

Refinancing facilities: IFAD introduces an innovation in rural finance development



Enabling poor rural people
to overcome poverty

This publication is the result of an initiative of IFAD's Near East and North Africa Division to document IFAD experiences with refinancing facilities in the Republic of Armenia, the Republic of Macedonia and the Republic of Moldova. It is based on the *comparative study on refinancing facilities in economies in transition* undertaken by Dr Jorma Ruotsi, senior rural finance and banking specialist. This initiative is funded by the Facility for Farmers' Access to Markets programme, financed by the Government of Italy.

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IFAD uses highly concessional loans in an innovative way in the Republic of Macedonia, the Republic of Armenia and the Republic of Moldova. Low-cost refinancing capital makes rural investments attractive and profitable for formal financial institutions and reduces rural poverty by stimulating economic growth.

In the past seven years, IFAD has successfully used refinancing facilities in economies in transition to stimulate investments on farms and in rural processing companies. The facilities have refinanced projects for a total value of over US\$50 million in the Republic of Moldova, the Republic of Macedonia and the Republic of Armenia, with an excellent recovery performance. Refinancing operations have proved to be a viable alternative to established modes of financing rural investments through lines of credit and microfinance. And they have encouraged financial institutions to expand their rural networks and start investing in agro-projects from their own funds.

The approach supports the financial system as a whole, allowing it to respond more effectively to the financing needs of rural clients, whether individuals or enterprises. Participating banks and credit institutions assume all the risks, and operations do not weigh down state budgets. Near-perfect loan repayment rates are spurring banks and credit institutions to adopt more flexible collateral requirements for rural lending, a major goal of IFAD's rural finance policy.

The impact of the financed investments on farmers' incomes, companies and rural value chains has exceeded expectations. The market-based refinancing model in rural finance has various advantages that make it an interesting option for future interventions in the financial sector worldwide. While refinancing facilities have worked well in the three countries, their use in other countries and regions would require partnering with a number of well-managed, regulated financial institutions that demonstrate a solid interest in expanding their operations in rural areas.

Fueling financial development to accelerate rural growth

Radical changes shook the political, social, economic and financial systems of the newly independent countries in Eastern Europe and the former Soviet Union following the collapse of socialism early in the 1990s. The transition from centrally controlled systems meant that emerging economies had to create completely new institutions and systems.

Initially, IFAD's interventions in financial markets in the newly independent countries followed established patterns based on lines of credit or support to microfinance. As the financial systems developed, the challenge was to find a better, more appropriate approach. In response to the changing environment, IFAD developed an innovative way to sustain rural investments, shifting support to financial systems as a whole and injecting longer-term investment capital from highly concessional loans into national financial systems to speed up rural growth.

Refinancing operations started in the Republic of Moldova, the Republic of Macedonia and the Republic of Armenia in 2001, 2003 and 2006, respectively. IFAD's allocations for refinancing facilities, provided through loans and grants, form the core of the organization's investments in the countries. As a result of its popularity with governments and with financial institutions and rural clients, refinancing attracts relatively large amounts of cofinancing in the Republic of Macedonia and in the Republic of Armenia from other partner institutions, including the World Bank and the European Investment Bank.

Through IFAD-supported refinancing facilities, governments offer on demand medium- and long-term refinancing capital to banks and other financial institutions, at attractive rates that stimulate keen interest in the potential profitability of rural financial operations. To reduce the risks involved in investment operations, refinancing facilities also provide capacity-building services to financial institutions and their clients.

After more than seven years of experience, refinancing facilities are showing a positive impact on development at the individual farm or enterprise level. On a broader level, they are changing the way financial institutions operate in rural areas.

Three countries, three paths towards economic and financial development

Republic of Moldova

Russia's financial collapse in 1998 had a devastating impact on the economy of the Republic of Moldova, causing a sharp drop in gross domestic product (GDP) and a huge wave of emigration. Agriculture accounts for 50 per cent of employment, 40 per cent of GDP and 75 per cent of exports, mainly to the former Soviet republics. At least 27 per cent of the country's working-age population is employed abroad.

The Small Enterprise Development Fund (SEDF) was established under the Rural Finance and Small Enterprise Development Project in 2000, at a time when the economy was severely depressed. Since then the country has registered an average annual GDP growth of 7 per cent, fueled by structural reforms and a rising demand for its goods. The percentage of people living below the poverty line dropped from 52 per cent in 1998 to 29 per cent in 2005.

In the late 1990s, there was a major consolidation of the country's banking sector, and the positive trends have continued during implementation of refinancing operations over the past six years. During 2007, total bank assets rose 40 per cent, total loans increased by 50 per cent and total deposits were up 34 per cent. Overall, banks are profitable and have ample reserves. The quality of their loan portfolios is good, with bad and doubtful loans representing 4.3 per cent of the total.

The Republic of Macedonia

With the break-up of Yugoslavia, the Republic of Macedonia lost a large and protected market, as well as its industrial linkages and a number of key transport routes. Growth in GDP remained low during the 1990s.

During a relatively stable period in 2000, IFAD designed the Agricultural Credit Discount Fund (ACDF), a refinancing operation. After a brief disruption as a result of civil conflict in 2001, the economy rebounded to an average annual growth rate of 7 per cent. The country lags behind the other countries of the region in foreign investment and job creation. In 2007 unemployment was estimated at 35 per cent. Although GDP per capita in 2007 was US\$8,400, significantly higher than in the Republic of Moldova or in Armenia, about 22 per cent of the population of the Republic of Macedonia is poor. Indications of strong agriculture-led investments and growth in 2008 were signs of a new economic take-off.

After the troubled years of the 1990s, central bank control became more effective, but in 2000 bad loans accounted for more than 40 per cent of the banking portfolio, representing the legacy of ill-advised credit and insider lending. Since then lending volumes have increased and the quality of the portfolio has improved. Non-bank financial institutions known as savings houses participate in refinancing operations, using flexible, member-based lending techniques to reach large sections of the farming community

Republic of Armenia

The agriculture sector in Armenia, smallest of the former Soviet Union countries, is the main source of livelihood for low-income households. Agricultural development has been slow, but in recent years rehabilitation of the irrigation network, development of more efficient marketing systems and strong Russian demand for Armenian products have invigorated the sector.

Armenia's GDP per capita fell by about 75 per cent between 1991 and 1994. Since then stabilization and reform have led to steady economic growth, which recently reached 13 per cent, driven by rapidly expanding exports. GDP per capita is US\$1,060, roughly equal to that of the Republic of Moldova. But distribution of income growth has been uneven, and unemployment is still a crucial issue.

Of the three countries, Armenia has had the most turbulent financial history. Asset and lending volumes are still significantly lower than in the other two countries. The failure of banks in the post-Soviet era caused lingering public distrust of domestic banking institutions, and a large segment of the economy continues to operate on a cash basis. Since the 1990s, Armenia's central bank has improved the supervision of and requirements for the banking sector. This laid the basis for the Rural Finance Facility (RFF), which began in 2006.

Operations: rapid decisions and streamlined steps

Refinancing operations in the three countries use a similar approach. Taking into consideration economic conditions in the rural areas, IFAD works together with the government to establish a semi-independent refinancing unit in the relevant ministry, with a small professional staff. The selection of participating financial institutions (PFIs) is carried out according to standard evaluation techniques that measure the PFIs' financial and managerial performance and focus particularly on their rural outreach potential.

At the start-up of operations, key players such as the Ministry of Finance, Ministry of Agriculture, PFIs, IFAD and project management agree upon main financing terms and criteria. These are then included in the framework contracts with the PFIs and in the operational guidelines. In day-to-day operations, the process begins with the PFI's approval of a borrower's request for a loan and confirmation that the loan is eligible for refinancing. The PFI sends the loan documents with a refinancing application to the refinancing facility. In the Republic of Macedonia and in the Republic of Armenia, the refinancing facility's credit committee decides whether the loan qualifies, and in the Republic of Moldova the decision is made by the facility's senior staff.

If the decision is favourable, the refinancing facility transfers the refinanced part of the loan capital to the PFI to finance the client's loan. The PFI pays the refinanced capital back to the refinancing facility according to the loan repayment schedule agreed upon by the borrower and the PFI. The facility then uses the repaid capital for lending to new borrowers.

Adherence to a strict time schedule when processing refinancing applications from PFIs is crucial to maintaining the institutions' interest in refinancing operations. The general rule is that a decision on each refinancing application should be reached within 10 days of receipt of the application. The actual transfer of refinanced capital to the PFI for disbursement to the client is immediate.

Loan types and lending terms

The size of loans in refinancing operations is tailored to cater for all actors in rural supply chains (from the farmer to the processing company) (see Table 1).

Policies on interest rates charged for refinancing and lending vary significantly and are in line with market-based criteria and government policies at the time of intervention. The most recent operation in Armenia follows the market-based policy favoured by IFAD. In the Republic of Macedonia the government pursued a policy of fixed rates for both refinancing and lending. In the Republic of Moldova the policy is a blend of the policies in the other two countries.

Policies concerning credit risk and collateral are similar in all three countries. PFIs bear the full credit risk and establish collateral requirements. Refinancing facilities encourage PFIs to accept softer collateral, particularly from farmers. As a result of the refinancing operations, banks in all three countries are moving towards more flexible, client-friendly collateral policies.

Table 1
Key refinancing/lending terms and rules

	SEDF Republic of Moldova	ACDF The Republic of Macedonia	RFF Republic of Armenia
Loan size	US\$2 000 to US\$150 000	€2 000 to €200 000	US\$2 000 to US\$150 000
Maximum duration of loan	180 months	96 months	84 months
Maximum grace period	60 months	48 months	18 months
Refinancing interest rate	US\$ loans: LIBOR* Lei loans: 12 months inflation rate	Fixed at 0.5%	LIBOR (cap of 4%)
Lending interest rate that PFIs charge clients	Fixed at 4% above refinancing rate	Fixed at 4% to 6.5% for all PFIs	Free for PFIs to set (now 10% to 12%)
Collateral requirements	PFI's own policies apply	PFI's own policies apply	PFI's own policies apply
PFI's minimum share of total loan financing	15% of working capital share of loans, 0% on investment loans	20%	30% on working capital loans, 0% on investment loans
Client's minimum share of project costs	20%	20%	20%

* London Interbank Offered Rate, the rate of interest at which banks borrow funds from each other, in marketable size, in the London interbank market

Outreach and recovery

Overturing initial scepticism on the part of formal financial institutions, refinancing has become the main financial instrument for supporting rural investments. Demand has been strong in all three countries (see Table 2).

The oldest and largest refinancing scheme, the SEDF in the Republic of Moldova, disbursed US\$5.9 million between January and April 2008. Estimated total disbursements for 2008 may reach a total of US\$18 million.

In the Republic of Macedonia, refinancing operations have expanded smoothly since they began in 2003. The Swedish International Development Agency (SIDA) provided a grant for ACDF operations for technical assistance and training of PFI staff. In terms of scaling up, when the ACDF faced serious shortages of capital in 2007, the government obtained approval from the World Bank and the European Investment Bank to use more than €40 million for refinancing operations. In the first four months of 2008, the ACDF refinanced 570 new loans for a total value of €5.5 million, more than for the entire year of 2006.

Table 2
Cumulative refinancing from IFAD funds since start-up

	SEDF (2001) Republic of Moldova	ACDF (2003) The Republic of Macedonia	RFF (2006) Republic of Armenia
Number of PFIs	9	7	8
Loans approved	601	2 745	178
Total amount approved	US\$22 600 000	€11 533 000	US\$7 151 000
Current portfolio	US\$18 515 200	€6 541 000	US\$5 744 000
In-time recovery rate for clients	98.5%	96%	98%

Table 3
Key characteristics of refinanced loans/projects

	SEDF Republic of Moldova	ACDF The Republic of Macedonia	RFF Republic of Armenia
Average approved loan size	US\$37 950	€6 300	US\$40 100
Favoured loan duration (most common range)	60 to 96 months	36 to 60 months	25 to 48 months
Principal purposes of loans (by proportion of loans))	Agricultural machinery (38%) Horticulture Agro-processing	Livestock (63%) Horticulture Fruit-growing	Livestock (32%) Dairy processing Horticulture

In Armenia, where IFAD allocates funds to poorer mountainous regions, about 70 per cent of the allocation for refinancing capital has been used since refinancing operations began in 2006, and recovery rates are almost perfect at 98 per cent. Interest from other donors resulted in an allocation of US\$6 million as additional refinancing capital from the World Bank and US\$8.5 million from the Millennium Challenge Corporation (MCC).

The average loan size and key characteristics of refinanced loans and projects vary from country to country (see Table 3).

Impact: promising results

The impact of the refinancing operations is evident at three levels: the financial sector, companies in rural areas and related value chains, and financed farmers and their households.

Impact on the financial sector

At a systemic level, a key objective in the establishment of the refinancing facilities was to increase the interest of formal banking operators in serving rural clients. Once the PFIs had acquired the appropriate skills, the aim was to encourage them to start working in rural areas with their own funds as part of their mainstream operations. Progress in achieving this crucial target has been impressive in each of the three countries.

Trends in the Republic of Moldova are encouraging. When refinancing operations started in 2001, banks had limited long-term capital. Refinancing operations not only helped strengthen their competitive position but were also instrumental in significantly speeding up their entry into rural markets and especially agriculture-related activities. Various banks even advertised their new rural investment products in the media. As the country's banks learned to work with rural clients and registered recovery rates close to 100 per cent, they expanded rural operations, using their own funds. The IFAD-assisted Rural Business Development Programme provided technical assistance and training to facilitate the development of new types of collateral for commercial banks, in collaboration with other partner organizations such as the United States Agency for International Development (USAID) and the Citizens Network for Foreign Affairs (CNFA).

In the Republic of Macedonia, the role of rural operations in the seven PFIs of the ACDF has changed significantly. In 2002, the combined agro-portfolio of the financial institutions was €6 million, representing 1.3 per cent of the total portfolio. By the end of 2007, the amount increased to €90 million, which was 7.8 per cent of total outstanding loans. The number of bank branches with a mandate to approve agro-loans increased during the same period from 12 to 60, and all credit officers and branch managers were fully trained. In 2002, the seven institutions had 19 officers processing agro-loans; by the end of 2007 their number had increased to 98.

In Armenia, eight leading commercial banks use the RFF services. With the exception of IFAD's traditional partner institution, the Agricultural and Cooperative Bank of Armenia, none of the banks had previously issued loans to rural clients. Most have now started to use their own funds to expand their operations to rural areas and some have even established a unit dedicated to rural loans. Prime Minister Tigran Sarkisian, former governor of Armenia's central bank, noted these positive developments, commenting on the important role of the RFF in supporting banks to engage in rural areas, and encouraging the RFF to include new, well-managed and active banks in the scheme.

Modern processing company stimulates dairy sector

Swedmilk Macedonia, the first modern dairy plant in the Republic of Macedonia, started operations in 2007. A Swedish equity capital firm provided 28 per cent of the initial share capital, and the rest is owned by a local company and the management team, for an overall investment of more than €20 million. The ACDF has provided a small contribution of €200,000, and two of its PFIs are major financiers of the company.

Swedmilk radically changed the way a dairy company can operate with its suppliers in the country. Unlike other companies, it provides written contracts to its suppliers and guarantees purchase of all of the milk they deliver. It actively encourages higher milk production volumes, provides coolers to farms and plans to pay bonuses based on milk quality, while ensuring that all products meet European produce standards.

The company's policies have proved to be extremely popular with farmers. It has 1,500 suppliers, and others are joining them. Currently it spends €1.5 million per month to buy milk, and volumes are increasing from the current 120 tonnes a day. Channels are open for exports of Swedmilk products to neighbouring countries. Now, to stay in the market, other leading dairies have started to issue written contracts to their suppliers. For the ACDF, Swedmilk's operations have meant a major increase in livestock loan applications in 2008, as farmers are actively increasing their herds.

Ljopco Gizarovski, a small-scale farmer, is one of Swedmilk's suppliers. In 2008 he borrowed €3,900 from a bank under an ACDF-refinanced loan that enabled him to enlarge his herd from one to four cows. Satisfied with Swedmilk's written contract, guaranteed price and commitment to buy all the milk he supplies, he plans gradually to increase his herd to 10 cows. Many other farmers in his village have similar expansion plans.

Impact on companies, rural employment and value chains

Agroprocessing companies are vital to rural development in all three countries. They drive key supply chains and provide earning opportunities for the entire farming community. Impact studies conducted in the three countries have shown promising results.

An impact evaluation covering a sample of 33 out of 101 financed companies in the Republic of Macedonia at the end of 2007 found that in the first year after loan disbursement average sales increased 35 per cent. Full-time employment increased by 19 per cent and part-time employment, mainly of women, by 41 per cent. There was a 24 per cent increase, representing 5,700 new rural suppliers, in the number of suppliers to the sample companies, and the volume of produce bought by the companies rose by 76 per cent.

In Armenia results from a small sample base of refinanced companies in 2006 show an average increase of 26 per cent in sales in two years, with 63 per cent more workers employed in dairy companies and 24 per cent more in the wine industry. Suppliers to the dairy industry increased by 77 per cent and suppliers to the wine industry by 19 per cent.

In the Republic of Moldova, an impact evaluation focused on on-farm and off-farm company loans refinanced from 2001 to 2005, with positive results. During the first year following investment, turnover and the profitability level of the companies each increased by an average of about 33 per cent. Assets grew at an average annual rate of 12 per cent, and an estimated 2,000 new jobs were created for all loans disbursed with SEDF refinancing from 2001 to 2005.

Impact on farmers

Impact evaluation studies carried out by IFAD programmes on the refinancing of farmers' operations show highly encouraging results.

A completion report for the IFAD-assisted Rural Finance and Small Enterprise Development Project in the Republic of Moldova estimated that 8,500 farmers and 220 large farming enterprises gained access to markets through the sale of produce to enterprises financed through the SEDF. In addition, refinanced loans had an indirect impact on the low-income rural population. SEDF activities benefited an estimated 26,500 rural households by enabling them to lease their land to larger-scale farmers financed under the facility.

In the Republic of Macedonia an impact evaluation for the first year after loan disbursement shows that for a sample of 934 farmer borrowers the average family business income increased by 30 per cent. A smaller sample of 301 borrowers for the second year showed an average increase of 60 per cent over the base year.

In Armenia the 2007 impact survey shows good development impact on refinanced farms. Over the two-year survey period, revenues in small farm households rose by 168 per cent in the first year and by 17 per cent in the second. Small farms employed more labour as they expanded operations, from an average 31 days of seasonal labour per farm per year to 150 days per farm by 2007.

Refinancing and IFAD's rural finance strategy

IFAD dedicates more than 20 per cent of its resources to rural finance. The strategic objective is to strengthen the capacity of rural finance institutions to operate effectively with the rural clientele and to allocate financial resources to high-yielding projects in rural areas.

Refinancing facilities have contributed to the development of the rural financial sector in all three countries.

- A total of 24 banks and credit institutions in the countries have actively participated in IFAD-funded refinancing operations, learning to work with an entirely new, rural clientele.
- Positive results have encouraged many banks to expand their rural networks, increase agriculture-oriented staff and decentralize decision-making on rural loans. Many institutions have started to lend their own funds.
- Nearly perfect loan recovery in refinanced lending has encouraged banks and credit institutions to introduce more flexible collateral requirements.
- The financial sector's increased interest in rural operations has been achieved, contributing to a smooth and gradual move towards totally commercial lending operations with the rural clientele.

There is evidence of activity and impact on the farmers and rural companies in all three countries.

- Since 2001, refinancing facilities have financed long-term investments for a value of about US\$50 million in the three countries. Investment volumes are increasing sharply, and the volume for 2008 alone is likely to be between US\$30 million and US\$40 million.
- According to impact evaluation studies, refinanced investment loans have led to a significant increase in the level of farm incomes and farm-level employment. There has been consistent growth in the turnover of the financed companies and their profitability.
- Refinanced companies have employed much more labour in their operations and procured produce from a substantially larger number of rural suppliers, at significantly higher volumes.
- Refinanced investments have contributed to modernizing processing equipment, and more generally to restructuring the way rural value chains operate with suppliers, leading to higher quality standards and new export opportunities.

Before the refinancing model can be adopted in other countries and regions, it is necessary to make a careful assessment of the financial sector and the structure of rural and agricultural markets in those countries. A crucial requirement for this type of facility is a number of well-managed, regulated financial institutions as potential partners with an interest in expanding their operations in rural areas and developing their business in the new markets on a commercially viable basis.



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