if financial services are to be sustainably expanded to rural areas. Partner FSPs must see the market as a competitive advantage and growth market.

The FSP must also be prepared to assign a staff member as the point person on the IFAD project. This person will liaise with the PMU to ensure adequate advancement, issue resolution, risk mitigation, monitoring and reporting. The manager must be senior enough to command the authority needed to implement the project and to represent the project at the highest levels of the FSP relative to established organizational structures (i.e. in a commercial bank, to a senior manager or the CEO, or in a smaller financial institution, to the management committee or governance body).

Developing a performance-based workplan with partner FSPs

In addition to integrating the IFAD project into the business plan, the PMU and partner FSP should develop a detailed workplan before any funding is disbursed. Performance-based workplans should be developed that require the partner to meet specific goals before additional resources are turned over. The plan must outline a detailed set of activities, performance standards for each activity, time lines for meeting standards, and the project inputs required to meet the given time lines and standards.

Workplans should set out specific goals, including:

- Mechanisms for staff accountability through performance-based incentive schemes;
- Mechanisms to reduce administrative costs and enhance productivity;
- Prudent time lines for product/service development (i.e. not so slow as to inhibit timely roll-out of services, but not so fast as to jeopardize their quality); and
- Plans to roll out new services or products relatively rapidly once they are operational.

The project workplan should not overdefine the target clients or financial products and services to be offered. Strong support from senior management should be reflected in any agreements (especially the workplan) to ensure that the minimum essential conditions for effective rural finance operations are in place.

The project team and FSP will also establish detailed capital requirements for project implementation. If funding is required, then FSPs should be encouraged to commit a portion of their own resources as a complement to IFAD funding, particularly loan portfolio capital. Dedicating cofunding to a project allows an FSP to demonstrate its interest in the market, commitment to project implementation, and institutional confidence in facing the risks inherent in any rural finance project.

Partner apex organizations

As with FSPs, apex bodies must be assessed to determine their ability to provide services efficiently and effectively towards the project's goals (Levy 2002). Among other considerations, the main criteria to select partner apex organizations should include:

- A clear sense of mission and market-oriented management;
- Organizational structure with decision-making autonomy, free of political interference, particularly when apex institutions are state-owned or agencies of a government administration. Governments should not control apex bodies, and their participation in management should be limited to the extent possible;
- Segregation of microfinance from other mandates and responsibilities;
- Sound management information systems and internal controls;
- Strong leadership, with extensive experience in microfinance and the capacity to resist possible external pressure;
- Well-trained and motivated staff, with appropriate incentives.

Except in the rare case where a large group of substantial, credit-worthy FSPs exists when the apex body is set up, it is strongly recommended that initial funding to an apex be small, with subsequent tranches disbursed based on progress in expanding outreach and improving the financial performance of partner FSPs. Disbursements should follow, rather than try to drive, demand from promising FSPs and the development of the apex organization's own skills and systems. All stakeholders should be educated to expect only modest results from the apex institution in its initial years.

Apex bodies should also avoid unnecessary conditions for FSPs, such as interest rate caps or a focus on target populations or regions that may not be bankable. In addition, apex institutions must avoid competing with commercial lending from banks and investors or crowding out savings.

Finally, and perhaps most importantly, apex bodies should be free from inappropriate donor and government pressure. Donors and governments often have a strong preference for large, rapidly disbursing projects. But this kind of outside pressure makes the task of apex managers exceedingly difficult by hampering the application of sound funding criteria and interfering with the natural evolution of the apex body's skills and systems. Furthermore, acquiescence to outside pressures creates an environment in which political interference becomes more likely. Where disbursement pressure is likely to be great, and the apex institution and member FSPs have only limited capacity, IFAD projects should avoid partnering with an apex organization.

Partner technical service providers (TSPs)

Technical assistance (TA) to partner FSPs and apex organizations can be an important part of any IFAD intervention in rural finance. The workplan, mentioned above, should focus on the organization's capacity-building priorities and should detail all TA-related activities, the required human and budgetary resources, implementation milestones and time lines, and related performance expectations. It should also be aligned with the project's logical framework and key performance indicators to ensure that overall goals are being met in a manner consistent with the IFAD RFP.

TA plan

While each partner institution will require a unique approach, many will often need the same or similar TA services. The PMU or equivalent should organize and manage all TA provision using a TA plan. Such a plan outlines how technical assistance will generally be provided (e.g. short-term, fly-in consultants, long-term resident advisers), though it is important to maintain some flexibility on the specific services provided in the short- to mid-term in order to accommodate changing FSP needs and inevitable scheduling challenges.

Box 20 shows a number of options for providing technical assistance. The support required will depend on the types of FSPs or apex organizations involved in the project and the nature of their strengths and weaknesses.

At this point, it is important to define how these TA services will be delivered. A rural finance expert can then estimate the types and costs of TA service provision (though the most accurate estimates are derived from a competitive project management bid). Various TA service-delivery models are available:

- Contract a project management consulting firm (for- or not-for-profit) that designs and delivers TA service-provision systems, sharing the responsibility with them to meet project goals. This is the most effective delivery system;

- Hire long-term resident technical advisers that work on site at the FSPs on a range of TA challenges;
- Contract a mix of long- and short-term advisers to do specific tasks. This is the most common approach.

Adviser models require significant expert input on TA service delivery, as well as knowledge of when FSPs are likely to need specific services in their development cycle. More often than not, PMU staff do not have the capacity to organize and source expert, international-quality technical assistance. Nevertheless, using the PMU staff to manage and/or provide such assistance is usually the least effective model. Whatever strategy is chosen, it will be important to include social, gender and, where relevant, environmental expertise as part of the assistance.

Conducting a transparent, competitive selection process for TSPs

Establish a clear selection framework for TSPs in the project design in order to attract the best expertise, make the process as transparent as possible and ensure that TSPs are accountable for the results.

- Identify specialized TSPs – whose expertise is proven and acknowledged as international-quality – that could be relevant to the IFAD-supported project.
- Outline a transparent, competitive selection process for international-quality TSPs that clearly details the requirements, qualifications, selection criteria and performance metrics used to evaluate their potential participation.
- Prepare to establish contractual agreements between the IFAD project and the TSP that include a detailed workplan, time line, expected results and the required human and financial resources.

Box 20
Common TA activities

- Human resources
  - Design staff hiring policies and procedures
  - Plan staff training
  - Expand training modules for staff
  - Support staff assessment and incentives
- Operations
  - Streamline and improve operational processes and procedures
  - Organize branch offices
  - Prepare process manuals on administration, accounting, operations and internal controls
  - Manage information systems
  - Establish internal audit and control systems
- Methodologies and tools
  - Develop systems and techniques for mobilizing savings
  - Improve loan appraisal and portfolio management
  - Implement marketing research and client surveys
  - Develop marketing plans
- Product development
  - Design and test savings products
  - Design and test credit products
  - Design and test new products, such as insurance and leasing

In most cases, national, regional or international rural finance TSPs will need to be recruited to help the IFAD-supported project meet the challenge of building new rural finance networks or strengthening partner FSPs. It is important to set the right selection framework to attract the best expertise, making it clear that the TSP will be accountable for the results.

Where tendering is used for such recruitment, the following framework for a request for proposals could be used (adapted as needed) to select potential applicants. It needs to address both technical and financial dimensions and should include:

- A brief description of the rural finance TSP firm, its rural finance projects or programmes (including past, present and planned projects), and the administrative, financial and technical support services that the TSP firm can provide;
- A description of its capacity-building strategy, areas of technical expertise and resources required;
- The human resources available to implement programme activities, including their qualifications (i.e. résumés or curricula vitae) and references;
- A preliminary workplan, including a time line.

In order to rank the proposals for final selection, a scoring methodology could be used to distribute points among the selection criteria. On the basis of a scale of 100 points, for example, the technical quality and feasibility of the proposal could account for 70 of these points, and the cost-effectiveness could account for the other 30. Each proposal could be evaluated as follows:

- Rural finance experience of the TSP (20 points);
- Proposed operational strategies for implementation (25 points);
- Experience and qualifications of the operating team assigned to the project, which is often the best assurance of the quality of the assistance to be provided (25 points);
- Cost-effectiveness of the proposal and the proposed budget for TA activities (30 points).

Box 21
TA workplan checklist

An effective workplan for the delivery of technical assistance should include the following elements, outlined in sufficient detail to be carried out in a timely, responsive manner:

- Assurance and evidence that FSP personnel have the capacity to support the project;
- Objective of the technical assistance and the means for its delivery;
- Clear identification of the person responsible, important benchmarks and deadlines for each activity;
- All aspects of expected institutional change;
- Any additional external professional assistance required;
- Pending or needed agreements;
- Process of risk identification and mitigation as well as issue resolution;
- Mechanism for monitoring and reporting on the workplan and updating it as needed;
- Clear timing schedule for fund transfers that corresponds to the overall workplan.

The number of points given to the criteria in this example is only illustrative and intended to show how the relative weight and importance of each section could be balanced when reviewing a proposal.

Establishing performance-based contracts

It is important to establish performance-based relationships with partner FSPs, TSPs and other service providers. Objective, measurable performance targets should be set by the FSP or TSP, PMU and governing body before project implementation, and should be included in the contractual arrangements. Disbursement of funds in IFAD-supported projects should be linked to the performance of an organization and its contribution to project objectives.

In general, projects should

- Use performance-based contracts with agreed performance targets and exit strategies;
- Include a few core indicators to track financial and social performance (for FSPs: general outreach, outreach to poor people, portfolio quality, profitability/ sustainability, efficiency), without burdening them with too many indicators;
- Collect the baseline measurements of these core indicators to understand the current performance of the institution, highlight weaknesses that call for prompt intervention, and define a point of reference to later understand progress towards the project's objectives;
- Tie renewal or continuing support to the achievement of clear, meaningful performance targets;
- Be prepared to stop supporting institutions that do not perform as agreed, either by discontinuing subsequent tranches of support or requiring reimbursement (where feasible);
- Require institutions to fulfill their own responsibilities under the contract (e.g. timely disbursement, prompt responses to questions) (CGAP 2006a, 12).

Corrective action must be taken if performance does not meet the pre-agreed standards. Project designers should:

- Allow sufficient time for technical assistance to show results, and define progressively higher minimum performance standards;
- Create a provision that, if the institution has difficulty meeting the standards, a series of discussions or negotiations could be held to determine a mutually agreeable course of action and define new performance targets;
- Set a time limit on meeting any new standards. How long an institution should be given will ultimately rely on expert judgment, but most projects do not allow more than a year to turn things around.

If an institution cannot meet this challenge, then the project design should provide for the suspension or withdrawal of funding. When more than one FSP is involved in the project, funds can be moved from underperforming FSPs to others with stronger performance.

4. Conducting performance monitoring and evaluation

4. Conducting performance monitoring and evaluation

- **Action**: Effectively conduct ongoing and annual performance monitoring.
- **Objectives**: Monitor performance of projects, introduce corrective measures as needed, and distil lessons from project implementation.
- **Key players**: PMU for implementation and CPM for supervision.

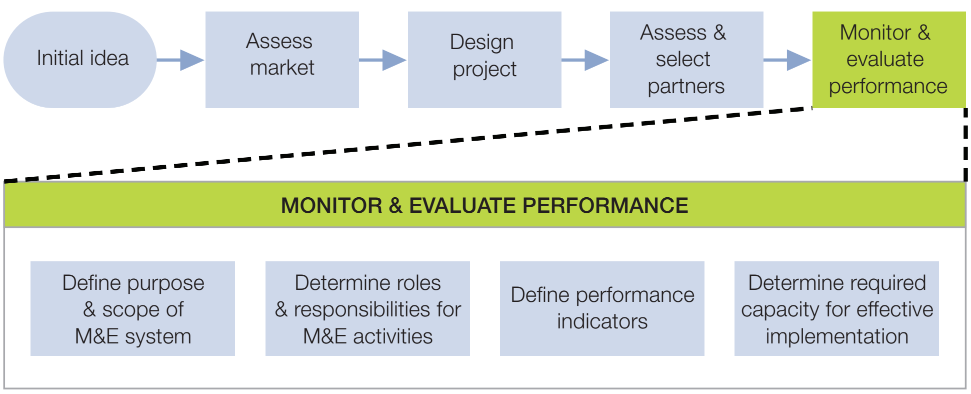
Project performance M&E is a critical component in a well-functioning project. Although M&E takes place during implementation, it should be developed as part of the project design to ensure performance-based results.

Performance-monitoring and evaluation framework

'Performance' has been defined as the extent to which FSPs or delivery mechanisms reach their target market (depth), the number of clients served (scale), and the degree to which they do so equitably and sustainably (see also World Bank 2006). Designing the framework for performance monitoring and M&E includes a number of key steps:

- Clearly define the purpose and scope of the M&E system and the information and outputs expected;
- Provide a general description of key stakeholder audiences (e.g. PMU, IFAD headquarters) and the types of performance information they each expect, when that information is required, in what format, and who is responsible for collecting it;
- Define the performance indicators to be collected and analysed for each stakeholder audience (see Box 24 on page 64 and Table 9 on page 65, for recommended financial, outreach and social performance indicators);
- Detail the necessary conditions and capacities required to manage the M&E, including the number of M&E staff, their responsibilities and linkages to other management activities, and incentives;
- Develop a budget for M&E activities;

Figure 8. Monitor and evaluate performance phase



- Define the steps that will be taken if the programme or partner FSPs fail to meet the established performance criteria over a given period of time. IFAD should be in a position to stop supporting implementing partners on a timely basis if they are not meeting performance expectations (see section 3 on performance-based contracts).

Identifying relevant performance indicators

Only information that can be easily gathered, tabulated and used to draw simple, meaningful conclusions should be used for monitoring purposes. Each indicator should be clearly defined, and a common format for their collection should be developed. Avoid extraneous information and non-standard formats, as these can lead to 'noise', make it difficult to measure progress, and detract from the focus of the project.

Table 9, at the end of this section, provides some standard indicators.

- Indicators should be results-based, emphasizing project and institutional performance and development impacts (e.g. portfolio quality and operational efficiency of FSPs), rather than simply the achievement of a certain number of activities or outputs (e.g. number of meetings or number of people trained) (Rosenberg 2009; IFAD 2002a).
- Include key performance indicators and targets in the project design and in contracts with partner FSPs, in addition to quarterly governance committee meetings, annual supervision missions and evaluations. FSP performance requires constant vigilance to anticipate developing problems, identify ongoing management challenges, and meet needs.
- Include participation in the MIX Market in the project design and in contracts with partner FSPs (see Box 23 on page 63).[14] IFAD requires partner FSPs to share their outreach and financial performance information on the MIX Market on an annual basis, to the extent possible.

Box 22
Key processes related to the M&E system

1. **Planning**. The process of setting up project objectives, deciding the time needed to achieve them, how, and by whom, is the first necessary element of a project M&E system.
2. **Identification of performance questions**. This phase specifies what information should be collected in order to respond to the knowledge demand expressed by project stakeholders. This implies specifying what information has to be collected, when, for what reason, and how this is expected to be used.
3. **Data collection**. This phase relates to the collection of data needed to respond to the performance questions formulated by project stakeholders. Data should then be stored and processed in order to be used for analysis.
4. **Data analysis**. The information is analysed, clarified and organized in order to assess whether results have been achieved, identifying best and worst practices while pointing out correlations and changes that have occurred over time at the level of individuals, households, communities or institutions.
5. **Communication**. The results of the analysis are communicated to stakeholders concerned: government, funding agencies, beneficiaries, implementing partners, donors, managers. M&E findings can be reported in various ways: written reports, audio-visual techniques, workshops and brochures.

Source: IFAD (2007b, 3).

[14] MIX Market website, www.mixmarket.org.

- For highly decentralized, community-based models of financial services – including self-help groups and village savings and credit groups – with limited capacity to keep records and simple manual tracking systems, it would be important to at least track an outreach indicator (e.g. number of active borrowers and savers, average loan size) and a repayment indicator (e.g. loans at risk, current recovery rate) (see Table 9 on page 65).

This information could be supplemented by follow-up studies, as necessary, to examine emerging problem areas, such as gender inequalities in access, and how to address them.

Box 23
The MIX Market

The MIX Market™ is a global, web-based, microfinance information platform. It provides information to sector actors and the public at large on FSPs worldwide, public and private funds that invest in microfinance, FSP networks, raters/external evaluators, advisory firms, and governmental and regulatory agencies. The MIX Market seeks to develop a transparent information market to link FSPs worldwide with investors and donors and to promote greater investment and information flows.

IFAD requires partner FSPs to participate in the MIX Market and share their outreach and financial performance information on an annual basis, insofar as possible. Reporting to the MIX Market requires that FSPs use standard formats for financial statements and indicators for portfolio quality and outreach, thus building their capacity and further integrating them into the mainstream financial sector. Listing on the MIX Market also provides FSPs with exposure to potential investors and international networks and encourages improvements in outreach and performance.

Box 24
Core social performance indicators

In microfinance, the success of an FSP has long been associated with financial performance, as measured by operating efficiency, profitability and the quality of the loan portfolio. Yet, these indicators tell only part of the performance story in microfinance.

Most microfinance institutions strive to meet both financial and social goals, managing a double bottom line. Strong financial performance underpins an FSP's ability to pursue its social objectives, and conversely, achieving social goals generally enhances financial performance.

The core indicators for social performance management fall into four categories: intent; strategies and systems; politics and compliance; and social outreach and outcomes.[15]

1. **Intent**
- **Mission and social goals**. Mission statement; social goals of the mission include outreach to poor, very poor and low-income people, SMEs, underdeveloped areas, women (together with empowerment), and socially marginalized people and communities, as well as employment creation;
- **Governance**. Experience and background of the management, including specific training on social performance; the independence of the body of directors; executive compensation and achievement of social goals;
- **Values of social responsibility**. Policy for client protection; social responsibility to community and the environment.

2. **Strategies and systems**
- **Range of services**. Financial products; non-financial services; lending methodology;
- **Use of social performance (SP) information** by board and management. Management evaluation; use of SP data on product development, marketing and strategy planning;
- **Training in mission**. Staff training in social mission;
- **Staff incentives**. Incentives related to social mission and values;
- **Market research**. Systems for obtaining feedback from clients; client satisfaction surveys;
- **Client retention**. Exit/dropout rates; exit surveys or informal feedback from exiting clients;
- **Poverty evaluation**. Methods of calculation of poverty levels of clients; methods of collection of information;
- **Services supporting empowerment**. Promotion of women's empowerment.

3. **Politics and compliance**
- **Social responsibility to clients**. Fair treatment of clients;
- **Costs for clients**. Transparency in pricing; information disclosure;
- **Social responsibility (SR) to staff**. Elements included in FSP's SR towards staff;
- **Social responsibility to community**. Elements included in FSP's politics of SR towards community;
- **Social responsibility to the environment**. Elements included in FSP's politics of SR towards the environment.

4. **Social outreach and outcomes**
- **Geography**. Percentage of clients living in diverse geographical areas;
- **Women**. Percentage of women clients;
- **Poor and very poor**. Poverty rates according to national and international poverty lines;
- **Client exit rate**. Client exit/dropout rate;
- **Client retention**. Clients still with the institution after three or five years;
- **Households in poverty**. Clients still below the poverty line;
- **Families out of poverty**. Clients who moved above the poverty line.

[15] MIX Social Performance site, www.themix.org/standards/social-performance.

Table 9. Key indicators for partner FSPs

This table highlights the nine key indicators to track for partner FSPs in an IFAD-supported programme. When evaluating and interpreting these indicators, it is important to look at the trends in the FSP over time: is it reaching more borrowers compared with three years ago? Is it increasing its operational self-sufficiency over time? Has it become more efficient and productive in the last three years?

It is also useful to compare the results with other FSPs serving the same market. Benchmarking against peers in the market can help an FSP set reasonable targets for performance and encourage a healthy sense of competition (Rosenberg 2009).

Indicator	Unit	Definition/calculation	What it measures	Interpretation
Outreach				
1. Total number of active borrowers	Number	Total number of individuals who currently have an outstanding loan balance with the FSP as of 31 December of that year[a]	Number of people the FSP reaches with loans	Compare this with the number of potential borrowers in the market
2. Total number of active women borrowers	Number and percentage	Total number of women who currently have an outstanding loan balance with the FSP as of 31 December of that year[a]	Number of women the FSP reaches with loans	Compare this with the number of potential women borrowers in the market
3. Total value of gross loan portfolio	US$	Total outstanding principal of all outstanding loans[a] • Includes all loans – current and non-current • Excludes non-microfinance loans, interest receivable and loans that have been written off	Total value of loans made by the FSP at a certain time	Compare this with the total estimated demand for microcredit in the market
4. Total number of voluntary savers	Number	Total number of individuals who currently have voluntary funds deposited with an FSP[a] • Count the number of savers, not the number of savings accounts • Include voluntary savings[b] • Exclude compulsory savings[c] • Include deposits on the balance sheet • Exclude savings mobilized by a non-deposit-taking FSP and held in another institution	Number of people the FSP reaches with deposit-taking services	Compare this with the number of potential savers in the market
5. Total value of voluntary savings	US$	Value of voluntary deposits from FSP clients[a] • Include voluntary savings[b] • Exclude compulsory savings[c] • Include deposits on the balance sheet • Exclude savings mobilized by a non-deposit-taking FSP and held in another institution	Total value of voluntary savings held by the FSP at a certain time	Compare this with the total estimated demand for savings services in the market

Indicator	Unit	Definition/calculation	What it measures	Interpretation
Performance				
6. Operational self-sufficiency (OSS)	Percentage	$\frac{\text{Financial revenue}}{\text{Financial expense + loan loss provision expense + operating expense}}$	• Overall performance and sustainability • How well an FSP covers its costs with its operating revenue, and how reliant it is on donor funds • The smaller the loans the FSP makes, and the higher their relative cost (i.e. more rural outreach), the lower this ratio	The higher the percentage, the stronger and more sustainable the FSP Target: More than 120% Sector median: 113.1%[d] Trouble: Less than 80% OSS depends greatly on the institutional model of the FSP and the market in which it operates
7. Operating expenses/ Gross loan portfolio	Percentage	$\frac{\text{Operating expenses}}{\text{Period average gross loan portfolio}}$	• Efficiency • How much it costs the FSP to make a loan (excluding the cost of funds or loan loss/profit)	The lower the percentage, the more efficient the FSP Target: Less than 20% Sector median: 20.0% Trouble: Depends on the region and the model Efficiency is related to the type of FSP – the smaller the loans, the higher this percentage FSPs that serve poor people tend to have a higher percentage (i.e. are less efficient) than those that target better-off borrowers and make larger loans
8. Active borrowers/ Staff members	Number	$\frac{\text{Number of active borrowers}}{\text{Number of staff members}}$	• Productivity • Overall staff productivity of an FSP	The higher the number, the more productive and efficient the FSP Target: Depends on the region and the model Sector median: 100 Trouble: Depends on the region and the model

Indicator	Unit	Definition/calculation	What it measures	Interpretation
Performance				
9. Portfolio at risk > 30 days (PAR)	Percentage	$\frac{\text{Outstanding balance of all loans with a payment over 30 days late}}{\text{Gross loan portfolio}}$ Value of outstanding loans that have an instalment past due by more than 30 days, as a percentage of the value of the entire portfolio of all outstanding loans Include the outstanding value of all renegotiated loans, including rescheduled and refinanced loans, because they have higher than normal risk, especially if a payment is missed after renegotiation	• Risk • Risk of the loan portfolio of an FSP	The lower the percentage, the healthier, less risky the loan portfolio Target: Less than 5% Sector median: 3.1% Trouble: More than 10%
9a. Loans at risk > 30 days (LAR)	Percentage	$\frac{\text{Number of all loans with a payment over 30 days late}}{\text{Total number of outstanding loans}}$ Number of outstanding loans that have an instalment past due by more than 30 days, as a percentage of the total number of all outstanding loans	• Risk • Risk of the loan portfolio of an FSP	The lower the percentage, the healthier, less risky the loan portfolio Target: Less than 5% Trouble: More than 10% Some FSPs and many revolving funds do not have information systems sophisticated enough to calculate PAR, but they should be able to calculate LAR If the repayment rate is roughly the same for large loans and small loans, LAR will not be much different than PAR

Indicator	Unit	Definition/calculation	What it measures	Interpretation
Performance				
9b. Current recovery rate (CRR) and Annual loan loss rate (ALR)	Percentage	1. CRR = $\frac{\text{Cash collected during the period from borrowers}}{\text{Cash falling due for the first time during the period, under the terms of the original loan contract}}$ 2. ALR = $\frac{[(1\text{-CRR}) \times 2\ ]}{\text{Average loan term in years}}$ Always convert CRR into ALR. Variations in late payments and prepayments cause the CRR to jump around over short periods, often registering above 100%. Thus it must be applied to a period long enough to smooth out random or seasonal variations (typically a year) Include either only principal payments or both principal and interest payments	• Risk • Risk of the loan portfolio of an FSP	The lower the percentage, the healthier, less risky the loan portfolio Target: Less than 5% Trouble: More than 5% This calculation gives a good approximation of the percentage of the loan portfolio that an FSP loses to default every year. Community-based models of delivering financial services or revolving funds often do not have the capacity to calculate PAR, but they should be able to calculate CRR
9c. Repayment rate		$\frac{\text{Amount received}}{\text{Amount due}}$	• Risk • It does not reflect the quality of the loan portfolio, only the historical rate of loan recovery.	The repayment rate has significant shortcomings as a performance indicator, though it is often used Repayment rates can be particularly misleading if the FSP portfolio is growing rapidly and if loan terms are long. This is because the percentage that has become due (the numerator) is relatively low compared with the amount disbursed or the amount outstanding (the denominator). This means that a delinquency problem may not show up right away

[a] This is a stock figure as of a particular date (typically the end of the year), not a cumulative figure.

[b] Voluntary savings: deposits made by clients unrelated to other products.

[c] Compulsory savings: deposits made by clients as a requirement to access a loan, a kind of collateral.

[d] The MicroBanking Bulletin (MBB) provides financial and portfolio data on leading microfinance institutions worldwide. Published by the Microfinance Information eXchange (MIX), the MBB gives the sector a snapshot of its performance and provides a useful frame of reference. The figures for the sector median are from 2008 and represent 1,084 MFIs. More information on the MBB can be found at its MIX site, www.themix.org/microbanking-bulletin/microbanking-bulletin

Performance monitoring and reporting

There are a number of different users of performance-monitoring information, each with their own needs and interests. The PMU should closely monitor the implementation of project activities and the performance of participating FSPs. A range of key financial and social performance indicators for partner FSPs should be collected on a quarterly basis in order to make day-to-day project management decisions. Other indicators related to general project objectives would also be important, though this document, with its focus on rural finance, will not address them (see IFAD 2002a; 2007b,c).

In addition, on an annual basis, IFAD headquarters should track the overall performance of a project, as well as of the Fund's overall portfolio, using key indicators for rural finance. The PMU should collect these indicators from partner FSPs and then submit them to IFAD headquarters. Given IFAD's global partnership with the MIX, all IFAD-supported FSPs should also report annually to the MIX Market (see Box 23 below).

Highly-decentralized community-based FSPs (e.g. self-help groups) will likely face challenges in reporting many indicators or participating in the MIX Market. Nevertheless, at a minimum, they should still report an outreach indicator (e.g. number of active borrowers and savers, average loan size) and a repayment indicator (e.g. loans at risk, current recovery rate) to the PMU (see Table 9).

Table 10. Performance monitoring and reporting

Goal	Who is responsible?	Audience	Frequency	Performance indicators
1. Regular, ongoing performance monitoring				
Monitor key indicators to make informed day-to-day management decisions	PMU financial expert, partner TSPs	PMU, CPM and other involved stakeholders	Monthly, quarterly	Key milestones in the workplan, baseline, key indicators for financial and social performance (see Box 24 and Table 9)
2. Annual reporting				
Monitor overall performance, identify weaknesses and suggest corrective measures	CPM, PMU rural finance expert, TSP	CPM, PT, partners involved, government counterpart	Annual	Key milestones in the workplan
Report to IFAD headquarters and participate in the MIX Market	PMU, CPM	IFAD headquarters, MIX Market	Annual	Key indicators for rural finance

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Glossary

agricultural finance: Financial services that focus on on-farm activities and agricultural businesses, without necessarily targeting poor people. Fresh thinking has identified some of the key features of successful agricultural microfinance, replacing the heavily subsidized, unsustainable and unsuccessful approaches of the past.

apex lending institution/organization: A second-tier or wholesale organization that channels funding (e.g. grants, loans, guarantees) to multiple MFIs in a single country. Funding may be provided with or without supporting technical assistance.

community-managed loan fund: A fund operated by group members, with no professional management or supervision of lending and collection, often referred to as revolving funds, self-managed village banks, self-help groups (SHGs) or accumulating savings and credit associations (ASCAs).

credit bureau: A database of information about consumers, including demographics, payment patterns of various types of credit obligations, and records of bad debt. Lenders and others use credit bureaux to screen and evaluate parties to whom they are considering extending credit.

financial service providers (FSPs): Institutions and community groups that offer financial services, including commercial and development banks,[16] non-bank financial institutions, cooperatives, savings and credit cooperative organizations (SACCOS), postal savings banks, self-help groups (SHGs), village savings and loan associations (VSLAs), financial service associations (FSAs), and even telecommunications providers, particularly in providing remittance services. Input suppliers, traders and agroprocessing companies can also provide financial services such as credit for inputs and insurance to farmers through the value chain.

greenfielding: The establishment of new microfinance institutions.

guarantee/guarantee instrument: A financial contract in which a lender (e.g. a local bank) extends credit to a borrower (e.g. an MFI), based on a promise by a guarantor (e.g. a donor) to absorb a specified portion of losses if the borrower fails to pay as promised. By reducing the lender's risk, the guarantor hopes to encourage the lender to make loans that the lender would otherwise have rejected as too risky.

inclusive financial system: A financial system that provides services to all kinds of clients, not just microentrepreneurs or employed people. Inclusive financial systems are those in which the goal of widespread access to finance is reflected at the micro, meso, and macro levels of the financial system.

line of credit: A loan to a financial institution that it will use to make many smaller loans to its individual customers.

macro level: One of three levels of the financial system, comprising government policies and systems, including laws, regulations and enforcement bodies, such as bank supervisors.

market infrastructure: The market infrastructure of a financial system consists of services and systems that support the functioning of the industry, not just a single institution. It includes transfer and payments systems, credit bureaux, rating agencies, auditors, professional networks, trade associations, information technology and technical service providers (TSPs). These actors make up what is referred to as the 'meso' level of the financial system.

16 Commercial banks may not directly serve IFAD's target group, though they could play an important role as part of a linkage strategy and reach IFAD's target group through intermediary institutions.

meso level: One of three levels of the financial system, comprising the financial market infrastructure, such as auditors, rating agencies, networks and associations, credit bureaux, transfer and payments systems, information technology and technical service providers (TSPs).

micro level: One of three levels of the financial system, comprising retail financial and non-financial institutions, including private and government-owned banks, savings and credit cooperatives, postal banks, member-owned community organizations, finance companies and other suppliers (such as moneylenders, agricultural traders, etc.).

microcredit: The provision of loans to low-income clients – a part of the field of microfinance.

microfinance: Financial services that focus on low-income households and small-scale businesses in both rural and urban areas. Growing beyond microcredit, microfinance has blossomed in the last 10 years to include a range of financial services targeted to low-income clients, including savings, money transfer and insurance products.

poverty reduction strategy process/paper (PRSP): PRSPs are prepared by countries through a participatory process involving domestic stakeholders as well as external development partners, including the World Bank and the International Monetary Fund. Updated every three years with annual progress reports, PRSPs describe the country's macroeconomic, structural and social policies and programmes – over a three-year or longer horizon – to promote broad-based growth and reduce poverty, as well as associated external financing needs and major sources of financing.

social performance: Effective translation of an institution's social goals into practice (actions, corrective measures, outcomes), in which the social value of microfinance relates to improving the lives of poor and excluded clients and their families and widening the range of opportunities for communities. To create this value, the social objectives of an MFI may include serving increasing numbers of poor and excluded people sustainably, improving the quality and appropriateness of financial services available to the target clients, and creating benefits for the clients of microfinance, their families, and communities related to social capital, and social links.

sustainability: Refers to the ability of a provider to continue and to expand its operations without need of further subsidies. It involves two elements: (1) operating revenue (excluding subsidies) is sufficient to cover all financial and administrative costs; and (2) loan delinquency or default does not exceed the levels that industry experience has shown to be necessary to avoid eventual collapse of repayment discipline among clients.

rural finance: Financial services that focus on households and businesses in rural areas, encompassing both agricultural and non-agricultural activities, and targeting both poor and non-poor women and men. Rural finance encompasses the full range of financial services that farmers and rural households require.

rural microfinance: Financial services that focus on relatively small-scale products and services targeted to poor clients in rural areas. Given its focus on women, youth, indigenous peoples and the very poor, this is IFAD's area of focus.

value chain finance: Financial products and services that flow to or through any point in a value chain in order to increase the returns on investment, growth and competitiveness of that value chain. Value chain finance has a long history in many rural areas, given that food processors, input suppliers and large commercial farms may be the only source of credit available to their clients and suppliers.

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