CORPORATE-LEVEL EVALUATION

Evaluation of IFAD's Rural Finance Policy

September 2007

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IFAD's Rural Finance Policy

Corporate-level Evaluation

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Photo on cover page:
Composite of photos from selected IFAD rural finance projects
Photo: IFAD Photo Library

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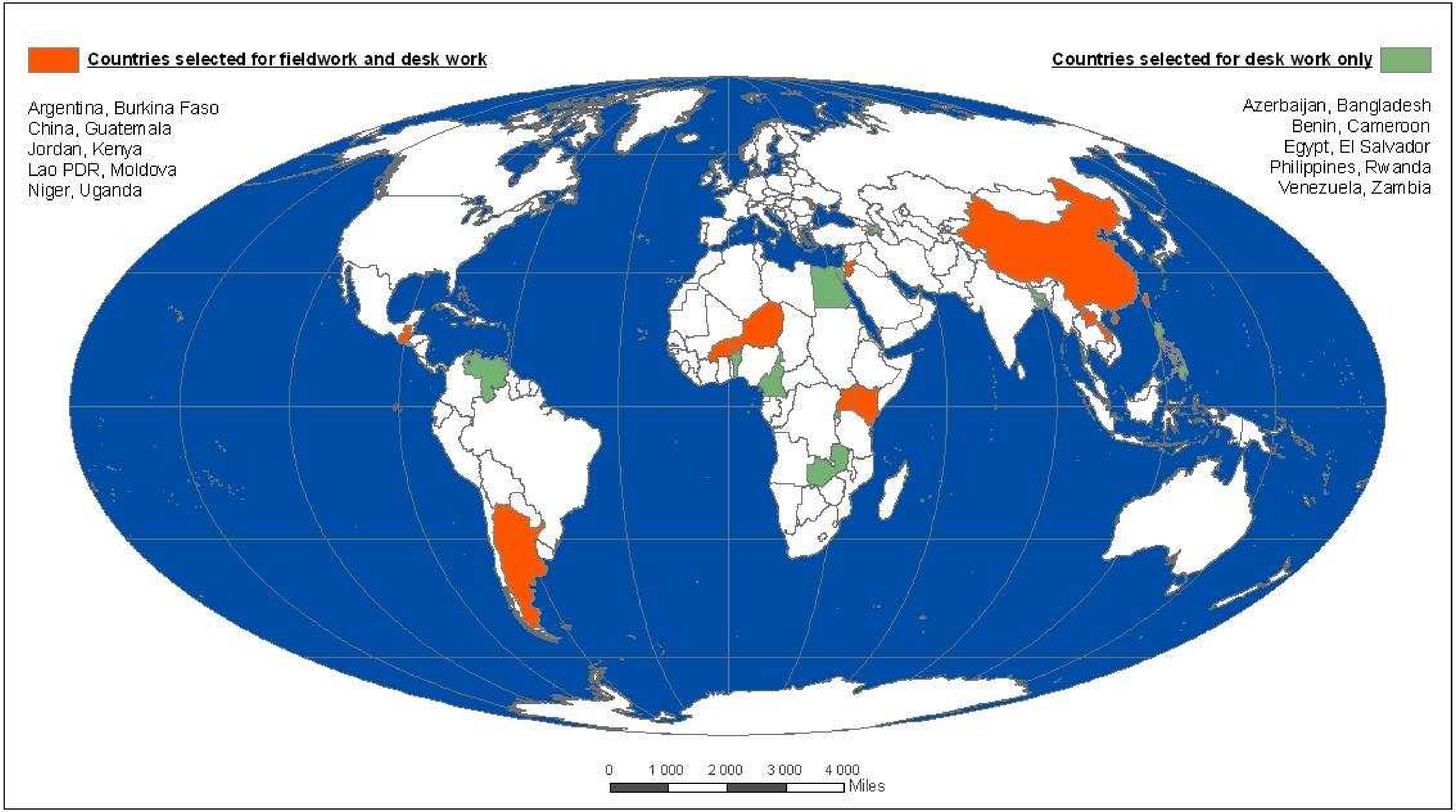
Abbreviations and Acronyms

AFRACA	African Rural and Agricultural Credit Association
APRACA	Asian Regional Agricultural Credit Association
AsDB	Asian Development Bank
CGAP	Consultative Group to Assist the Poor
CIs	Cooperating Institutions
CLE	Corporate Level Evaluation
CPM	Country Programme Manager
COSOP	Country Strategic Opportunities Paper
DFID	Department for International Development
DPR	Donor Peer Review
EB	Executive Board
FAO	Food and Agricultural Organization of the United Nations
FINCA	Foundation for International Community Assistance
FSS	Financial Self-sustainability
FSA(s)	Financial Services Associations
GNI	Gross National Income
GTZ	German Agency for Technical Cooperation
IADB	Inter-American Development Bank
IEE	Independent External Evaluation
IFAD	International Fund for Agricultural Development
IFC	International Finance Corporation
IFPRI	International Food Policy Institute
IFI	International Financial Institution
IMI	Innovation Mainstreaming Initiative
KFW	German Reconstruction Credit Bank
MFI	Microfinance Institution
MIX	Market Information Exchange
NGO	Non Governmental Organization
NPL	Non-performing Loans
OE	Office of Evaluation
OSC	Operational Strategy and Policy Guidance Committee
OSS	Operationally Self-sustainable
PA	Western and Central Africa Division (IFAD)
PDT	Project Development Team
PF	Eastern and Southern Africa Division (IFAD)
PFI(s)	Partner Financial Institutions
PL	Latin America and the Caribbean Division (IFAD)
PMU	Project Management Unit
PMD	Project Management Department (IFAD)
PN	Europe and Central Asia Region
PRODECOP	Development of Rural Poor Communities Project (Venezuela)
PKSF	Palli Karma-Sahayak Foundation (Bangladesh)
PT	Technical Advisory Division (IFAD)
RFP	Rural Finance Policy
SFV	Structure Finance Vehicle
SHG(s)	Self-help Groups
TA	Technical Assistance
TAG(s)	Technical Assistance Grants
TRC(s)	Technical Review Committee
TSP(s)	Technical Service Providers
UN	United Nations
UNCDF	United Nations Capital Development Fund
UNDP	United Nations Development Programme

USAID	United States Agency for International Development
WOCCU	World Council of Credit Unions

Rural Finance Corporate Level Evaluation



IFAD

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Map compiled by IFAD

FOREWORD

As a pioneer in the field of rural finance, IFAD is now one of the world's largest, if not the largest, lender in rural finance as a tool for reducing poverty. Between 1996 and 2005, IFAD approved 194 projects with rural finance components for a total loan amount of USD3 billion, of which USD822 (more than 27 per cent) was allocated to rural finance.

When IFAD's Rural Finance Policy (RFP) was approved by the Executive Board in December 2000, expectations were high. Rural finance operations have been a key focus of IFAD operations, and with the RFP, IFAD wanted to provide strategic guidance to IFAD portfolio managers internally and maintain its visibility and leadership among donor agencies, practitioner organizations, civil society groups and national decision makers in IFAD partner countries. Subsequently, the Policy has been the key document for IFAD rural finance operations, but has not been amended or updated up to now.

Against this background, a corporate level evaluation of rural finance was conducted in 2006 including 58 projects in 20 countries from all regions assisted by IFAD. The objective of the evaluation was to assess the quality and effectiveness of the RFP. The evaluation contains two different but closely related perspectives. First and foremost, the policy document itself is evaluated in its relevance for IFAD programme operations with recommendations for updates and amendments. Second, the evaluation team also had to take stock of the status of IFAD's rural finance operations and related design and management aspects of this prominent part of the IFAD portfolio. This was required in order to determine whether the RFP has been implemented and to which effect and whether adequate resources, instruments and processes are in place to meet the objectives of the RFP.

The evaluation determined that the RFP constitutes a step in the right direction inasmuch as it provides a general framework to develop IFAD's country strategies and project design. The evaluation has also noted that the RFP policy is in line with best standards in a number of important areas, such as sustainability of financial institutions and increased diversification of the financial sector (institutions and services/products).

The report highlights a number of areas where thinking has advanced in the seven years since the approval of the RFP by the Board. For example, the evaluation emphasizes the need for differentiated instruments to ensure a demand driven and client tailored delivery model; it also draws attention to simple and uniform benchmarks for sustainability of partner institutions in line with current best practice; and underlines the need to have financial services providers that are regulated and supervised by qualified agencies, and interventions that specify requirements for capacity building with well defined entry and exit criteria.

Other recommendations of the evaluation concern mainly issues where greater clarity and focus would have benefited the strategic value of the policy right from the outset. For example, the target clients require closer pro-poor definition with a stronger focus on women; in addition, the concept of demand-driven services instead of supply-side interventions could have been developed, and products and services encompassing much more than lust simple loan and deposit services would have deserved more attention. Moreover, clear standards and targets are missing for outreach and demand driven financial services and are ambiguous at best in other areas.

The review of the current status of IFAD rural finance operations also contains important pointers regarding business processes and human financial resources currently dedicated to rural finance development and technical support. The evaluation concludes that no blueprints exist as yet for developing the rural finance sector with no silver bullet solution for ensuring financial services to rural poor people on a sustainable basis. Through this large and detailed evaluation, an important thrust towards a more purposeful development of IFAD rural finance policies and operations has now been made. This is reflected in the Agreement at Completion Point, a document that illustrates the concrete next steps and follow up recommended to this evaluation. Implementation of this agreement will contribute to maintaining IFAD's prominent position in rural finance within the U.N. family and donor agencies as a whole.

Luciano Lavizzari
Director, Office of Evaluation

IFAD's Rural Finance Policy

Corporate-level Evaluation

Executive Summary

1. **Rural Finance.** The rural poor – over 800 million people – require and use a variety of financial services. However, in most cases these services are inappropriate and provided on usury terms and not on conditions that are conducive to rural poverty reduction. Microfinance has evolved as an efficient and effective means to provide financial services to the poor. Some of the good practice standards of microfinance have been applied to rural areas. However, low population densities, remoteness of areas, and risks associated to lending to agricultural production increase the risks and impede the extent to which financial service providers extend outreach to rural areas.

2. **IFAD's Lending, Grants and Policy for Rural Finance.** Over the last ten years (1996-2005) IFAD approved 194 projects with rural finance components for a total amount of US$3 billion. Of these total loan amounts US$822 million were earmarked for rural finance with an additional US$912 million raised from co-financiers. In addition, the International Fund for Agricultural Development (IFAD) approved US$21.5 million in grants for global, regional, and project level rural finance activities. In 2000, IFAD adopted its Rural Finance Policy (RFP) to underpin its commitment to the sector and provide policy guidance to its operations. The RFP was complemented by Decision Tools, a donor peer review organized by the Consultative Group to Assist the Poor (CGAP), and an action plan for rural finance.

3. **Corporate Level Evaluation of Rural Finance.** The rationale for this evaluation was the size of the rural finance portfolio, its performance observed by previous evaluations, and the fact that the RFP had been in place for five years. The objective of the evaluation was to assess the quality and effectiveness of the RFP, and in particular to determine whether it meets best practice standards, has been implemented and to which effect, and whether IFAD has the right resources, instruments and processes to meet the RFP objectives. The evaluation analyzed corporate policy and strategy documents, country strategies and projects of twenty countries, plus selected evaluative information for an additional eight countries. The coverage was global and included visits to ten countries in all regions assisted by IFAD.

4. **Meeting Best Practice Standards.** The RFP sets out four challenges: sustainability and outreach, stakeholder participation, differentiated (or diversified) financial systems, and conducive policy and regulatory frameworks. On the positive side, the RFP sets standards for sustainability that exceed best practices for microfinance, and includes sector diversification and conducive regulatory frameworks, which are a *sine qua non* for sector development. However, the RFP does not meet best practice standards in a number of areas: for outreach it does not set clear targets (rapid expansion), for sector diversification it falls short of the meso-level intermediary institutions necessary to make the sector function, and for the regulatory framework it could have included a condition, namely to work at this level only when necessary, rather than making it an equal part of the whole. The challenge that stands out the most is that of stakeholder participation, which fits more with IFAD's *modus operandi* rather than being specific to rural finance. On the contrary, making it one of the four challenges diverted attention away from the more important concept of demand-driven services, which is fundamental to providing the rural poor with appropriate financial services that meet their needs.

5. **Consistency with Other IFAD Policies.** The RFP is consistent with other corporate policies of IFAD, which generally are supportive of the rural finance objectives set in the RFP. However, in a couple of areas improved consistency between policies would enhance IFAD's work in rural finance, in particular: (i) the rural enterprise development policy speaks of guarantee mechanisms, the

soundness of which would have to be assessed in context of the financial sector; (ii) the gender dimension of rural finance is insufficiently represented in the RFP; and (iii) environmental sustainability and the link to rural finance is not recognized as an area relevant to IFAD.

6. **Providing Strategic Guidance.** The RFP combined information on rural finance and rural development together with IFAD's policy in such a way that description and prescription were mixed together. While informative, this limited the extent to which policy requirements stood out clearly, priorities were set, or norms were established. Some of these shortcomings were addressed through subsequent initiatives, such as the Decision Tools, the action plan for rural finance with followed the donor peer review, or the learning notes on rural finance. The regional strategies, generally, did not translate the corporate RFP into region-specific strategies, with the exception of one division where such strategy was articulated and resulted in better policy compliance and higher project design quality. Systematic portfolio reviews in this and another division contributed to strategic orientation and knowledge generation in those regions.

7. **Project Performance in Meeting RFP Standards.** Projects are increasingly meeting the RFP challenges, although overall performance falls short of being satisfactory. The average performance rating for the five years before adopting the RFP was 2.7, which improved to 3.2 for the five years after the RFP was approved. This rating indicates that positive performance characteristics only marginally outweighed the negative. Some projects embodied RFP principles even five years before it was written, although the number of better performing projects increased after its adoption. In terms of each of the RFP challenges, the evaluation observed (i) on sustainability: 60 per cent of partner finance institutions achieved operational self-sufficiency, but only 24 per cent met the RFP's requirement of meeting financial self-sufficiency. This is comparable to the performance of financial institutions working with the United Nations Development Programme; (ii) greater diversification has been introduced in terms of types of financial intermediaries – gradually moving away from state-owned service providers – and of types of financial products – gradually introducing more off-farm credit services, but still falling short of a gamut of new services like insurance and remittance transfers; (iii) there was limited change in the frequency of working on policy or regulatory frameworks, but a slight improvement in the quality of interactions was noted; and (iv) there was no change in stakeholder participation. In terms of outreach, IFAD-supported partner finance institutions continued to reach the rural poor, although the percentage of women among clients of rural finance services was lower than of comparators working with the poor.

8. **Explaining Performance: Process and Experience.** The continuous, but limited improvement in project performance can be explained by a number of factors. Some of them are systemic – related to the project cycle – others were generated from the project examples that the evaluation reviewed. The project cycle shows weaknesses that are not conducive to designing rural finance projects. The design process is longer than that of comparators and a technical appraisal of the project concept (for rural finance) often comes too late in the process. Project implementation is managed by units and cooperating institutions that do not have the technical expertise to manage the rural finance component with the level of competence required for this sector. Reporting lines mean that rural finance components can be subjected to political interests rather than professional considerations, introducing interest rate caps or preferential treatment for select clients, none of which ensures the rural poor receive professional and reliable rural financial services. In the earlier projects in the sample, rural finance projects lacked sector analysis and, instead provided supply-led directed credit: clients and products, including terms and conditions, were so over-defined that they were impossible to implement and of limited interest to the rural poor. More recent projects work, more and more, through financial service providers that are professional and provide an increasing range of financial products to their clientele. However, whatever gradual improvements in design have been achieved also mean projects get technically more sophisticated, which goes hand-in-hand with increasing challenges during implementation.

9. **Corporate Arrangements – Matching RFP Requirements?** Best practice experience shows that governments are best at providing a conducive policy and regulatory environment and ensuring supervision of the sector and its actors. It is less efficient and effective in providing financial services. IFAD's lending to governments thus is inherently not in line with best practice and will always affect the way in its assistance to rural finance development is delivered. For instance, financial service providers that do not perform according to IFAD required standards (in terms of sustainability and/or outreach to the rural poor) cannot be called to correct their action, unless this is specified in the loan agreement (and subsidiary loan agreement) and government accepts to act together with IFAD. Related to this issue are limitations that arise from IFAD's instruments, typically a loan to government, which makes it difficult to meet more diverse financing needs of partner finance institutions, such as venture capital, private equity, or subordinate debt. Finally, the limits of working through cooperating institutions and without field presence apply to rural finance components as well, although technically specialized expertise would be needed in the field to have a significant impact on the performance and impact of IFAD-assisted partner finance institutions.

10. **Human and Financial Resources.** The RFP did not estimate whether human or financial resources would be sufficient to attain its objectives. Instead, it assumed the *status quo* of resource allocations. This meant that a considerable amount of IFAD lending (27 per cent of the total over the last 10 years) was handled by one full-time staff and country programme managers, who however, in general, would not be able to dedicate a commensurate amount of time to rural finance. This is reflected in IFAD's administrative budget (dedicated fully to rural finance), which is small compared to that of other institutions, such as the International Finance Corporation, the United States Agency for International Development, or the United Nations Development Programme (UNDP). In terms of qualifications, country programme managers need to cover a range of sectors, of which rural finance is but one, even if an increasingly demanding area from the technical point of view. IFAD has tried to address this issue through staff training, establishing a network among technical regional centers that will provide expertise during design and implementation, and through an internal thematic working group that serves to exchange views and distribute latest knowledge products. IFAD also supports an international database for performance data from financial service providers by aiming to have its partner finance institutions report to the database, which will not replace the need for technical in-house expertise to assess the information, but make it more accessible and comparable with international, regional and country standards. On this basis, country programme managers will know whether their partner finance institutions are performing according to expectations.

11. **Conclusions.** IFAD has led the work in rural finance in terms of approved loan allocations. It has made steps in the right direction with the RFP, which meets in some areas international best practice, while it can be improved (easily) in others to catch up with evolving best practice. The prescriptions of the RFP are increasingly met in project designs, although unevenly so, and challenges remain in project implementation. Many of the shortfalls can be explained by systemic weaknesses, in particular in the project cycle and in the founding agreement of IFAD that limits through whom and how IFAD provides loans and how it manages its assistance programme. Nonetheless, given the amount of resources and some of the key ingredients that IFAD has, it has the potential to become a much needed leader in assisting the development of rural finance, provided a commitment exists to making fundamental changes.

12. **Recommendations.** The evaluation provided two options to IFAD's Senior Management and Executive Board. The first option would entail gradual and less resource intensive change, but also mean only a gradual improvement in the programme. It would require clarifying the norms set out in the RFP, ensuring compliance with policy requirements through an integrate quality check, provision of technical appraisals of project proposals earlier in the process, and building greater in-house capacities. The second option would require more fundamental changes, but would promise IFAD could assume rightfully a leadership role in the sector. This option would entail deciding to become a leader and developing strategy for doing so, with region-specific strategies, allocating commensurate

resources to the rural finance portfolio; developing and testing new instruments; and shortening the project cycle to become more efficient and relevant to the development of rural finance services.

IFAD's Rural Finance Policy

Corporate-level Evaluation

Agreement at Completion Point

I. INTRODUCTION

1. This Agreement at Completion Point (ACP) was drawn up at the end of the Corporate-level Evaluation (CLE) of IFAD's Rural Finance Policy (RFP) and operations. The ACP represents the IFAD Management's agreement on the evaluation's main findings and to adopt and implement its recommendations. The methodology of the CLE was developed at the end of 2005. The phases of the evaluation (namely preparation, fieldwork, reporting, and providing feedback) took place between February and November 2006.

2. The CLE addressed three questions: (i) does the RFP meet best practice standards of the rural/microfinance industry and provide practical guidance to IFAD operations; (ii) has the RFP been put into practice; and (iii) has IFAD deployed the right resources, instruments, and processes to implement the RFP? The scope of the evaluation included the RFP and supporting documents, IFAD corporate policies and strategies, all 6 regional strategies, country strategic opportunities papers, and an in-depth analysis of 58 projects in the 20 countries included in the CLE. Projects in ten of the countries were visited.

3. The CLE was carried out by a team of independent evaluators, who worked under the guidance of the Deputy Director, Office of Evaluation. It benefited from the interaction with International Fund for Agricultural Development (IFAD) staff and managers and from the feedback of the core learning partnership, in which all divisions of the Programme Management Department (PMD) and of the Policy Division were represented.

II. MAIN FINDINGS OF THE EVALUATION

4. **Financial Services are Important to Rural Poverty Reduction. Still, Only 10 per cent of the Rural Poor Have Access.** Financial systems have seen great changes in the past ten years that have left most developing country national financial systems generally stronger, but not typically to the benefit of the rural poor. Microfinance has emerged as a potential pro-poor financial sector counterweight to these developments, but its application to rural areas has neither been straightforward nor rapid. As a result, access to financial services is extremely limited in most rural areas, leaving millions of rural poor dependent on no or inappropriate financial services, to their own detriment and that of rural development in general. While not a panacea to poverty reduction, rural financial services go hand in hand with promoting rural development and the alleviation of poverty.

5. **IFAD – Potential Leader in Rural Finance.** IFAD's pioneering rural finance work has faced great challenges helping to establish pro-poor financial systems. It is also a sector for which IFAD has a relatively comprehensive set of ingredients (the RFP, Rural Finance (RF) Action Plan, RF Decision Tools, regional partnerships, monitoring tools, etc.) that can make up a strategic approach to sector development. Past experience, the impressive volumes of IFAD lending, the existence of the RFP and commitment to improved development effectiveness leaves IFAD potentially the most important global actor in rural finance. It is, certainly, the only one solely focused on rural areas. However, for the time being, IFAD is leading mostly in terms of the sizable level of its overall investment in this sector.

6. **RFP – Meeting Best Practice Standards in Some Areas, Not in Others.** The RFP has proven to contain a number of elements that are best practice, although some areas of the Policy lack clarity and need to be improved to meet latest best practice standards. The RFP provided a general

framework to develop regional and country strategies and project design, but without setting clear policy directions for expected norms and standards. The RFP is not sufficiently normative and prescriptive. The permissive character and ambiguity of the RFP resulted in an only limited, albeit increasing reflection of RFP principles in regional and country strategies and contributed to projects that are not fully compliant with RFP requirements. Two other main shortcomings of the RFP lie in the absence of a costing for its implementation and a requirement to retrofit ongoing projects to meet RFP standards.

7. **Progress towards Implementing the RFP.** In meeting the four challenges of the RFP[1], IFAD-assisted projects performed moderately well across all dimensions. Partner Financial Institutions (PFI) sustainability was achieved in the case of 24 per cent of partner institutions – a low percentage, but comparable to that of some agencies that work in less challenging urban areas. The diversification of financial products and services and financial intermediaries showed positive, but modest results. Against the challenges of stakeholder participation and promoting conducive regulatory frameworks, little change in performance has been noted. IFAD's rural finance assistance is meeting the RFP goal of serving rural poor (albeit not the poorest of the poor, which is in line with best practice) and by serving 60 per cent women.

8. **Explaining Improvements.** Modest advances made by rural finance projects towards greater RFP conformity can be ascribed to a number of factors, which include (i) Decision Tools which set out frameworks of best practice; (ii) the Consultative Group to Assist the Poor (CGAP) donor peer reviews and subsequent rural finance action plans, which brought greater attention and focus to the strategies for improving rural finance operations; and (iii) IFAD's increasing general knowledge of best practice in rural finance, supported by publications and efforts to improve capacity. The continuous trend in improving project design and progress made in resolving some project implementation issues provides a good platform from which IFAD can address a number of outstanding issues that will further improve the performance of its rural finance assistance.

9. **Resources Limitations Account for the Slowness of Improvements.** The modest positive trend was countered by significant factors that impeded more rapid performance improvements. These factors include insufficient resource allocations, in particular from the administrative budget, to ensure an adequate amount of technical in-house expertise in rural finance. IFAD is well below par in this area compared to other international agencies active in microfinance. Human resources, though improving, still fall short of what is needed in quantitative terms[2] to provide the necessary support to the sizable and complex IFAD rural finance portfolio. Moreover, while the CLE recognizes the collective effort to improve rural finance activities at IFAD, by concentrating the leadership for IFAD's rural finance work into the responsibility of a single staff (i.e., rural finance technical expert in Technical Advisory Services division (PT)) the institution now faces significant key person risk. Moreover, support to rural finance activities is based on highly personalized relationships that now need to be institutionalized. Funding has also fallen short of requirements for the provision of Technical Assistance (TA), which is a key factor in the success of many microfinance projects.

10. **Fundamental Changes Necessary for Significant Performance Improvements.** Finally, there are a number of barriers to the effectiveness of IFAD assistance for rural finance. These barriers stem from IFAD's founding agreement and entail *inter alia*: mandatory lending to government rather than directly to PFIs, structure and staffing of project implementation units, as well as limited IFAD field presence and constraints on IFAD to provide direct supervision and implementation support. The forthcoming policy on supervision and implementation support is likely to change the limitations on IFAD in this respect, but whether these changes are sufficient to address the requirements of technically qualified rural finance expertise in the field remains to be seen. Unless these changes are made, IFAD's rural finance assistance is at risk of continuing to perform below expectation and, more

[1] The four challenges are sustainability and outreach, financial sector diversification, policy and regulatory framework, and participation.

[2] The quality of the limited number of rural finance experts is high.

importantly, to endanger the meager financial resources of the rural poor, if unsustainable financial service providers are supported.

III. RECOMMENDATIONS AGREED UPON BY IFAD

11. Based on the recommendations made in the CLE, IFAD Management agrees to take the following actions. Some of them are already reflected in IFAD's rural finance action plan, the implementation of which will be actively pursued, as per the recommendation of the CLE.

12. **Action 1: Decide to Take a Leadership Role and Define a Strategy to Get There.** IFAD Management decides to make Rural Finance an area of excellence and define a strategy to do so, through the development of effective partnerships with rural finance centers of excellence, field practitioners and donors. IFAD is committed to making the necessary investments to improve the RFP, in-house capacity, and instruments (as detailed below) to ensure the Fund lives up to its ambition.

13. **Action 2: Clarify the RFP Standards and Supporting Instruments.** IFAD [PMD] will prepare an *Update* to the RFP, which will summarize its current policy prescriptions, clarify areas that are insufficiently prescriptive, and add more recent best practice standards. The *Update* will be a stand-alone document that will incorporate the major thrusts of the present RFP, for ease of reference, and will have a maximum of ten pages and clarify in particular financial sector analysis, participation, social performance, performance-based contracts for partner finance institutions, gender, and the environment. The *Update* will be presented for information to the Executive Board (EB) in an informal session during 2007. Revisions to the supporting instruments (such as the Decision Tools) will follow the adoption of the RFP *Update* and will entail an ongoing process to continuously capture advances in the sector.

14. **Action 3:** IFAD Management does not agree with this recommendation[3] because requiring the divisions to prepare a detailed regional strategy would not enhance the impact of IFAD's work in rural finance, given that the challenges of rural finance are more closely linked to each national context, and not to the wider regional environment. In addition, Management concluded that a more effective way to improve the design and implementation of IFAD projects in the field would be to develop strategic partnerships with technical institutions and centres of excellence.

15. **Action 4: More Systematic and Earlier Provision of Technical Expertise in the Design Process.** PMD will also ensure that from mid 2007 onwards, all projects with a rural finance component have adequate continuous rural finance expertise available during the project identification and design process. This will be achieved through continuously improving IFAD's in-house capacity (see Actions 5 and 6) and through regional partnerships for rural finance, which IFAD has started to form as part of the RF Action Plan. The development of technical partnerships with regional RF centers of excellence will therefore be pursued and expanded (in particular in Latin America and Asia, where they are still to be defined).

16. **Action 5: Ensure that Rural Finance Operations meet RFP Standards.** PMD will ensure that the standards of the RFP Update and supporting instruments are reflected and interpreted in country context, in all new RF formulation exercises. PMD will institute a rigorous check of each new

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[3] Embed RFP Principles into the Work of Regional Divisions. As part of the commitment to become a leader in rural finance, each regional division of IFAD will (i) undertake or update sector analyses of regional challenges to rural finance, using the CGAP macro, meso, micro framework; (ii) determine priorities within each region and translate the principles of the RFP into meaningful objectives for each of the regions; and (iii) define a strategy for achieving the rural finance objectives for each region. The regional strategies will be used at the corporate level to position the Fund vis-à-vis other development partners, and inform the update of IFAD's Rural Finance Action Plan, which provides the framework for building IFAD's in-house and outsourced capacities.

project that includes rural finance (as a component or in stand-alone rural finance projects) to ensure projects meet RFP standards. This quality check will be undertaken by PMD and result in the Assistant President, PMD, requesting revision or redesign of projects that do not meet RFP standards. In addition, the new quality assurance mechanism being developed by IFAD will include measures to check on policy compliance and quality of rural finance components. Finally, the issues paper prepared for the OSC meetings will continue to cover compliance issues, but be updated to reflect new requirements of the RFP *Update.* The results of these quality checks will be reported to the EB in the annual Portfolio Performance Report to inform the EB of the quality of new project proposals. This system will be developed in 2007.

17. **Action 6: Build Greater Capacity.** PMD commits itself to develop in 2007/2008 (and provide the required funding to do so) a short 2-3 days basic course on rural finance, as part of the Rural Finance Action Plan. This course will be offered on a regular basis (at least twice per year) and be a requirement for all staff designing or managing projects with rural finance components. It will include, among others, modules structured around the key messages of the RFP Update, RF Decision Tools, the MIX, how to optimize the use of IFAD funding instruments, innovative product design, key policy issues etc. The modules will be continuously updated and expanded to keep them in line with latest industry developments. Staff will be required to attend training and their participation in training will be acknowledged in their annual performance evaluation.

18. **Action 7: Allocate Commensurate Resources to Rural Finance and Reduce Key Person Risk.** IFAD commits to ensure that the position of the senior technical advisor for rural finance will be selected as soon as possible, preferably by April 2007[4] and that all necessary steps will be taken to move the two current RF positions from temporary status to more stable contract types and funding sources, to ensure continuity of essential expertise (e.g. for monitoring the partnership with the MIX and maintaining essential thematic and regional partnerships). As a second step and in order to mobilize the means necessary to fully implement the actions recommended by the CLE and accepted in this agreement at completion point, PMD will deploy all necessary means to create two additional professional positions in 2007/2008 to provide the required in-house technical expertise. In parallel and as a potential alternative support mechanism, PMD will seek to replace departing staff with new staff with strong technical skills, including in rural finance, in order to enhance the technical capacity within regional divisions in this area.

19. **Action 8: Mainstream the Use of the MIX[5] as a Reporting Platform for RF across IFAD.** As part of IFAD's RF Action Plan, PMD will ensure that the global partnership between IFAD and the MIX continues at least over the next three years, in order to mainstream the use of the MIX as the reporting platform throughout IFAD RF programs[6]. PMD will secure the required funding to that effect.

20. **Action 9: Develop More Relevant Instruments, Better Delivery, and Stronger Supervision.** To meet the more fundamental challenges that the CLE identified[7], which may require amending IFAD's founding agreements and therefore interaction with and guidance from member countries, IFAD Management will organize opportunities for interaction with its EB on best practice for rural finance and the implications that IFAD faces when aiming to meet them, as well as practical change processes required to (i) optimize the use of IFAD funding instruments, including for increased provision of technical assistance and (ii) improve project implementation mechanisms through testing alternative modalities to the standard "project management unit" approach. The EB may decide that

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[4] The current incumbent has taken up a position with UNCDF, starting February 2007.

[5] Microfinance Information eXchange: a web-based platform enabling MFIs to report on their outreach and overall performance.

[6] The MIX captures, among other ratios, all the RIMS indicators set up by IFAD in the area of rural finance.

[7] These challenges include working more directly with partner finance institutions; placing responsibilities for project management in institutions that are technically better qualified to supervise financial sector projects; and using larger amounts of loan money for the provision of technical assistance.

amendments to IFAD's founding agreements are needed to implement those changes. IFAD management is prepared to submit a relevant proposal to the EB and the Governing Council on this subject.[8] Management is also ready to involve the EB in regular ad-hoc seminars on relevant issues in rural finance on the margin of scheduled sessions. Such EB seminars are included in the PMD departmental management plan.

21. **Action 10: Gain Greater Relevance through a More Efficient and Effective Process.** To shorten the project cycle (including from approval to effectiveness), IFAD will pilot, as part of the implementation of its corporate Action Plan, a shortened project cycle that will also concern a selected number of rural finance project. The pilot will aim to reduce the total time from inception to start-up to less than 24 months and to reduce project design documentation to 50 pages in total. Details of the pilot process will be determined in 2007 and implemented over two years.

8 The evaluation had originally recommended that IFAD establish an EB working group on rural finance. According to the evaluation, this working group could provide a platform to discuss with EB members best practice for rural finance and the implications that IFAD faces when aiming to meet them. However, while management recognizes the importance of interacting with the EB on key issues and challenges in rural finance, they recommended that IFAD avoid establishing additional working groups of the Board.

IFAD's Rural Finance Policy

Corporate-level Evaluation

Main Report

I. INTRODUCTION TO RURAL FINANCE AND IFAD ACTIVITIES IN RURAL FINANCE

A. The External Context

1. **The Rural Poor and Financial Services Needs.** Every day, over one billion people around the world cannot fulfill their most basic needs, let alone attain their dreams or desires. Of these over 800 million poor women, children and men live in rural areas. These are subsistence farmers and herders, fishers and migrant workers, artisans and indigenous peoples whose daily struggles seldom capture world attention. More than half of their daily income is used to obtain or produce staple caloric intake.

2. Despite their poverty, most people including the very poor, require and use a variety of financial services. Stuart Rutherford's invaluable *Financial Diaries of the Poor*[9] show how the poor actively manage even the smallest sums to survive from day to day and increase household financial assets. In the virtual absence of pro-poor financial service provision, however, the rural poor often resort to using inappropriate and or usurious financial service providers to their own detriment and that of rural economic development. Finance is not a panacea to rural poverty, but life for the poor, as it is for those with higher incomes, is more difficult without access to appropriate financial services. Benefits reach beyond the immediate households too, and many positive economic and social multiplier effects result from rural economies enjoying access to finance including job creation, gender and social empowerment, to community cohesiveness. As recent World Bank study[10] observes, poverty falls faster in countries with well developed financial institutions than those without.

3. **Rural Finance Systems.** Agricultural finance has been a prominent element of most rural development strategies endorsed by development agencies. Over the past 40 years billions of dollars have been invested in agricultural production finance, mostly though not uniquely, benefiting large agri-business and large landholders. Small rural enterprise and producers have also benefited – albeit modestly – from credit programmes.

4. Traditionally, most rural development finance has been made available through governments and state banks and is characterized by poor loan repayment and unsustainable subsidies. Increased attention to fiscal responsibility emerging from developing country debt crises in the late 1980s, lead to a reciprocal decrease in the financing of unsustainable agricultural programmes. At the same time, developing country economies were rapidly restructuring and liberalizing, this along with decreasing importance of agriculture to many national economies, precipitated state withdrawal from many of its traditional supply roles in rural areas, including finance.

5. Liberalization and its corollary – increased access to global markets – has opened new market opportunities for rural economies in many developing countries, but has largely benefited rural areas with sound infrastructure, stable macroeconomic conditions, and abundant access to inputs to production. Finance has proven to be a particularly difficult input to provide as economic

9 Rutherford, Stuart, The Poor and Their Money (New Delhi: Oxford University Press, 2000).

10 Beck, Thorsten, Demigue-Kunt and Ross Levine, (2006) Finance, Inequality and Poverty: Cross Country Evidence, prepared for Access to Finance: Building Inclusive Financial Systems, hosted by the World Bank and the Brookings Institute, Washington, DC, May 30 and 31, 2006.

liberalization policies have almost always provoked financial sector consolidation leading to a withdrawal of service from rural areas.[11] This, combined with shrinking resources to state banks, has contributed to a sharp decrease in access to finance in rural areas that were poorly attended to begin with. The confluence of liberalization, globalization and withdrawal of the state from traditional economic activities and support services in rural areas is the stage upon which the pro-poor rural finance challenge is set.

6. **Constraints to Serving the Rural Areas with Financial Services.** Even if broader development contexts favored stronger rural economies, financial service providers would still face significant constraints to providing sustainable services to rural populations. The main and constant constraints are distance and low population density. Transacting retail financial services in low density population areas given current banking methods is often too costly to sustain for service providers and clients alike. High transaction costs are compounded by risk management tools not well suited to rural environments that typically suffer from frequent exogenous economic shocks, natural disasters, and cyclical crop failures amongst other significant covariant risk events. At the household level, service provision is challenged by a lack of reliable information about borrowers, lack of collateral, seasonal income and loan demand cycles that hamper traditional approaches to financial service provision. Overlying these conditions is a typically inhospitable policy, legal and regulatory environment. As a result of all of these factors, financial services are often provided to less than 10 per cent of rural areas[12]. Annex 1 provides more background information on rural finance.

7. **Can Financial Institutions Serve the Rural Poor?** Microfinance emerged in the late 1990s as a means to provide sustainable financial services to the poor. The initial microcredit approach – offering of small working capital loans, with short terms, high interest rates, and no or very low collateral – has since blossomed into a wide range of financial products and services for poor and low-income households from microsavings, insurance, services to transfer and receive remittances, to a score of credit products including housing, school, and consumer loans.

A loan giving ceremony in Lombok, Indonesia. Small groups are formed, trained and then receive credit to finance their income-generating activities
Photo: Lucilla Salimei, IFAD photo library

8. Still primarily an urban phenomenon, microfinance has made significant, if uneven advances into rural areas. Khan and XAS banks in Mongolia, Prodem in Bolivia, Self Help Groups (SHGs) in India, and community-managed village savings and credit organizations in West Africa and some

[11] De Sousa-Shields and Frankiewicz, (2005) Financing Microfinance Institutions: The Context for Transitions to Private Capital, USAID.
[12] See the Consultative Group to Assist the Poor (CGAP) & IFAD, (2005) "Emerging Lessons in Agricultural Microfinance: Selected case studies," December 2005.

Central American countries all serve the rural poor to varying degrees in some of the most difficult rural environments in the world. For all the variety and success of these institutions, replicating them in different contexts or at a certain scale of outreach in rural areas remains challenging. Experience has shown that blueprints do not exist for the rural finance sector.

9. Agricultural value chain finance is an emerging model that attempts to tap the symbiotic relationship between agri-business and the rural poor.[13] Value chain finance has a long history in many rural areas as food processors, input suppliers, and large commercial farms have often been the only source of credit available to their clients and suppliers. Donor efforts in this field are promising but nascent and typically provide highly context-specific solutions and limited financial services.

Box 1. Ten Characteristics of Pro-poor Financial Institutions Successful in Rural Areas

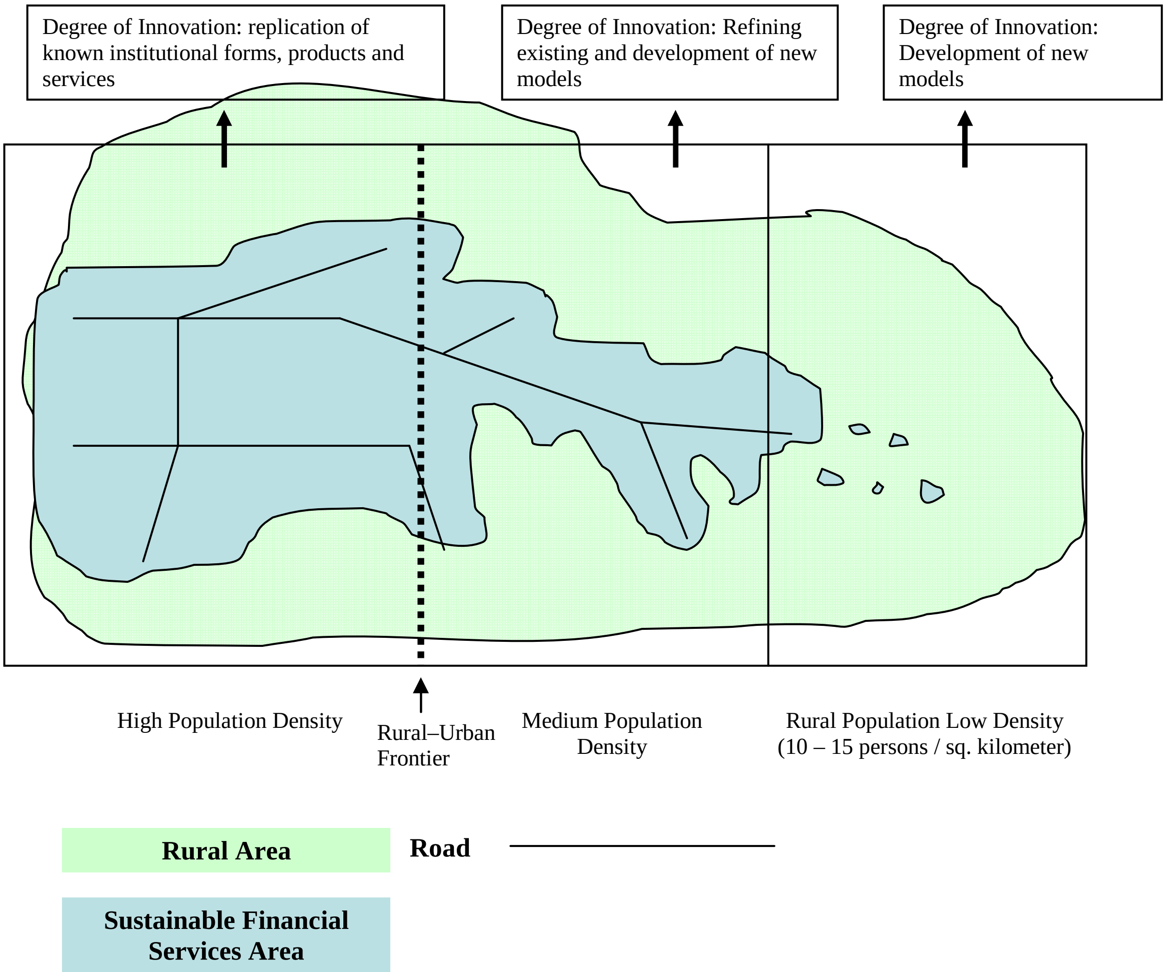
- Repayment not linked to loan use
- Character based lending combined solid lending criteria
- Savings mechanisms available
- Portfolio risk diversified
- Loans adjusted to household income cycles
- Contractual produce relations between farmers and buyers
- Strategies for reducing transaction costs
- Tap into membership organizations (e.g., producer cooperatives)
- Employ area based index insurance where appropriate
- Insulate finance from political interference

Robert Peck Christen and Doug Pearce, Managing risk and designing products for agricultural microfinance Features of an emerging model, Consultative Group to Assist the Poor (CGAP) and International Fund for Agricultural Development (IFAD), 2005.

10. Figure 1 below shows a simplified view of how pro-poor rural finance in most countries reaches rural areas up to certain population and infrastructure densities. In higher density markets, a variety of sustainable rural finance approaches have been developed from informal Non Governmental Organisations (NGOs) to capital intensive, technology driven commercial bank models. Markets are not homogeneous, however, and most models must serve a range of client income levels to achieve sustainability – very few uniquely serve the poorest of the poor at any level of population density. Beyond the sustainable financial services boundaries shown in Figure 1, there is no real certainty about how to provide financial services on a sustainable basis. What works well in some areas can and often fails in others.

[13] A series of actors and activities is needed to bring an agricultural product from production to the final consumer. When credit or other financial services flow through this chain from one actor to another, it is called value chain finance. See for example, RFAI Notes, Issue 1, A Fresh Look at Rural & Agricultural Finance, United States Agency for International Development (USAID).

Figure 1. Serving the Rural Poor and the Rural Financial Frontier



11. Social and cultural considerations can also have considerable influence on the viability of one model over the other. In West Africa, for example, cooperative institutions have thrived whereas in some Asian and European countries, traditional shareholder owned, private sector companies serving individuals is more common. Other key considerations include regulations that permit savings mobilization, availability of debt funding from wholesale organizations, and absence of market distorting interventions by state banks and government programmes.

12. Understanding which pro poor financial service provision model will work in a given market has advanced greatly in recent years given improving but as of yet incomplete knowledge of the application of urban microfinance to rural areas. There are, however, some general characteristics of success. First, to understand risk and market conditions, financial service provision must be close to the market. Second, providers must have an efficient way to transact financial services (such as mobile banking, mobile phone banking, or palm pilot transaction technologies, or self managing models such as SHGs). Besides these general traits, there are ten specific characteristics identified by Christen and Pearce (Box 1) variously found in sustainable rural finance provision efforts.[14].

13. **Development Partners and Rural Finance.** Until the mid 1980s, many development partners focused on supporting subsidized credit programmes as an input to agricultural production activities. Funds were typically managed either by a local project staff which lent directly to clients or through relationships with government managed lending schemes and state banks. This approach seldom

[14] Peck Christen, Robert and Douglas Pearce, (2005) Managing Risk and Designing Products for Agricultural Microfinance: Features of an Emerging Model, CGAP Occasional Paper, No 11. CGAP, 2005.

resulted in sustainable service delivery or poverty alleviation, and was mostly replaced in the 1990s by projects which channeled credit through agricultural development banks and their retail intermediaries to highly targeted populations with tightly defined credit use. Most programmes typically neither covered costs nor emphasized loan recovery, leaving them unsustainable and encouraging a culture of non-payment. More recently, development partners have begun to apply best practice urban microfinance to rural and agricultural finance projects, taking a financial sector development approach. Supporting institutional capacity is an integral part of a financial sector development approach that seeks to integrate and or link pro-poor financial services to the formal financial sector. The strategy also calls for agencies to consider a range of interventions from institutional support to regulatory change. A variety of agencies follow the sector development approach, some with significant rural finance commitments, though none are as specialized as the International Fund for Agricultural Development (IFAD)[15] on serving the rural poor.

B. The Evolving Rural Finance Context within IFAD

14. IFAD has become one of the world's largest, if not the largest, lender in rural finance for poverty reduction. Between 1996 and 2005[16], IFAD approved 194 projects with rural finance components. The loan amount for these projects totaled US$3 billion, of which US$822 million (over 27 per cent) were allocated to rural finance. These projects generated additional co-financing of US$912 million for rural finance. As a result US$ 1.7 billion of total project funding was allocated to rural finance over the past ten years. The large majority of projects approved since 1996 are still ongoing with only 35 of the 194 projects completed by the end of 2005.

15. Over the last 10 years, IFAD's rural finance portfolio has seen a number of changes. The number of loans decreased by 20 per cent from 107 approved prior to the RFP to 87 per cent after the adoption of the RFP and overall rural finance lending decreased by about 25 per cent. Across regions, major shifts took place. In Eastern and Southern Africa (PF) funding for finance increased while the total number of projects dropped from 30 to 25, indicating a shift to larger standalone rural finance projects. Lending for rural finance decreased in the Latin America and the Caribbean (PL) region from 22 projects and US$75 million (1996-2000) to 9 projects and US$17 million (2001-2005). All other regions saw a decline in terms of number of projects and loan amounts, albeit less dramatically. Annex 2 provides summary data tables.

16. In addition to loans, IFAD also finances Technical Assistance Grants (TAGs). During the period 1996–2005, US$21.5 million in grants were approved for global, regional and project level rural finance activities. This represents 3.3 per cent of the approved rural finance loans during the same timeframe. Grants ranged in size from US$10 000 for workshops to US$1.8 million to support the CGAP.

[15] The Inter-American Development Bank, the Asian Development Bank, the International Finance Corporation, USAID, and the United Nations Capital Development Fund were interviewed. CGAP, which is the focal point for microfinance for the World Bank, was also interviewed. Specific rural finance data from these agencies was not available.

[16] The CLE chose a 10-year timeframe (1996-2005) to observe changes that occurred over this period and determine whether these can be attributed to the RFP. Also, the CLE aimed to assess the results of IFAD's assistance in rural finance, which necessitated analyzing projects designed prior to the adoption of the RFP, as more recent projects are not sufficiently advanced in their implementation to assess impacts.

Box 2. IFAD’s 4 Rural Finance Challenges

1) Enhancing Institutional Sustainability and Outreach to the Rural Poor
2) Stakeholder Participation
3) Differential (diversified) Rural Financial Infrastructure
4) Promoting a Conducive Policy and Regulatory Environment

17. The desire to improve rural finance project quality related to these significant commitments lead to the formulation of the Rural Finance Policy (RFP) in 2000[17]. The Policy’s objective is to support rural finance system development to increase sustainable access of the rural poor to financial services[18]. The RFP describes IFAD's approach to rural finance, sets standards for designing and implementing projects, and offers guidance to IFAD staff and partner institutions on best practice rural finance project design, implementation, and monitoring. The RFP outlines four main challenges (Box 2) that IFAD would aim to address with its rural finance assistance. Subsequent to the approval of the RFP, IFAD has further formalized its commitment to rural finance. The IFAD Strategic Framework for 2002 – 2006 designated access to financial services and markets as one of three strategic objectives. Each of IFAD’s regional strategies addresses rural finance with the objective of providing region specific guidance.

18. As a part of its commitment to quality rural finance projects, IFAD underwent a Donor Peer Review (DPR) under the auspice of CGAP in 2003. A team of CGAP members assessed IFAD’s rural finance activities and policy. Using standard criteria to compare IFAD with other donors active in microfinance, the DPR found IFAD’s performance relatively strong in the areas of staff capacity and knowledge management. Weaknesses were uncovered in strategic clarity and accountability for results. IFAD was found to be weakest in its use of appropriate financial instruments. The DPR recommended IFAD achieve a stronger agency-wide vision and operational plan for rural finance, obtain better knowledge and results of its rural finance portfolio, and enhance technical capacity of Country Programme Managers (CPMs) and partners. It also recommended for IFAD to promote learning and innovation within and across regions, between the field and its headquarters in Rome, and with other development partners. In response, IFAD developed an Action Plan (adopted in January 2003 and continuously updated since 2005) which has the objective of supporting the effectiveness of rural finance operations at IFAD.

19. Also in 2003, IFAD developed the Decision Tools in Rural Finance [19] which have the objective of guiding rural finance project design, implementation, and monitoring. A variety of other documents including the Rural Finance Learning Notes and others addressing more specific rural finance themes have since been published to support the implementation of the RFP. Twenty-one formal and informal international and regional partnerships have been formed to support IFAD’s Partner Financial Institutions (PFI) and IFAD’s capacity and development needs. A portfolio monitoring system using the Market Information Exchange (MIX), an online microfinance performance monitoring system, is under development.

20. A follow-up DPR was completed in April 2006. It reported improvements in strategic clarity and staff capacity, and some changes in the accountability for results area, but no changes in the use of appropriate instruments.

[17] IFAD. 2000. Rural Finance Policy. EB 2000/69/R.12.
[18] IFAD. 2000. Rural Finance Policy. EB 2000/69/R.12, page 2.
[19] IFAD. 2002. Decision Tools in Rural Finance (EB/2002/77/R.10).

C. The Rural Finance Evaluation: Objectives and Methodology

21. The rationale for undertaking this Corporate Level Evaluation (CLE) was threefold: (i) the size of the rural finance portfolio; (ii) the adoption of the RFP five years prior (i.e. sufficient time to assess first results); and (iii) the findings of other evaluations that indicate poor performance ratings for rural finance components. The objective of the CLE was to assess the quality and effectiveness of the RFP in guiding IFAD's rural finance assistance. The evaluation addressed the following three questions:

(i) Does the RFP meet best practice standards of the rural/microfinance industry and provide practical guidance to operations? In other words: is the RFP relevant to its external and internal context?

(ii) Has the RFP been put into practice? That is, are projects designed and implemented following the prescriptions of the RFP?

(iii) Does IFAD have the right resources, instruments, and processes for implementing the RFP and meeting its objectives?

22. The timeframe of the CLE covered operations that were approved between 1996 and 2005, i.e. five years prior to and after the approval of the RFP. This timeframe allows sufficient time for the Policy to have had a demonstrable effect on IFAD's programming, including design and implementation of projects, and redesign where applicable.

23. To determine the quality of the RFP (question 1), it was analyzed in comparison with best practice standards, checked for internal consistency with other IFAD policies and strategies, and assessed for the extent to which it provided practical guidance to operations.

24. To assess the operationalization of the RFP (question 2), four countries were selected from each of IFAD's five regional divisions. A total of 58 projects in the selected 20 countries were reviewed in-depth, including visits to 23 projects in 10 countries. Field work was conducted between April and June 2006. A structured data collection method employing a variety of primary and secondary sources was used, including an assessment of country specific financial sector and economic conditions. Key internal and external stakeholders were interviewed. A lighter desk review was undertaken of projects in eight additional countries.

25. Finally, to determine whether IFAD had the right institutional arrangements to support rural finance activities (question 3), an organizational analysis was undertaken. It included desk review of IFAD documents and secondary sources, interviews with key external stakeholders, and semi-structured interviews and structured focus groups with approximately 30 IFAD staff.

26. The findings of the evaluation were presented to and discussed with IFAD's Senior Management Team, the management team of the Programme Management Department (PMD), and with members of the core learning partnership.

II. IFAD'S RURAL FINANCE POLICY

27. To assess the quality of the RFP and the tools that IFAD designed to ensure its implementation, the evaluation chose three criteria: (i) how does the RFP compare to international best practices; (ii) is the RFP in line with other operational policies such as IFAD's Strategic Framework; and (iii) does the RFP provide a guiding framework balancing programmatic choice and flexibility against normative prescriptions. In comparing the RFP with today's best practice standards, the evaluation recognized that some best practice standards have evolved over the last five years. The assessment was done, nonetheless, to determine whether the RFP remains relevant in today's context.

A. The RFP and Best Practice

28. A central tenant to best practice support for microfinance and rural microfinance is the sector development approach. It is based on the understanding that more poor people will benefit more rapidly if development focuses on the financial sector rather than on isolated institutions that may not be able to operate effectively or become sustainable due to the context in which they function.

Box 3. Pro-poor Financial Sector Development: Macro, Meso, Micro Best Practice Framework

A macro, meso micro framework assesses a financial sector holistically, seeking to understand the challenges, constraints, and opportunities at each of these levels. Donors use this approach to understand how best to support pro-poor financial sector development by identifying strategic interventions suited to their resource capacity.

Macro level considerations include macro economic conditions, government policy affecting private and public sector business development. Regulatory and supervisory regimes affecting finance are of particular interest, as are general economic and legal policies.

Meso level considerations focus on a range of actors that affect the health of a financial sector. They include capital providers, credit bureaus, information and technology companies, payment clearing systems amongst sector associations etc, or those organizations that help facilitate and or support retail level financial sector activities.

Micro level considerations include a range of retail financial from banks and cooperatives, to self help groups. They also include insurance companies, non-financial private lenders and leasing companies. Retail level market conditions and trends are also important micro considerations.

Building Inclusive Financial Systems: Donor Guidelines on Good Practices in Microfinance, CGAP, December 2004.

29. A financial sector approach calls for interventions at micro, meso, or macro level (Box 3), depending on the current status of existing bottlenecks in the financial sector. The sector approach is used to varying degrees by a host of development agencies, such as the British Department for International Development (DFID), German Agency for Technical Cooperation (GTZ) and United States Agency for International Development (USAID) bilateral agencies, and some of the multilateral agencies (Asian Development Bank (AsDB)), Inter-American Development Bank (IADB), and the United Nations Capital Development Fund (UNCDF). It involves using a rigorous analytical framework, such as the CGAP model shown in Box 3, to determine where the financial sector needs to be developed before deciding on the "point of entry" for providing assistance. The sector development approach goes hand in hand with a number of best practice standards – at each level – as detailed in the following paragraphs.

30. The micro level comprises households and individuals (clients) and the principle tenet of best practice is that their financial needs should be met. It entails providing them with appropriate services, including a choice of different products, at an affordable price. Best practice also includes a particular focus on women, because experience has shown women tend to reinvest gains from their investments into the family: financing expenditure for schooling and health care or improved nutrition. These are positive development effects that development agencies aim to achieve through the provision of financial services to the (rural) poor.

31. Still at the micro level, immediately linked to the clients, are the financial service providers. Sustainability is an overriding principles for service providers, which combines the necessity to meet the financial needs of the poor while being (or becoming) financially sustainable. Best practice standards concerning service providers is the demand that they provide ***demand-driven services***, meaning they have to understand who their clients are and what they need. In the case of the rural poor, financial service providers would have to understand the income cycles of the rural poor and their financial needs, and design specific products to meet them, such as credit and savings schemes, insurance, leasing, housing, and transfer services for remittances[20]. Services should not be tied to particular clients or types of use and be provided at prices and with terms appropriate to the incomes and financial goals of the rural poor – individuals, households, and enterprises. A further tenet is the need for rapid outreach to serve increasingly large number of clients, which serves both development goals (providing an increasing number of poor customers with access to financial services) and sustainability requirements as a larger, and more varied clientele ensures that financial service providers can become viable and operate in a sustainable manner. Best practice standards require financial services providers to be – or have the potential to become – Operationally Self-sustainable (OSS), meaning covering their operating costs. A more stringent sustainability indicator is Financial Self-sustainability (FSS), which measures the degree to which financial institutions cover operating and capital costs. Both of these measures are best practice standards in the microfinance industry and have withstood over a decade of testing by financial institutions and development partners around the world.

A money saving co-operative receiving a deposit from one of it's members, Côte d' Ivoire
Photo: Christine Nesbitt, IFAD Photo Library

32. Best practice also urges development partners to measure the impact of financial services at the household level. This includes how services affect household income, food security, and numerous social capital assets such as education, housing, and health. Social performance measurement best practice has two approaches. The first stresses integrating impact measures in the management and market development information systems of financial institutions. The second relies on rigorously defined social impact studies that are longitudinal and observe whether individuals, households, or enterprises move out of poverty and reduce their risk of falling back into it.

20 Pro-poor appropriate is defined by products and services that provide utility to the poor or those that help to increase household income or asset value. Care must be taken to ensure that credit products, for example, do not unnecessarily overburden the poor with debt and that savings products provide positive interest etc.

33. At the meso level, best practice requires a range of institutions that help the sector develop, while undertaking supervisory functions. Meso-level institutions are, for instance, apex institutions, credit bureaus, or supervision agencies. At this level, best practice prescribes that financial service providers – regardless of their ownership (public, private, or community-owned) – come under the supervision of a qualified agency and agree to transparent reporting on key performance indicators. This standard is vital to ensuring the performance of the financial sector as a whole and that of financial service providers in particular and serves to protect the financial assets of clients, including the rural poor.

34. At the macro level, policy and regulatory frameworks should ensure that financial service providers operate in an environment that enables them to provide appropriate financial services to the poor and become sustainable. Interest caps, directed credit, and other similar policies that distort the financial sector are not in line with international best practice.

35. These guiding principles have led development agencies to make specific choices before giving assistance for microfinance or rural finance. They concern most prominently the demands on the financial service providers, selecting those with the potential and commitment to become sustainable while expanding outreach to poor clients. To ensure that sustainability and outreach requirements are met, best practice requires frequent monitoring of a few indicators, such as those adopted and published by CGAP. In addition to selection and performance monitoring, best practice dictates that the type of assistance provided to the financial service provider should depend on their existing capacities. Many times, service providers require technical assistance to build their capacity rather than a credit line to increase their resources for portfolio lending, or require funding that allows them to take risks for venturing into new markets (such as the rural sector, lending to the rural poor)[21]. A thorough sector analysis (including existing liquidity in the market and its location) and institutional diagnostic (strengths and weaknesses of the financial service provider) would indicate what kind of assistance is most relevant. Under any circumstances, financial service providers – whether public, private, or community-owned – are required to meet transparency and accountability standards.

36. Due to the dynamic nature of financial market developments and because of its private sector orientation, best practice interventions recognize the need to ensure that projects be designed and started in the shortest time possible, typically within a year. This aim is challenging, particularly because the main microfinance development partners also recognize the importance of working together to ensure that sector development programming is consistent and coordinated, often a difficult task given different mandates and operating policies.

37. The RFP's four main challenges to developing pro-poor rural finance services reflects a number of these best practice tenets, though in some cases awkwardly so. Each challenge is assessed in turn below, though separating the discussion of the one challenge that combines sustainability and outreach.

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[21] This view argues that financial institutions go through a life cycle from youth, growth to maturity, each requiring specific types of capital which in turn have potential impacts an institution's growth and sustainability prospects. Young and growth institutions require more risk capital. Young and growth stage institutions need a good deal of capital which can withstand high risk. To the institution this means patient capital, while to the investor it means good financial (and in the case of development partners) social returns to investment. Development partners, for their part, must accept high levels of risk, particularly in innovative or difficult markets (including most rural markets), which means aiming for a few highly successful investments offset by a good number of equally spectacular failures. Such an investments approach can only be successful if a donor takes well calculated risks. To date, most development partners have neither invested the majority of their capital in the highest risk financial institutions nor have they adopted strong investment risk calculation systems. For more information, see de Sousa-Shields and Frankiewicz (2005), Financing Microfinance Institutions: The Context for Transitions to Private Capital, USAID.

38. **Sustainability of Financial Service Providers.** The RFP clearly insists that projects will have sustainable outcomes, referring specifically to the provision of pro-poor financial products and services through financial institutions[22]. Sustainability is defined as PFI FSS including the ability to raise portfolio funding to sustain lending and service operations. This test is more demanding than that employed by most development partners who generally apply OSS. While FSS is the main sustainability criteria, the RFP also provides a more extensive list of sustainability and performance indicators than required from a policy oversight perspective (as opposed to a project management perspective). Some indicators such as *Yaron's subsidy dependency index* of viability is – today – not widely used; it has not become industry standard contrary to what the RFP anticipated at the time when it was drafted. A much shorter list of indicators, such as that presented for performance benchmarks is more in line with current best practice and effective management oversight[23].

39. The RFP struggles to define how to support sustainable institutions given the instruments to IFAD. Best practice suggests using grant funding for building the capacities of financial service providers, which is more often required than credit lines or debt for portfolio funding (i.e., on-lending to clients). The RFP recognizes the limitations of credit lines but is not entirely clear on alternative options. It advises that credit lines can be used in situations where liquidity is a problem and rightly points out that they should not displace local resources where available. Funding capacity building is mentioned only in the context of grants, of which only few were country-based at the time of writing the RFP, and currently the amounts are not commensurate with the needs of PFIs. Co-financing and equity participation are the only other instruments mentioned in the RFP, both of which are difficult for IFAD to employ – the former because of the effort required to align different donor priorities (among other reasons) and the later due to a lack of experience in equity investing. No mention is made of the best practice strategy of using portfolio financing only in proportion to an institution's ability to absorb it on a sustainable basis.

40. An important consideration for sustainability is the ability to identify and enforce compliance. The RFP performance measures and benchmarks provide triggers to enforce standards, but no mechanism for doing so is spelt out (e.g., any PFI not meeting sustainability within a certain time period will be dropped from programming). This lack of direction is compounded by the delegation of implementation responsibility to Cooperating Institutions (CIs) and national government[24], which impedes the extent to which IFAD can insist on enforcing performance standards. Direct lending to PFIs would allow for more straightforward control – loans and grant support can be cancelled for not meeting project performance standards – as some other development partners have demonstrated. The United Nations Development Programme (UNDP) microfinance policy[25] states, for example, that Microfinance Institutions (MFIs) not meeting performance standards within a reasonable time period should be dropped from programmes. In this regard, the RFP and IFAD's *modus operandi* fall behind best practice standards.

41. The combination of oversight and enforcement works only if there is intensive monitoring on a quarterly – if not monthly basis. The RFP is not specific about monitoring requirements except to say implementation will be closely monitored at the project level. The RFP does not delegate responsibility for monitoring; though in practice it falls to IFAD which is awkward as the Fund does not have authority over project implementation. A clear line of authority and accountability is a hallmark of effective policy, particularly where monitoring should be intensive and meet technical standards.

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22 This prescription is somewhat misleading as the RFP recognizes very informal services agents such as self help groups, tandas, and roscas, which are not institutions per se.

23 IFAD, Rural Finance Policy, page 63.

24 Ultimate responsibility for the design and implementation of a project rests with IFAD's government partner, or, in the case of grants, with the beneficiary NGO or research institution. IFAD, Rural Finance Policy, page 22.

25 UNDP Microfinance Policy: http://www.uncdf.org/english/microfinance/undp_policy.php.

42. **Outreach.** The RFP treatment of sustainability overshadows that of outreach. There is no clear policy objective for *depth* or level of poverty IFAD programming should reach except that it should reach the poor. What poor means is not defined and but is generally interpreted at IFAD to mean the poor as defined by the Millennium Development Goals – or those living on less than US$2 a day in Latin America and less than US$1 in other regions. This is not problematic as a policy objective *per se*, but experience suggests that providing financial services uniquely to the poorest[26] of the poor in rural areas on a sustainable basis is difficult at best. The best practice standard of working with a cross-section of client is not anticipated in the RFP. This omission could be interpreted to exclude all but the poorest of the poor, a feature that should greatly complicate PFI sustainability expectations. The RFP mentions the best practice of expanding outreach, noting the positive correlation between scale of operations and sustainability. However, it does not specifically state an objective of serving a rapidly growing number of poor. The absence of a specific target allows IFAD to support projects that reach very few poor through volunteer-managed, sustainable SHGs, which is an RFP compliant but entirely inefficient use of resources, contrary to best practice use of donor funding. The RFP takes note of impact studies, but does not emphasize their importance in line with best practice. As a result, impact assessments have assumed low priority.

43. **Stakeholder Participation.** The focus on the RFP with respect to participation relates to IFAD's approach to project development. It calls for the active participation of a range of stakeholders in the identification, design, implementation, and supervision of projects. These stakeholders normally include government, the poor and other development partners. Such approach is consistent with IFAD's participatory approach to development, but is somewhat at odds with best practice standards for microfinance and rural finance, which focus on ***demand-driven services***. The latter require an understanding of the financial needs of the poor, which can be determined through professional market surveys and research rather than through consultative multi-stakeholder processes, which may distract from the needs and views of the poor. The RFP embeds the need to provide demand-driven services under one of the four challenges, namely that of sustainability and outreach, where it receives less attention than the more generic concept of participation, which is elevated to the level of one of the four challenges. The problem that arises from the RFP's treatment of stakeholder participation is the interpretation that all stakeholders, including the poor, need to be involved in the ownership or management of rural finance institutions. In some cases, such as cooperatives or village banks, this is appropriate, but in other, more commercially operated financial service providers, such participation would not be desirable from the perspective of the poor or the PFI. The main general distinction is that the RFP emphasizes stakeholder participation in project development, whereas best practice focuses on demand driven project outputs.

44. **Differentiated Financial Systems.** A clear understanding of demand leads to a clear understanding of the kinds of institution and products that are best suited to meet the financial service needs of the poor. The RFP is clear that IFAD must be open to a range of institutions and products. This is consistent with best practice view of supporting a context-driven diversification of the (rural) financial system. The RFP rightly points out that the best pro-poor institutions in some areas may be commercial service providers, while in others a cooperative or SHGs owned by the rural poor is more appropriate. The RFP does not offer similar direction at the "meso" level, where there is often a need to support actors offering risk pooling mechanisms, payment systems, banking technology, credit rating services and other elements of a diversified financial infrastructure.

45. **Promoting a Conducive Policy and Regulatory Environment.** The RFP provides a strong best practice emphasis on policy environments supportive of pro-poor financial systems. This includes sound macro economic conditions as well as business and financial regulations such as interest rate deregulation, financial institution autonomy, and legal systems protecting the property and land-use rights. The RFP also emphasizes prudential regulation and supervision, a central tenet of sustainable,

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[26] The same experience also shows that the poorest may not need financial services but rather other types of assistance and are further impoverished, if they are provided with unsuitable micro credits that indebt them for a long time.

best practice pro-poor financial services. The RFP reflects that the role of governments is most often best suited to regulatory development and supervision, or in some cases, wholesaling funds to retail financial institutions (assuming it is not distorting the market). The RFP designates IFAD's role to advocate with, and on behalf of, the poor for such conducive policy environment. While the RFP's treatment of policy and regulatory issues is consistent with best practice views, the need for such interventions varies greatly by country. As a result, best practice policy considerations are often cast as an element to consider, rather than a main challenge. The difference between emerging pro-poor financial activity in China, for example, demands an entirely different approach than in countries such as Benin where legislation is being developed, or other countries like Uganda and Peru where a system of laws are already in place.

46. **Other Best Practice Considerations.** The RFP recognizes the importance of strategic linkages among organizations engaged in rural finance and that "donor coordination" is part of effective stakeholder participation. The RFP also places value on knowledge generation and sharing and the use of innovation as befits best practice.

B. The RFP and IFAD's Policies

47. Normative policies seem to be held back at IFAD by the inertia of its current and previous business models[27]. In the absences of norms, strategies remain important guiding mechanisms or "policy proxies" at various levels of the institution. The CLE compared the RFP against major policies and strategies of IFAD to test whether RFP principles were reflected in these documents, when necessary, to understand whether there is internal consistency between policy directions.

48. **Strategic Framework 2002-2006.** The Strategic Framework is fully in line with the RFP goal of developing programmes that lead to "sustainable access of the rural poor to financial services, to be enhanced by institutional diversity and a supportive rural financial infrastructure." It asserts that assistance should focus on developing professional and responsive financial institutions, with a strong emphasis not just on providing credit, but also encouraging savings[28]. While clearly supportive of the spirit of the RFP, the Strategic Framework's reference to working with PFIs that are "professional institutions" introduces an unnecessary ambiguity. For example, what constitutes professional is hard to define and more complexly, an institution may be both "professional" and unsustainable. In addition, the Strategic Framework implies a limited focus on credit and savings products, rather than the wider perspective of the RFP on a range of pro-poor financial services, including such products as transfer services for remittances, insurance, and micro-leasing.

49. **Sector Wide Approaches for Agricultural and Rural Development Policy and the Rural Enterprise Policy.** The policy for *Sector Wide Approaches for Agricultural and Rural Development* and the *Rural Enterprise Policy*, directly and indirectly support the RFP. Both policies were adopted after the RFP. Nonetheless, they espouse the importance of an appropriate enabling environment that allows private sector producers and market intermediaries to expand economic activities and market relations in rural areas[29]. These policies also recognize the increasingly multifaceted and segmented nature of rural economies consistent with the RFP view to supporting the financial needs of the full range of enterprise found in rural areas (e.g., on and off-farm enterprise). Both policies also stress a sector development approach of locally adapted strategies, where the poor are engaged in design and implementation. They call on a variety of financial solutions including venture capital, micro leasing and other innovations. However, the *Rural Enterprise Policy* inappropriately promotes the idea of "funds for medium term credit and or guarantee mechanisms aimed at limiting the risk borne by

[27] IEE, page 7.
[28] IFAD Strategic Framework 2002 - 2006, page 11.
[29] Sector Wide Approaches for Agricultural and Rural Development Policy, IFAD, page 8.

financial institutions that deal directly with small scale rural entrepreneurs"[30]. Such funds are difficult to establish on terms consistent with the RFP objectives of sustainability[31].

50. **Mainstreaming a Gender Perspective in IFAD's Operations.** The Gender Plan of Action provides an explicit guide to incorporating the priorities and needs of women and men in rural development[32]. This sentiment is found in the RFP but in no precise terms. The focus on women in development, presented in the Gender Plan of Action, is a critical element for equity in development. For the RFP it is essential, because women are important managers and consumers of financial products and services and contribute to the education and health of their families. As such, rural finance offers important points of entry exposing women to financial literacy and household financial planning. Some best practice microfinance initiatives offer proactive services to this end (i.e., integrated into the operations), while others have developed time-limited services (e.g., one time budgeting and investment advice courses). The RFP does not recognize opportunities for the advancement of women in the rural financial sector as an important element to gender equity in rural development or an important part of IFAD's approach to assisting the development of the rural finance sector.

A project client in front of her *sari sari* (small retail) shop in the Philippines
Photo: F.Felloni, IFAD's Office of Evaluation

51. **Environmental Sustainability.** Managing and conserving the world's natural resources including its biodiversity is a goal of IFAD (embedded in one of the three strategic objectives of the Fund) not mentioned in the RFP. Most environmentally sustainable financial initiatives are nascent (and did not exist at the time the RFP was developed), but today a few important examples provide best practice guidance. They include the Global Reporting Initiative, social and environmental impact management indicators, and corporate environmental policies. Each of these initiatives aims to provide financial institutions with guidance on assessing environmental impacts of investments they finance[33].

30 IFAD Rural Enterprise Policy, page 22-23.
31 See Flamming, Mark (forthcoming) paper on guarantees for CGAP.
32 IFAD, Mainstreaming: A Gender Perspective in IFAD's Operations, Plan of Action 2003 – 2006, page vii.
33 Triodos International Fund Management, a specialized social investment fund management company in the Netherlands has piloted, for example, a program to have six of its investee MFIs develop Global Reporting Initiative reports. A full coverage on the subject of finance and sustainability can be found in Jeuken, Marcel, (2001) Sustainable Finance and Banking: The Financial Sector and the Future of the Planet, EarthScan, 2001.

C. The RFP: Strategic Guidance and Supporting Mechanisms

52. The RFP, as with many similar policies, also mandates a number of support mechanisms, which in turn, have important influence on the achievement of RFP objectives.

53. **RFP Clarity, Priorities, and Norms.** Policies are meant to prescribe parameters around acceptable corporate behavior and actions. They should be clearly articulated and provide a strong sense of prioritization and strategic direction. They need a find the right balance between a certain degree of flexibility to allow for a variety operating environments and setting unambiguous boundaries to permissible actions and choices in line with corporate objectives. The RFP does not fulfill the basic requirement of prescription, because it provides information more typical for a thematic primer than a policy and because whatever prescriptive elements it contains are submerged in this background information. As a result, key messages are obscured and too much room is given for interpretation. Justifications, stories of success, and contextual qualifications are helpful to understanding a policy, but they distract from the non-negotiable norms that policies should make clear. By attempting to satisfy multiple purposes, the RFP misses an important opportunity to create a common understanding of and direction to what type of rural finance activities aims to assist and what not. Examples of shortfalls include the absence of an analytical framework that enables a sector development approach, a sense of prioritization among the four challenges, an excessive degree of flexibility introduced with the LogFrame lists in the RFP annex, ambiguous guidance on the use of credit lines and no prescriptions on the use of funding for capacity building.

54. **Mechanisms Supporting Rural Finance Strategy and Activities.** The RFP outlines a number of implications and recommendations for IFAD regarding the integration of the policy into practice. These include the development of operational guidelines, PFI selection criteria, the means to ensure close performance monitoring at the project level, and the integration of the RFP into regional and country lending strategies.

55. **Operational Guidelines, Design and Implementation Support.** The RFP requires that operational guidelines for rural finance development be brought to the Board for approval. This came in the form of the Action Plan for Rural Finance, which addresses fundamental shortcomings of IFAD's rural finance activities identified by the first CGAP DPR and issues emanating from the Independent External Evaluation (IEE). The original rural finance action plan focuses on four areas: improving strategic vision for rural finance across IFAD, establishing a simple way to measure results and impacts, and strengthening rural finance capacity both in the field and internally at IFAD. The updated version builds on this work and recommends reviews of the rural finance portfolios of regional divisions, continued development of results and impact measurement systems, continued strengthening of IFAD's internal rural finance capacity, and enhanced rural financial technical capacity in the Technical Division of the PMD.

56. The Decision Tools and its summary companion, the Learning Notes for Rural Finance, take the RFP principles to the "ground" with guidance on how to design and implement RFP compliant projects. The Decision Tools emphasizes important operating challenges and defines IFAD activities in the context of a rural finance frontier that demands constant attention to risk and innovation. A sector development approach to programming is underscored, as is the need for sound macroeconomic analysis. Challenges facing the selection of PFIs are highlighted, as is the preference for technical assistance over credit lines and stand alone finance projects. Performance-based monitoring is described and a small number of key performance variables are presented in a manner that clarifies the RFP on this point. The Decision Tools do not, however, offer a simple and concise analytic framework for programme design and implementation, again, such as the CGAP macro, meso, micro approach.

57. Both the Decision Tools and rural finance action plan address the key challenge of monitoring projects for RFP compliance. The 2003 rural finance action plan sets out the goal of identifying 3-4 key performance indicators that can be used in IFAD's project monitoring reporting. It also calls for the use of the MIX, a web-enabled MFI reporting system that offers a simple and cost-effective instrument for PFIs to report on operation and performance data. The updated rural finance action plan emphasizes the need to develop the MIX as an active management performance oversight tool that will allow IFAD's to shift rural finance monitoring from an activity to a performance-based system supporting PFI performance based contracts. The Decision Tools does not recommend the development of a MIX based management information system for senior managers; instead, it focuses implicitly on use by CPMs.

Box 4. PA Region Rural Finance Strategy

IFAD's West and Central Africa Region developed a medium term (2003-2006) strategy for rural finance, which is in line with the RFP. It outlines regional challenges and strategies for responding to them to increase access of the rural poor to rural financial services.

The strategy focuses on institutional development, technical assistance, and saving mobilization and credit. It argues that credit recipients should be not "targeted" but rather financial products should be designed based on the demand of the target market. Various approaches are foreseen, including supporting member-based financial service associations, linking financial institutions in national networks, establishing appropriate legal and regulatory frameworks, and developing new products.

The Strategy presents three objectives for increasing access to finance for the poor:

1. Increase outreach of viability of rural finance;
2. Strengthen implementation capacity at all levels (IFAD staff, PMUs, regional partners, clients); and
3. Improve MFI monitoring, reporting and impact assessment.

Each objective has detailed quantifiable goals and indicators of success. The regional strategy highlights the necessity of using good practices and innovation. It stresses technical assistance as well as supporting the development of sector infrastructure (i.e., meso level activities), such as audit firms and training facilities. The strategy notes that all projects designed before the regional strategy should be appropriately updated, either through redesign or, if necessary, terminated.

The regional strategy provided an important focal point for rural finance in the regional division. There is a great degree of knowledge and ownership of the rural finance strategy among CPMs in the division. As a result, the understanding of the guiding principles of the RFP embedded in the regional strategy is also high.

58. **Regional Strategies.** With the exception of Western and Central Africa division (PA) which has a separate rural finance strategy (Box 4), regional strategies provide little specific guidance or insights on how rural finance will be applied to regional rural development challenges. Nor do they offer a systematic view to the RFP and its dictums, or a summary of analytical underpinnings that would be necessary to develop a region-specific strategy to assist the rural finance sector. Regional strategies, like the RFP itself, do not provide a clear sense prioritization, except to focus programming on target populations (which are generally the poorest of the poor found in remote, low density rural areas). Conditions across regions are, however, not homogenous and intra-regional diversity challenges the utility of operable regional rural finance strategies just as diversity between regions challenges the relevance of the RFP. This limitation notwithstanding, establishing specific rural finance targets has helped PA concentrate interest and activities while encouraging compliance with the RFP.

59. **Country Strategies.** The RFP has had more varied but generally less success filtering into country strategies. Typically, country strategies mention one or two of the RFP challenges, but seldom provide the necessary analysis of the financial sector to determine which challenges need to be

addressed as priority. This weakness is less pronounced in more recent country strategies, such as those prepared for Benin, China, and Zambia.

60. **Thematic Studies, Portfolio Reviews and Working Papers.** The RFP calls for working papers and research to support rural finance project effectiveness. In response, IFAD has funded and published a number of documents providing in-depth presentations on important issues related to best practice rural finance. Some are primers on critical rural finance issues such as governance or innovation, while others offer insight to complex issues of impact assessment[34]. Others are more general, addressing broad challenges in rural finance or providing on-line resources for rural finance practitioners[35]. Some regions, including PF and PA have undertaken rural finance portfolio reviews, which have contributed to strategic orientation and knowledge generation in those regions. Combined, these resources form a significant base for supporting the RFP and best practice rural finance.

61. **Memorandum Supporting Donor Coordination.** IFAD has recently signed a memorandum of understanding prepared by CGAP that expresses a commitment by major microfinance development partners to pursue financial sector development cooperation where possible.

D. Summary Assessment of the Rural Finance Policy

62. The RFP is in line with best practice standards in a number of important areas, such as sustainability of financial institutions and contributing to the diversification of the financial sector (institutions and services/products). In the area of outreach, the RFP focuses on the rural poor, but neglects the objective of large-scale expansion. It diverts attention from the more important issue of designing and delivering services and products that meet the needs of the poor by introducing a generic approach participation in project design and implementation. Shortcomings in the alignment of the RFP with best practice can, in part, be explained by the rapid pace at which best practice standards evolved over the past five years.

63. The spirit of the RFP is reflected in IFAD's corporate policies and strategies, ensuring internal consistency of policy directions, which is important to avoid further ambiguity. The emphasis of the Strategic Framework 2002-2006 – making rural finance one of three strategic objectives – on rural finance corresponds to the significant size of the portfolio for this purpose.

64. In principle, the RFP provides a guiding framework for operations, but leaves areas open to interpretation that, as shown in section III, have led to non-compliance with RFP requirements (in ongoing and newly approved loan projects) and subsequent shortfalls in performance. The supporting instruments, such as the Decision Tools and rural finance action plan, have filled some of the gaps, but an analytical framework, necessary for systematically understanding key bottlenecks to sector development and deciding on the best point of entry, is still missing.

[34] IFAD, "Assessing and Managing Social Performance in Microfinance," April 2006.

[35] Peck Christen, Robert and Douglas Pearce (2005), "Occasional Paper. Managing risk and designing products for agricultural microfinance: features of an emerging model", CGAP, Building financial services for the poor, August 2005 and Rural Finance Learning Centre (http://www.ruralfinance.org).

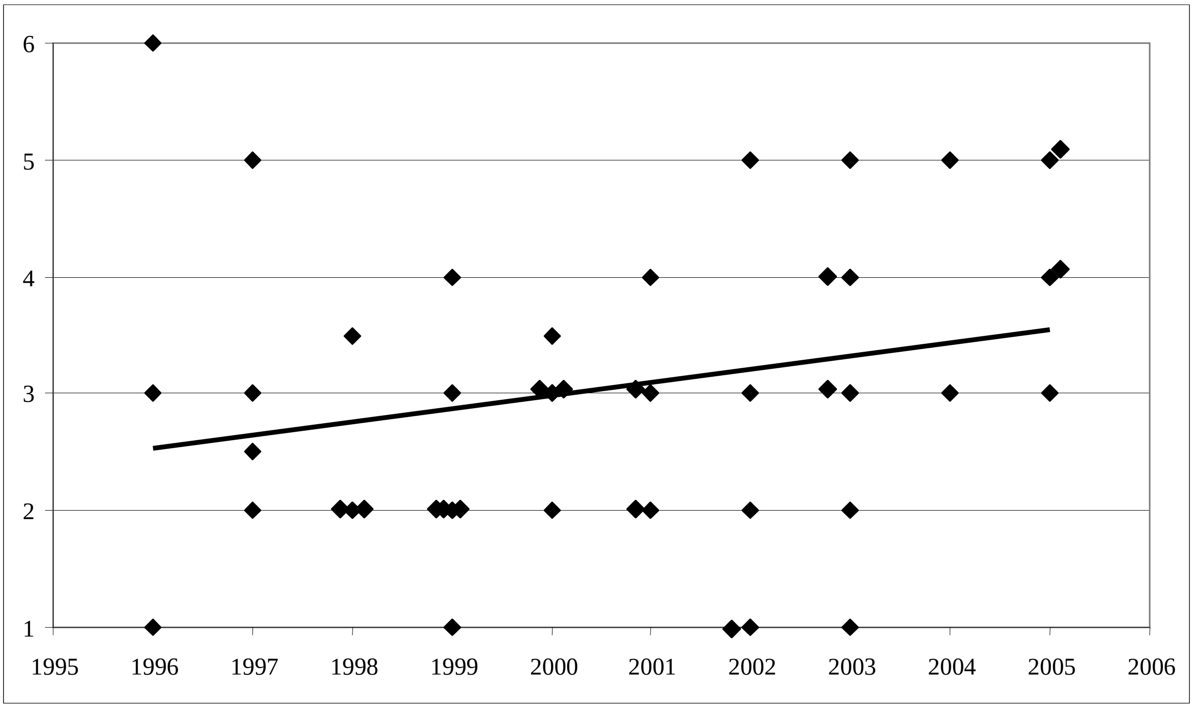
III. IFAD PROJECT PERFORMANCE AND IMPACT

65. The CLE assessed whether the RFP requirements were implemented in IFAD-financed projects. To understand whether the RFP *made a difference*, the CLE compared the quality of projects for the five-year period prior to the adoption of the RFP and for the five years after. For the purpose of this evaluation, quality was defined as the extent to which projects met the four challenges spelled out in the RFP (splitting one of the challenges into two, i.e. separating observations on PFI sustainability from outreach). The CLE assessed whether (i) PFIs were sustainable; (ii) the rural poor were served; (iii) stakeholder participation was significant and meaningful; (iv) projects contributed to financial sector diversification; and (v) policy dialogue was undertaken.

A. IFAD Rural Finance Project Performance

66. Projects are increasingly meeting the RFP challenges, although overall performance falls short of satisfactory. The average performance rating for the first period (1996-2000) was 2.7, which improved slightly to an average of 3.2 for the second period (2001-2005). This rating indicates that positive performance characteristics only marginally outweighed the negative. Figure 2 shows a positive trend line in the quality of projects over the entire evaluation period. The positive trend began just before the RFP, suggesting projects were benefiting from a growing institutional focus on rural finance at the time when the policy was articulated. Figure 2 also demonstrates that some of the early projects embodied good practice standards long before these were articulated in the RFP. The number of well performing projects (rated 5 or better) increases from two (Philippines and Venezuela), before the approval of the RFP, to five after (Bangladesh twice, Benin, China and Uganda).

Figure 2. IFAD Rural Finance Project Ratings



Note: The scale has six levels: (1) Seriously detract from RFP objectives; (2) Detracts from RFP objectives; (3) Net sum zero support of RFP objectives; (4) Some support of RFP objectives; (5) Good support of RFP objectives; and (6) Significant support of RFP objectives.

Sustainability of Partner Finance Institutions

67. Of the 25 PFIs reporting performance data to this evaluation, fifteen (60 per cent) had achieved operational self-sufficiency[36]. Six, or 24 per cent, met the RFP requirement for FSS, but none of the others were assessed to have the near term potential to do so[37]. The average portfolio at risk was 10 per cent[38]. Beyond this data, evaluators used a modified CGAP Appraisal Format[39] to estimate that approximately 30 per cent of all PFIs considered for this evaluation were operationally self-sufficient. Though not directly comparable, these findings are similar to those of a review of the UNDP microfinance portfolio, which observed 21 per cent of MFIs with good, and 78 per cent with weak to unacceptably weak performance – a finding consistent with the lower end of the spectrum of donor agency effectiveness in microfinance. Sustainability was the key determining factor in the UNDP review[40]. It should also be noted that the UNDP portfolio is a mixed portfolio of urban and rural projects, which suggests at least theoretically a less challenging context for developing financial services.

68. The RFP and its supporting mechanisms, the CGAP DPR, and best practice recognize that projects focusing on finance alone have a greater probability of achieving sustainability than multi-sector projects. This lesson has not been lost on IFAD which saw a 40 per cent increase in stand-alone projects (i.e., projects more than one thematic focus) in the sample post RFP. However, these projects are too recent to assess their results and impacts and compare the findings with older projects.

69. The CLE confirmed, albeit on a relatively small scale, the finding of the UNDP evaluation that PFIs reporting OSS are more likely to have received significant Technical Assistance (TA) than those that did not. Among the IFAD PFIs that reported OSS, three had no technical assistance from IFAD or other sources, three PFIs had two to three months annually, and four had over three months of technical assistance. Of those that had not achieved OSS, two had no TA, five had less than one month of TA annually, and only two had received more than one month. This relationship cannot be extrapolated across the IFAD portfolio but does underscore the importance of technical assistance. Also of interest is that ten, or 67 per cent of PFIs reporting OSS were judged to have financially literate CPMs, and two more had local IFAD representatives, *suggesting* as did the UNDP review, that higher quality oversight is related to sustainability.

Stakeholder Participation

70. In assessing whether stakeholders participated in a project, the CLE used the RFP focus on participation in project design in general. It did not assess whether this results in better financial product design (i.e. meet best practice standards of demand-driven services), as this was not a

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36 Only 25 PFIs reported self-sufficiency ratios despite repeated attempts by the evaluation team to collect data. These efforts included both a structured questionnaire sent repeatedly to all PFIs and on-site review of PFI performance data. Understanding the nature of non-response in microfinance is important as it has proven to be motivated by two conditions, each equally telling about performance. Many MFIs will not report sustainability because they are not sustainable and are concerned about reporting this. Many others simply cannot calculate these very basic management information ratios, indicating a lack of management capacity that is typically, though not always, associated with poor financial performance.

37 These findings are consistent with a sample of 73 PFIs that reported to the MIX in 2006. These PFIs report a median OSS ranging between 109 and 120 per cent across regions, and operating efficiencies of between 22 and 12 per cent indicating the potential for many PFIs to achieve FSS. It must be noted that this sample is likely biased towards PFIs with better performance (i.e., PFIs with better results tend to be more transparent and or able to report performance results).

38 Care should be taken when interpreting global averages as they often do not adequately explain differences in operating conditions at the country or regional levels.

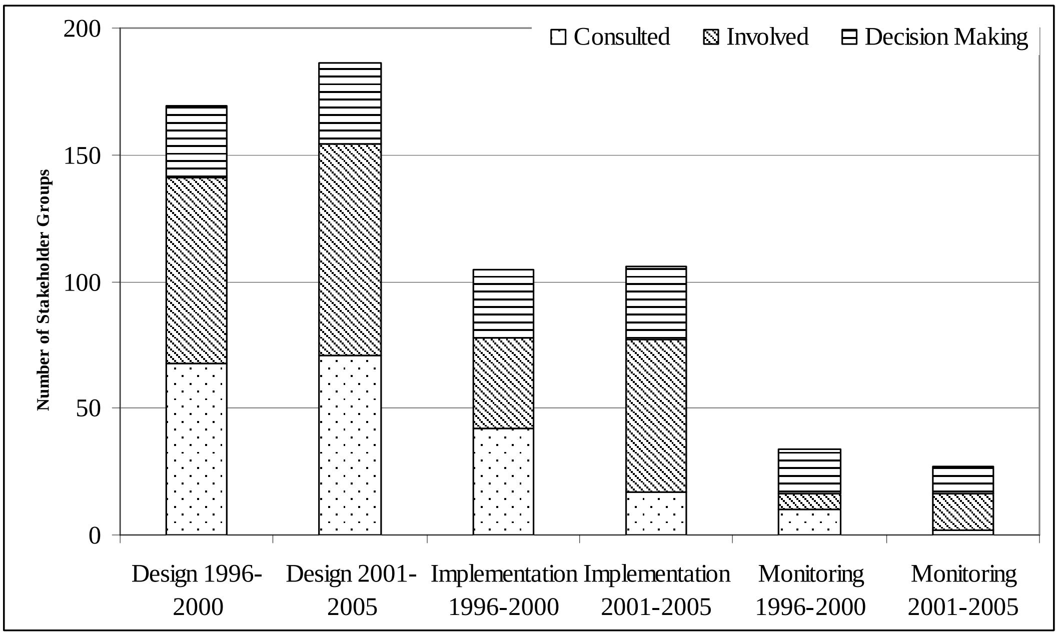
39 CGAP Format for Appraisal of Microfinance Institutions: A Handbook, see www.cgap.org.

40 Rosenberg, Rich, Review of UNDP Microfinance Portfolio, April 2005. http://www.microfinancegateway.org/content/article/detail/30203.

requirement of the RFP. Participation was considered at three levels: being consulted, being more actively involved, and having decision-making rights.

71. Up to 22 different types of stakeholders have participated in the design, implementation and monitoring of the sample projects. Figure 3 shows that the volume and structure of stakeholder participation in IFAD projects has remained largely unchanged since the introduction of the RFP with the exception of small trends towards more stakeholder involvement during design and implementation. These observations need to be qualified by the quality of participation which was often limited to short and one-time only focus groups. Serious analysis of the financial needs of the poor was typically rather limited (i.e., only few demand studies were undertaken, client satisfaction assessments were rare, etc.). Government and PFI input, by contrast, were found to be consistently more meaningful.

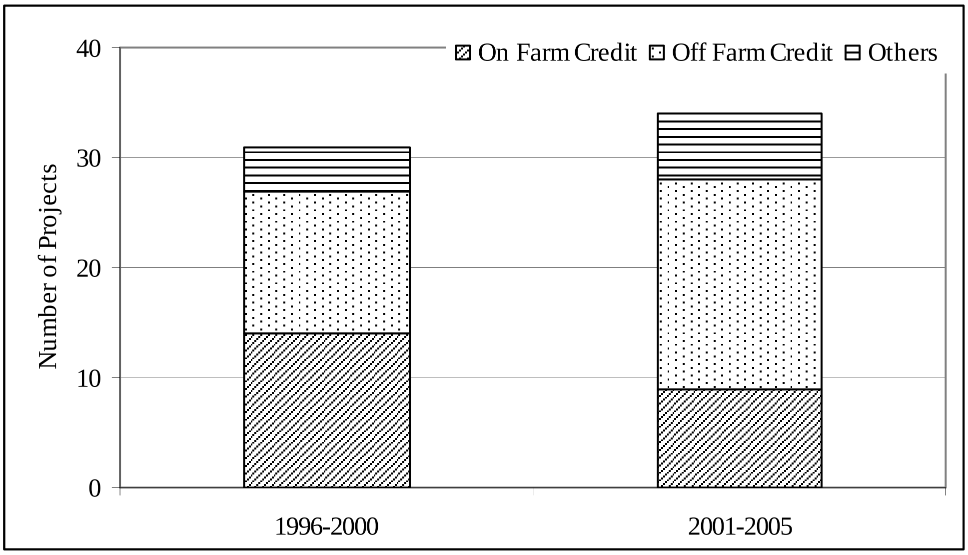
Figure 3. IFAD Stakeholder Participation



Financial Sector Diversification

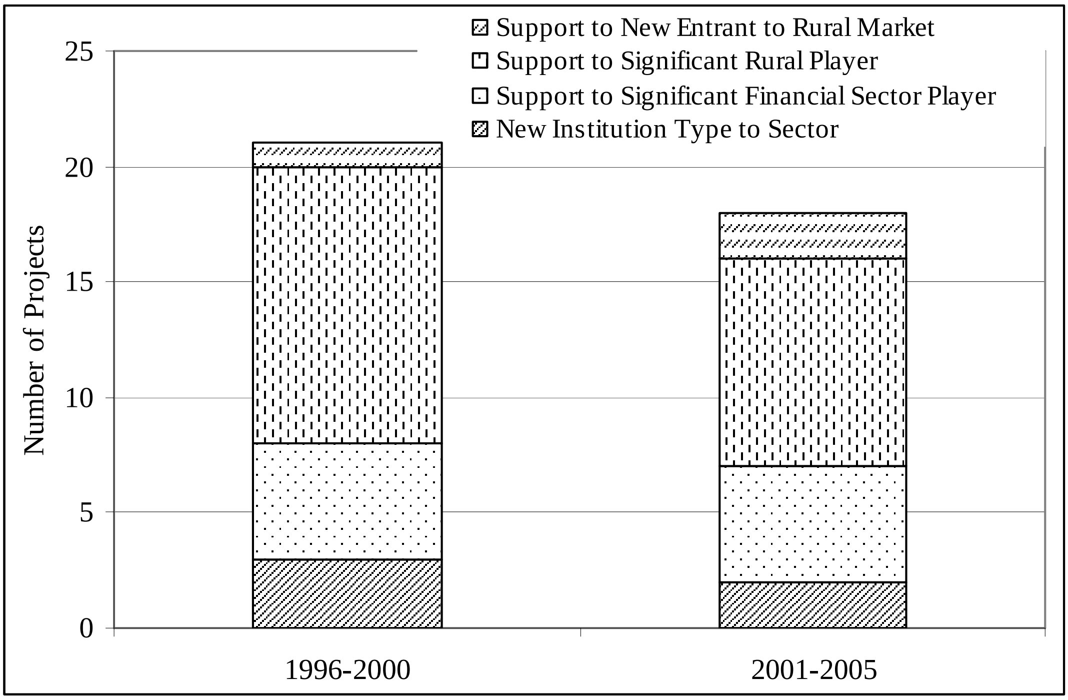
72. Microfinance development partners largely recognized by the late 1990s that credit was not enough and that the poor demanded a greater range of financial services. This was reflected upon, though not emphasized or well detailed, in the RFP. Nonetheless, IFAD has seen a notable movement towards supporting projects with a greater variety of products and services. A modest decrease in on-farm credit shown in Figure 4, particularly those tied to a specific production or farm improvement activity, is matched by a similar increase in off-farm credit recognizing the broader credit needs within rural households. Other types of products, from insurance to services to receive remittances, have also increased though less noticeably. There has also been a small increase in the number of projects with savings components, a key financial service for poverty alleviation as emphasized by the RFP.

Figure 4. Financial Product Offering



73. Financial sector differentiation also implies the use of financial institutions that best suite client needs and are adapted to local market and regulatory conditions. IFAD has seen a modest shift in the diversity of its partner institutions (Figure 5). Partnerships with important financial sector players have not decreased over time, though there has been a small decrease in partnerships with state banks (significant rural finance players). At the same time, support to new entrants to the rural sector has fallen off, underscoring a tendency to seek more established rural financial sector partners rather than introducing new ones. The overall trend suggests IFAD is partnering with more established financial organizations, often with some rural market exposure but new to pro-poor lending. These include commercial banks and non-bank financial institutions, as well as a few instances of agricultural input suppliers.

Figure 5. Partner Financial Institutions



Promoting Conducive Policy and Regulatory Environments

74. Tracking and evaluating the impact of policy dialogue and its results is particularly difficult in any development intervention as they are highly susceptible to exogenous factors (e.g., change of government personnel, priorities, etc.) and difficult to measure. The number of IFAD rural finance projects with policy initiatives remained largely unchanged in the sample. The CLE had no way to quantify the quality of policies initiatives except to note that they are limited by a lack of on-the-ground presence with finance policy experience. In some cases, IFAD regional partners were involved in policy debates and issues on rural finance policies in PA, such as GTZ and the African Rural and Agriculture Credit Association (AFRACA) initiative.

B. Pro-Poor Impact and Project Performance

75. Monitoring impact is more complex than measuring project or PFI performance. Best practice impact analysis integrates social performance measurement into an institution's management information system which can simultaneously produce social impact and business management information.[41] Very few examples exist, with IFAD or other development agencies, to apply these approaches. The most accurate means to assess rural finance impact, however, is long-term, longitudinal client welfare studies.

76. Conducting a full impact assessment at the household level would have considerably increased the cost of the CLE, (without necessarily providing better insights into impact) given the dearth of baseline and other self-evaluation data. For this reason, the CLE opted for a less ambitious but more cost-effective approach to use proxy indicators that are commonly employed in the microfinance industry. These are: (i) the ratio of average loan size to Gross National Income (GNI) per capita[42] which measures how poor the borrowers are (depth of poverty); and (ii) the number of women served, which is a proxy indicator for the nature of impact (i.e., women are generally more inclined to reinvest the proceeds of income-generating activities in household assets' development and enterprise). These indicators were complemented by expert assessment that relied on a variety of sources including product design, client surveys, secondary studies, PFI data and focus groups[43].

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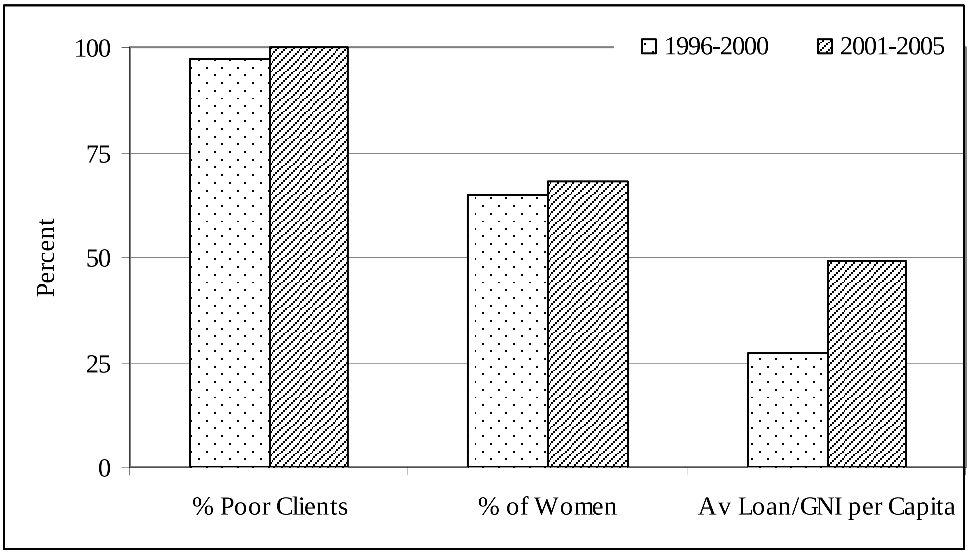
[41] See discussion of best practice standards, IFAD (2006), Assessing and Managing Social Performance Indicators.

[42] The formula for average loan balance per borrower per average gross national income is the institutions average loan balance per borrower divided by the gross national income in which it is resident. See www.mixmbb.org definitions for more details and most current global benchmark figures.

[43] The RFP does not distinguish between the types of poor which in microfinance are typically placed into two categories: the productive poor (those with some assets with which to produce a livelihood), and the poorest of the poor (those with no means to production).

Figure 6. IFAD Poverty Outreach



77. The CLE found, as illustrated in Figure 6, that IFAD was reaching the poor both before and after RFP approval. The CLE estimates, however, that fewer than 10 per cent of those reached were the poorest of the poor, which is in line with best practice which considers providing microcredit to a poor person might indebt them beyond his/her repayment capacity.

78. The CLE also observed that, on average, 60 per cent of PFI clients were women in the period 2001-2005, a slight increase over 1996 to 2001. This is above the global average of 57 per cent for serving clients with mixed income levels, but below the 87 per cent global average for MFIs serving uniquely low income clients.

79. The average loan size to GNI per capita for PFI clients is 49 per cent. This percentage is higher than the global average of 25 per cent for MFIs targeting low income markets and is closer to that of MFIs which serve a clientele with mixed income levels (64 per cent)[44]. This change is attributed to IFAD working with more sustainable and established financial sector actors who are more likely serve a greater client income mix.

Summary: Modest All Round RFP Quality Improvement

80. The quality of projects, measured in terms of meeting RFP challenges, has continuously improved over the evaluation period. However, it still falls short of meeting all RFP standards. Performance was better for working with PFIs, achieving sustainability of 24 per cent of PFIs and making inroads into diversification of service providers and types of products and services. It showed no change for stakeholder participation, which in part can be explained by the ambiguous definition of this challenge, advocating generic participation rather than a focus on pro-poor, demand-driven financial services. Performance was least discernable in the area of policies and regulatory frameworks, in part because this work is undertaken without resource allocation and often goes undocumented, although an improvement in quality of policy interactions was noted in a number of cases. The outreach of IFAD-supported PFIs is accurately focused on the poor, although the clientele of these institutions increasingly includes a mix of poor and non-poor (which increases chances for PFI sustainability), with 60 per cent of their services assisting women.

[44] See MicroBanking Bulletin 11 (MBB) (2005), http://www.mixmbb.org/en/mbb_issues/11/Online%20Tables/ 2003%20MFI%20Benchmarks.xls#OutAvg.

IV. DESIGN AND IMPLEMENTATION PERFORMANCE ISSUES

81. IFAD's programme/project design cycle has numerous inherent constraints to designing and implementing projects meeting the RFP norms. The CLE analyzed the project cycle *per se* to determine whether there existed systemic issues that impeded project quality, and provided a summary of observations from the 58 projects included in the sample, comparing pre- and post-RFP experiences.

A. Programme/Project Cycle

82. The programme/project cycle can be defined as a sequence of activities with defined inputs and outputs at each stage that lead to the development of a project. Each stage involves design and supervision responsibilities and numerous sub-processes. In the design phase, checks and balances are required to ensure project quality and compliance with the RFP. During implementation, monitoring and supervision provides similar performance quality checks.

Box 5. Estimated Project Design Costs

Inception Report	US$ 40 000	–	60 000
Formulation	US$140 000	–	160 000
Pre appraisal	US$ 60 000	–	80 000
Appraisal	US$ 60 000	–	80 000
Loan Negotiation	US$ 15 000		

Source: Engelhardt, Achim, Second Draft, Progress Report Review of Quality Enhancement Process in IFAD's Loan Project Cycle prepared for IFAD, May 2006.

Box 6. Time Required from Design to Effectiveness
(Estimates)

Direct Investments into PFIs

IADB	8 to 18 months
IFC	6 to 12 months
Private Fund	3 months

Sector Development and PFI Investment

IFAD	29 – 36 months

Sector Development Projects

UNCDF	12 to 24 months
USAID	12 to 30 months

Source: interviews with senior project officers and managers.

The Design Process

Box 7. A Simplified Investment Process

The International Finance Corporation of the World Bank invests in a range of microfinance activities, though primarily in mature, urban based institutions. Their investment process is simple and rapid, and relies on incremental commitment to pursuing investments. In the first step, an investment officer brings a prospective deal to a committee of senior managers for approval to place a deal into investment "pipeline". To be included, the prospective investment must be judged to meet International Finance Corporation (IFC) investment policy criteria. Once in the pipeline, the investment officer develops the deal. A second check is provided by the investment committee before the deal goes to approval. At this stage, a formal presentation is made to the committee which approves the deal or not.

The entire process takes less than a year and in some cases less than four months. Key to the process is early vetting by senior managers who are independent of deal development. Their involvement provides an independent assessment of the deal and that IFC investment policy is met. Incremental approval of deals acts to screen deals, saving investments of time and resources by ensuring pursuit of poorly conceived investments is stopped sooner rather than later.

(Note: the IFC is not a direct comparator institution as it makes direct investments in financial institution and does not engage in sector development projects).

83. Early design quality control is vested in CPMs and Division Directors. Each Division manages the development process differently, but most tend to work on a hub-and-spoke basis, between CPMs and Directors with little lateral consultation with other CPMs. A Project Development Team (PDT) provides important input, but of variable quality depending on who is on the team. IFAD's single rural finance technical expert is not always available for PDTs. This is unfortunate, as CPMs report that when fully available, input from IFAD's Technical Advisory Division (PT) invariably improves design. Consultants are often employed as well, though their capacity is variable.

84. The Inception Report is the first formal output in project design. This report costs an estimated US$40 000 to US$60 000 and represents a significant design investment, though not enough to discourage significant project redesign (Box 5). Formulation is next, where the broad strokes of project design are settled. Seldom does formulation provide significant details on rural finance activities. Formulation is led by CPMs, again in consultation with Directors, though the PDT is more active at this stage. In practice, and partly because of the related expenses, once Formulation is complete, projects have tended to be approved without significant revision.

85. The Appraisal Report defines project details based on Formulation. Detailed activities and implementation arrangements should be provided at this stage (e.g., PFI selection, performance objectives etc.), but in practice few are - in part due to the need to maintain project detail flexibility in the face of lengthy project approval processes. Comments of the Technical Review Committee (TRC) are provided at this stage. The TRCs are written by PT's rural finance expert who also often sits on the project's PDTs (raising concerns about conflicts of interest). Despite the typically high quality of TRCs, a non-binding status limits their overall influence, which is further diluted by project investments and CPM time limitations that tend to push projects forward. Recommendations of an estimated 50 per cent of TRCs found in the sample were not fully taken into account. For example, a rural finance project as recent as 2005 was considered by the TRC to be fully non-compliant with the RFP; yet it passed the Appraisal stage largely intact.

86. The final stages in the design process, namely the Operational Strategy and Policy Guidance Committee (OSC) and EB approval, should not have to deal with project designs that do not meet the requirements of the RFP. The overall rating of 3.2 in terms of project quality indicates that a number of projects are cleared by the OSC and approved by the EB that do not meet RFP standards. There is no evidence that non-compliant project proposals are returned for redesign to improve the quality of

rural finance components at these stages of the project cycle, suggesting that no quality assurance mechanism is in place that supports decision-making of the OSC and the EB.

Design to Loan Effectiveness

87. IFAD's project design cycle is a fairly complex process taking from 29 to 36 months on average from design to loan effectiveness[45]. The period under immediate control of IFAD, namely from identification to EB approval, has recently been shortened. However, a challenge remains to shorten the period from EB approval to effectiveness, which is subject to factors beyond IFAD's control and which is likely to become increasingly difficult with more complex project designs. However, as summarized in Box 6, processes for institutions making similar investments are normally faster, ranging from 6 to 30 months, often based on documentation that is 10 per cent the volume of IFAD's project documentation. Box 7 on the next page provides an example of a shorter business process.

88. As with many sectors of the economy, the financial sector can change relatively rapidly and design processes lasting more than a year raise significant risk to project relevance[46]. Effective lending requires update analysis of the current business environment without which assumptions guiding project activities can be seriously outdated. This is particularly true in liberalized economic and financial sector environments. Even some of the poorest countries witness rapid change. In Sierra Leone, for example, two commercial banks and two major international MFI network organizations are contemplating entering the pro-poor market within the next year; either one could dramatically reshape the competitive landscape and opportunities for financial sector projects. Time can also erode PFI interest, particularly if they are private sector institutions. It is difficult to objectively estimate how many IFAD projects in the sample have been affected by lengthy disbursement delays, but it is certainly between 30 to 50 per cent.

Project Implementation

89. Once at the implementation stage, IFAD cedes project control and supervision to national governments (usually represented by a project management unit or office) and to a Cooperating Institution (CI). Management responsibility falls to Project Management Units (PMUs) which are plagued by many general shortcomings noted by the Independent External Evaluation (IEE) (e.g., often selected by secondment rather than competitive bid, lack of capacity, politically constrained or motivated). This evaluation found that PMUs have very limited financial sector experience. If they do have some experience, it is seldom related to *finance for the poor*. Almost no PMU staff was found to have international level best practice microfinance development experience. Governments have mostly hesitated to use borrowed funds to bring capacity up to best practice standard, both within PMUs and PFIs.

90. IFAD's project monitoring and supervision relies on CIs. CIs undertake regular supervision assessments of projects, typically every 12 to 18 months. Their role has been described by the IEE as fiduciary as opposed to supervisory. Capacity among CIs to assess rural finance projects and PFIs varies, though this CLE found most rural finance supervisory reports to be cursory and of little value to performance monitoring, let alone performance enhancement. Even if reporting was of better quality, annual reporting is far too infrequent to ensure adequate oversight of PFI performance in challenging and rapidly changing operating environments. Annual work plans and budgets are useful from a project supervisory perspective, but not nearly frequent enough and seldom contain details required to oversight PFIs to RFP standards. Periodic regional rural finance portfolio reviews and occasional thematic evaluations are also useful but not frequent enough for ongoing oversight. The

[45] See IEE, page 31, Table 6 and assuming a conservative one year minimum from Inception to loan approval.
[46] Efficient private sector MFI lending takes less than three months for the first loan and less than a month for subsequent loans.

fact that PFIs seldom have verifiable financial reports makes the need for such supervision even more acute. More in depth mid-term project reports help, but because they are conducted three years (or more) into a project, they are inadequate from a prevention perspective.

91. Supervision is also hampered by a lack of consistently applied and collected PFI performance indicators. Measurements for financial sector diversification, stakeholder participation and policy dialogue, moreover, do not lend themselves to simple indicators. LogFrame monitoring tools can work for financial sector projects as well as any other, but require expert analysis to interpret which CIs and PMUs seldom have at their disposal (nor do many CPMs).

92. The RFP's call for a project performance monitoring system anticipates these challenges and the current use of the MIX provides a first step toward creating such a system. A full monitoring framework has yet to be developed, however. Two elements are missing. The first is a full fledged portfolio management information system facilitating and encouraging greater senior management and EB policy compliance oversight and strategic decision making information. The second is a stable funding base to ensure the growth and continuity of the system.

93. Monitoring impact is more complex than that of project activities, fraught as it is with numerous methodological challenges (paragraph 75). IFAD has not effectively measured the poverty reduction impact of its rural finance operations. None of the 58 projects reviewed had meaningful impact measures integrated into project activities. In a very few cases, PFIs produced impact studies on their own accord. These tended to be static, one-time only studies. As IFAD's own publication *Assessing and Managing Social Performance Indicators* points out, best practice impact analysis integrates social performance measurement into the PFI management information systems that simultaneously produce impact and business management information. The most accurate but seldom used means to assess rural finance impact would be long-term, longitudinal study of client welfare. No IFAD project has done this.

94. All of the above challenges to measuring performance are exacerbated by a lack of qualified on-the-ground monitoring and supervision personnel. The most successful microfinance projects typically employ internationally qualified financial Technical Service Providers (TSPs) on a permanent basis or contracted for frequent and regular technical assistance and monitoring visits[47]. IFAD has *de facto* relied on CPMs to provide this monitoring function, regardless of their technical qualifications and their workload. A network of partner organizations being created by PT to support PFIs will help, but will not likely replicate the results attained by other agencies with long-term, dedicated TSPs.

95. Even when IFAD has recognized project non-compliance with the RFP, corrective actions are seldom taken immediately and there is no identifiable and enforceable structural accountability for poor performance at IFAD.

B. Ten Years of Design and Implementation Challenges

96. The last ten years of IFAD's rural finance activities has seen improvements and challenges not captured by the broad performance review provided in Part III or the static view of design and implementation processes presented in section "A" above. This section offers a textured picture of IFAD's rural finance work, drawing out broad themes characterizing design and implementation pre and post RFP.

[47] See Rosenberg, Richard, (2006) Review of UNDP Microfinance Portfolio, CGAP, 2006: available at http://www.microfinancegateway.org/content/article/detail/30203 .

Design Pre-year 2000: Guiding Stars and Supply Led Finance

97. The sample project portfolio used in this evaluation had a small number of pre-RFP "star" projects that exhibited many best practice donor design features. The grant to the Kenyan Women's Finance Trust, for example, was a stand alone rural finance project first initiated in 1991. It provides direct funding from IFAD to the Trust. IFAD supported the Financial Services Associations (FSAs) in Benin, a new financial intermediary model providing savings and loans services and giving ownership control to the poor. In the Philippines, IFAD supported the Rural Microenterprise Finance Project (approved in 1996) which grew to fund over 120 rural MFIs, of which over 70 exist today. IFAD helped in creating a replicable self help group savings and loans model in Venezuela, which was developed within the Development of Rural Poor Communities Project (PRODECOP) approved in 1997.

98. Lack of sector analysis, however, generally plagued design prior to the articulation of the RFP and star projects were the exception rather than the rule. Supply-led, directed credit was *de rigueur* in the mid- to late-1990s. Poor definition of target markets was common and credit had restrictive uses and/or targeted too narrow a client base. In Jordan, for example, project credit products targeted farmers with less than 2 hectares of land for soil and water conservation improvements. Less than 10 per cent of projected credit demand was taken up because farmers did not want to borrow the amounts required for this activity (the grant programme supporting the same project was, however, successful). The same project offered an off-farm enterprise credit product with a minimum loan size and collateral requirements far beyond what the poor could absorb or provide respectively. This product was oversubscribed but largely by part-time farmers or fairly well off farmers with significant other income. Similar lack of demand analysis led to a product design in El Salvador where the poor were not interested in products being offered, as well as in Moldova where the poor could not provide collateral required for loans.

99. Overly defined and targeted products had other characteristics in conflict with the RFP, including minimum and maximum loan amounts unattractive to the poor, guarantee requirements the poor could not provide, and amortization schedules leading to long-term indebtedness. These kinds of restrictions typically do not support the kind of portfolio diversification PFIs need for sustainability, nor serve the poor particularly well.

100. In other instances, by choice or in the absence of a willing or appropriate financial institution, IFAD projects used PMUs to provide credit services, despite their typical lack of financial services management capacity or systems. Project designs selecting state banks as a PFI also seldom insisted on staff familiar with in low-income lending. Poor capacity, in combination with the frequent use of credit lines for portfolio funding instead of institution building, led to many well meaning but unsustainable efforts.

101. These issues were often complicated by the tendency toward multi-focus projects, many of which used credit to enhance other project activities such as agricultural production or farm improvements. Multi-sector projects had the effect of diluting programming resources and attention from finance components (e.g., management attention, overhead resources, appropriate levels and quality of human resources, adequate and professional facilities).

102. Pre-RFP project design relied almost uniquely on activity-based indicators which do not allow for realistic performance appraisals (e.g., number of loans versus collection records). This was often compounded by a lack of appropriate management information systems making project performance monitoring difficult even if appropriate indicators had been designated. Project designs, in any event, were often too inflexible even when, for example, indicators pointed to the need for programmatic change. This was the case in Burkina Faso where a PFI not selected during appraisal later appeared better able to meet client demand than the selected PFI; yet, it could not be incorporated into the project until after the mid-term review.

Design Post-2000: Financial Sector & Demand Orientation Grows with Uneven Application of RFP Standards

103. Design features post-year 2000 begin to show the fruit of increased attention to emerging best practice, developing regional partnerships, regional TAGs linked to projects, RFP support mechanisms, and growing in-house capacity. Design increasingly focused on sector development and on PFI strengthening and policy support. Not coincidentally, and as noted in Part III, there was movement towards more rural finance stand alone projects. PFI selection also improved.

104. Over the last five years, IFAD also began to work more effectively, albeit modestly so, with other development partners through joint projects and co-finance arrangements. At times, partnerships have given to projects access to important local supervision and/or access to greater volumes of TA funding. This was the case in Laos where IFAD has worked is closely with GTZ who had a national microfinance advisor. IFAD has also began shifting projects from the Ministry of Agriculture to the Ministry of Finance, a move that improved government oversight and capacity, albeit modestly.

105. Driven by a greater understanding of sustainability, PFI selection has improved, with IFAD moving away from state owned banks and PMUs as delivery agents toward more cooperatives, self help groups, commercial banks and cooperatives. The use of credit lines has also noticeably but modestly declined and there is an opposite trend towards more capacity development in a number projects including sector development approach projects in Niger, Benin, Zambia and Ethiopia.

106. While many IFAD project products are not always designed to meet the direct needs of the poor, Part III noted that there is a trend toward using a greater range of financial services, specifically savings - a critical financial tool for the rural poor. IFAD projects still focus more on credit than any other product, despite the need for others such as remittances, micro insurance, micro leasing, savings for asset building – from housing to education loans.

107. Over definition of target markets continues and in some cases excessively so. In Guatemala and Laos, for example, projects striving to reach the poorest of the poor are targeting areas so remote and isolated that the likelihood of project sustainability is practically impossible. In the case of Laos, many poor villages with obvious need for financial services lie in the path to government defined target villages but are left unserved to the detriment of the rural poor and to the sustainability of the PFI.

108. Improving sector analysis is similarly plagued by uneven application. In many projects, weak analysis was observed to cause programmes to either under-perform or miss potentially important interventions. In Argentina, for example, the microfinance sector has yet to respond to considerable and growing poverty. A micro, meso, macro analysis undertaken for this CLE observed that a sound policy dialogue supporting the organized growth of the sector would have been an appropriate and valuable intervention. Instead, IFAD followed a more traditional design route and chose to support a credit programme. In the absence of an appropriate PFI, the credit is managed by PMU officers with little or no financial services experience. The project has achieved highly limited outreach (currently serving just over 1 700 people in six states). The value of the project's demonstration effect is questionable – or at least requires testing – compared to a policy intervention which may yield the great results as similar efforts have in other countries.

Implementation Pre-year 2000: Lack Capacity and Under-Supervised PFIs

109. Implementation capacity pre-2000 was noticeably weak. Many projects relied on PMUs or their equivalents and state banks as credit delivery agents. PMUs seldom had the capacity or training opportunities to learn financial project management. State banks has capacity but tutored by decades of subsidized credit, underdeveloped credit risk and portfolio management, and poor collection habits,

often lead to projects to replicate the failings of banks. Project sustainability was the exception rather than the rule.

110. Lack of management capacity was greatly complicated by inadequate monitoring tools. Measures of sustainability were often vague or nonexistent. Few projects established regular monitoring reporting systems beyond annual reports and mid-term evaluations. CIs normally did not have the experience required to calculate and assess financial project performance ratios, or even interpret those that existed. Irregular and long intervals between supervision reports only intensified monitoring and hence implementation challenges.

111. Likewise, CPMs generally did not have the capacity to monitor finance projects. As the IEE pointed out, CPMs were typically overextended, had too many responsibilities, and lacked the tools and capacity to provide adequate project implementation oversight. Even when problems were detected by CPMs – as was the case of at least two state banks - many were not acted upon for simple lack of time. Failing projects that were redesigned had to wait until mid-term evaluations before remedial action was taken at great loss to project effectiveness and efficiency. In many cases, mid term reviews did not take place until three quarters of the way through a project, discouraging motivations to undertake project redesign.

Remaining Design Issues

112. However, a number of design issues still remain to be solved. Firstly, the quality of sector analysis was uneven and caused project designers to overlook potentially important interventions. In several projects, for example, a traditional credit approach was favored over other, more complex macro or meso level interventions that would have had greater potential to improve the rural financial system with commensurate larger rural poverty impacts. Secondly, project design still focuses too much on credit and not sufficiently on the need for a broader range of products (e.g., remittances, micro insurance, micro leasing, and savings for asset building). Thirdly, target groups continue to be over-defined, which frustrates the demands of the rural poor and hampers goals to attain PFI sustainability.

A beneficiary making a payment at the Bank of Maldives Ltd.
Photo: Horst Wagner, IFAD Photo Library

Implementation Post - 2000 Higher Design Standards Intensifies Implementation Challenges

113. Rural finance project design improved, if unevenly, across IFAD since 2000 even as projects became more complex and innovative, involving more sophisticated and numerous PFIs and products. To manage increasing complexity to RFP standards required significantly improved technical capacity within IFAD and PMUs, as well as more time-sensitive implementation arrangements and nimble government involvement.

114. Disagreement between two ministries competing for project control in Niger, for example, caused significant project delays and loss of interest among participating PFIs. Concern about government involvement in Burkina Faso caused PFIs to express the fear that the involvement by the ministry of agriculture would negatively affect repayment rates. In El Salvador, interest rate ceilings imposed by IFAD at the retail level caused a PFI to support an unprofitable product. Governments coming into and out of power and legalities surrounding the credit delivery (*fidicomiso* or trust/foundation) in Guatemala greatly affected project continuity and limited project outreach to just over 125 clients.[48]

115. Increased PFI and client sophistication required more informed and expert implementation managers, particularly in competitive markets such as Uganda. In this and other markets, a lack of qualified financial experts on the ground remains a key impediment, particularly in those cases where policy work is required, as it is in India where governments are threatening interest rate ceilings. Frequent and expert supervision is all the more critical when client savings are put to risk in IFAD-sponsored PFIs as they are in self help groups in Venezuela.

116. Unfortunately, IFAD projects still struggle to work with the right Ministries, ensure that appropriately skilled PMU staff is selected, and to convince governments to invest in quality TA. Improving loan contracts to increase enforceability is a critical element to motivating better supervision, as recognized in the 2006 Action Plan for Rural Finance Update.

117. Monitoring more sophisticated and complex PFIs also demands greater technical capacity. As noted, the introduction of the MIX Market post 2000 has helped to sharpen IFAD's and PFIs' focus on real time performance monitoring. It also provides CPMs ongoing exposure to best practice performance standards and benchmarks. However, the initiative has not yet translated into a systemic executive management information system, though there are some examples of IFAD addressing project difficulties before the mid-term evaluations. Enforcement remains weak as many projects do not meet RFP sustainability and outreach standards. In Argentina, for example, the project made loans despite credit arrears in excess of 40 per cent and project guidelines dictating that lending should not continue past 15 per cent. A lack of rural finance capacity within CIs compounds and underscores supervision and monitoring challenges. Examples to the contrary such as those cases where the World Bank is the CI, supports a broader call for improved expertise.

118. The creation of regional partnerships has expanded IFAD's knowledge base and has allowed IFAD to lever its own capacity through the actions of others. Improved knowledge exchange within and between regions is a case in point. For example, IFAD grants fund AFRACA to support pro-poor policy financial reform and development across the region to the benefit of clients, PFIs, and national rural finance systems. Regional and research partners are helping to facilitate capacity development and learning across regions as in the case of MicroSave, which supports PMU, CPM, and consultant capacity improvements. Working with implementation partners such as the German Reconstruction Credit Bank (KFW) in Benin frees IFAD from a number of operational constraints (see Part V) that would otherwise constrain best practice implementation.

[48] The delivery mechanism in this case is a *fidicomiso* or fiduciary trust fund in which capital is held prior to disbursement to project retail mechanism, in this case self-help credit group.

Summary: Capacity and Influence Issues

119. IFAD rural finance project development suffers from insufficient and technical expertise early in the project cycle. This is compounded by the often underdeveloped strategic guidance provided by Country Strategic Opportunities Papers (COSOPs) and an absence of a strong financial sector analytical framework (as noted in Part II). Project design elements are fixed in place and re-conceptualization often suggested by TRCs is inhibited by lack of authority of the reviews, as well as process inertia in the form of sunken development costs and pressure to bring projects to approval.

120. There is an evident tension between providing project details and the need to maintain design flexibility in order to ensure relevance at the time of loan effectiveness which, in some cases, is three years from inception. In the absence of details, it is difficult at best to ensure that all project elements will meet the terms of the RFP. This has lead to a variety of implementation problems, from government delays to poor sustainability performance. These conditions are exaggerated by weak implementation agents and less than desirable supervision and monitoring capacity.

121. The modest gains in the quality of rural finance projects is reflected in ten years of design and implementation, as are continued challenges. Design in particular has advanced, shining greater and sharper light on implementation shortcomings particularly related to instruments, delivery, and supervision arrangements. It would appear that efforts to improve projects have had their greatest impact on those elements of design and implementation most under control by designers. Other elements over which designers and implementers have less control have seen some change, particularly when IFAD has managed to "manage" around constraints and limitations (Table 1).

122. Compared to best practices, IFAD's project cycle is too long for projects to remain relevant to sector changes and the needs of PFIs. There are too few binding technical checks to ensure that project design meets RFP standards (or best practices), and these often occur too late in the design process. Nonetheless, project design improved over the evaluative period showing that: (i) more recent projects undertake better sector analysis (although the quality of analysis varies due to the lack of an IFAD-wide accepted analytical framework); (ii) there is a discernable shift towards government agencies better equipped to exercise oversight over rural finance projects and towards PFIs that share RFP aims of sustainability; (iii) there is a slight shift from credit lines to TA, although TA provision still falls short of actual needs of PFIs working (or wanting to work) in rural areas; (iv) somewhat more demand-driven service provision that meets the needs of the rural poor, although greater product and service diversification is desirable; and (v) still too many projects over-define clients and terms and conditions of financial products. With increasingly complex project design, the demands on implementation and in particular, implementation support, have increased. IFAD's technical in-house capacity improved to a certain extent and arrangements were made for regional technical partners. These provisions fall short of best practice of having internationally qualified technical expertise in the field.

Table 1. Design and Implementation Influence Examples

	Design	**Implementation**
Considerable Influence	• Market area served. • Sustainability focus. • Stakeholder input. • Time from inception to approval	• Capacity development of PMUs • Application of appropriate monitoring indicators.
Some Influence	• Choice of instrument (e.g., technical assistance grant funding over credit). • Selection of PFIs. • Donor coordination.	• Selection of PMUs. • Choice of line ministry. • Donor coordination activities.
Little to No Influence	• Use of CIs. • Time from approval to effectiveness	• Supervision frequency. • Government involvement.

V. CORPORATE ARRANGEMENTS SUPPORTING RURAL FINANCE ACTIVITIES

123. Corporate arrangements supporting design and implementation have an important influence on the quality of rural finance programming at IFAD. To understand how these influences guide, constrain, or support project design and implementation, this evaluation assessed three broad institutional arrangements: IFAD's founding agreement, human and financial resources, and processes for knowledge and innovation management.

A. IFAD's Founding Agreement

124. The founding agreement specified IFAD would finance agricultural development projects designed by other organizations to support food production for the rural poor in developing countries. The founding agreement did not anticipate IFAD taking a high degree of responsibility over and control of programming. This is as true for rural finance as it is for all projects and thus many of the operational prescriptions found in the original founding agreement that constraint programming generally apply to rural finance programming specifically and need to be addressed.

Leadership and Governance

125. IFAD's founding agreement gives the EB full authority to set strategic directions, including the nature of programming and approval of projects and grants. It also adopts and recommends actions, pending final approval of the Governing Council, on matters related to policy, and the annual administrative budget. Once policy is set, the EB must ensure the strategic objectives of the policy are being met over the long term.

126. In terms of rural finance, the EB has been at once supportive and under-prepared. It has approved a relatively solid RFP, lending importance and priority to rural finance at IFAD. The EB has not, however, familiarized itself with best practices in rural finance or required the establishment of a reliable quality assurance mechanism that would reassure it of technical compliance. In the past, this shortcoming resulted in the EB approving numerous projects that do not, in fact, meet RFP standards. An overloaded EB agenda, absence of adequate quality assurance mechanisms and inadequate executive reporting mechanisms that inform the EB of compliance of new projects and retrofitting of existing ones are all responsible for an inconsistent application of the RFP, including the approval of a number of non-compliant projects.

Governments Borrowers

127. A litany of failed or seriously underperforming state banks in developing countries is proof that financial institutions and governments do not generally mix well. The reasons are many, some specific to finance and some not. The *modus operandi* of government is often incompatible with private sector initiatives and rural finance activities. As a starting point, government officials seldom understand the demands of business. They are mostly unable or unwilling to hold business accountable to private sector performance standards, particularly when calling loans or denying resources is an appropriate response for failure to perform. Governments are seldom designed to do this or a myriad of other activities required to manage private sector support activities.

128. There are many immediate and concrete barriers as well. Governments are often reluctant to use borrowed funds for TA purposes, particularly for international level quality (which can be politically difficult to justify for price and national sourcing preferences). The need for TA support is, as noted, more frequent than for portfolio financing. While there is some movement towards more private sectors like lending practice, some governments continue in the tradition to think of loans to PFIs on a political basis and that performance and repayment is less important than the resulting political impacts. This often leads to interest rate caps, inappropriately large loans and long loan terms, targeted lending, any of which can impede PFI sustainability.

Box 8. A Range of Financing Needs

Venture Capital is typically invested early in a company's life and promises high and rapid share appreciation (e.g., over 59 per cent within five years). Because it often requires intense ownership share management, governments are seldom successful venture investors.

Private Equity is capital provided by an outside investor looking for good returns but not as explosive as venture capital. Often investors look to take annual dividends as well as considering long term appreciation of shares. Governments can make private equity investments if they take a passive role, but again, are seldom successful as a rule.

Subordinated (Convertible) Debt is debt which, in the event of cash flow difficulties, is paid after all other debt holders. It is often considered equity as a result and can count towards the equity base of a company (this is very helpful in financial companies which require equity reserves to back loan portfolio risk). Governments can provide subordinated debt as easily as they can other kinds of debt. Often, however, subordinated debt is invested with a conversion to equity covenant (i.e., owners of the debt can convert debt to shares). Governments, as noted, are not typically good as equity owners, except when able to be in a passive role.

Apex and Specialty Funds are funds usually established to invest in a particular sector. Apex funds are often run by government organizations (e.g., state banks or government departments). They are seldom without political interference which affecting development effectiveness. Specialty funds are the same except are typically privately owned. Governments have made many successful investments in specialty funds.

Structure Finance Vehicles (SFV) are special purpose instruments which take many forms. Like specialty funds, SFVs tend to invest in a specific sector. Typically SFV sell "tiers" of debt each with different risk levels – from straight debt to that which approximates subordinated debt. Returns are commensurate with risk: the higher the risk the greater the return. In the event of full or partial default of payments, lower risk tiers are paid out first. Governments can invest in SFVs, although more often than not in development finance, they provide guarantees to encourage investments (e.g., USAID's guarantee of the Deutsche Bank

129. Projects involving government in microfinance and rural finance programming have tended to work best when government's role is limited to providing a supportive enabling environment or capital through arm length relationships (e.g., independent wholesale funding instruments). "IFAD's cherished specificity of working with and through government"[49] is not best practice when it comes to working in financial sector development, especially building the capacities of financial services providers. Ensuring that programmes are consistent with government poverty agendas remains vital, as is coordination with key stakeholders. These considerations are not mutually exclusive for working directly with private financial sector actors. UNDP, for example, directly supports PFIs but has formal project agreements with national governments. The many International Financial Institutions also respect and work with government stakeholders but invest directly to PFIs or through sector development projects.

IFAD's Instruments

130. As the CGAP DPR pointed out in both 2003 and 2006, loan and grant instruments limit IFAD's ability to offer a full range of financing options required to support best practice. In particular, IFAD cannot provide sufficient volumes of grant based funding typically required for PFI capacity building. The RFP recognizes that IFAD should use a fuller range of instruments including equity, convertible debt, guarantees, and even structure finance to meet its goals but in practice, credit lines make this difficult at best, particularly in those countries where IFAD levies ordinary interest rates.

[49] IEE, page 56.

131. Current IFAD instruments *do not preclude* other financing options besides credit lines, though they do greatly complicate their development and use[50]. Governments can use IFAD loan funds for any mutually agreed-upon purpose, though microfinance has seldom seen governments manage more complex finance tools such as equity or convertible debt with good results. There are exceptions such as an IFAD investment in a private bank in Armenia, which provided what amounted to subordinated debt and helped to establish a leading national financial institution. Government guarantees programmes have been used more frequently and with some success, though they mostly have poor repayment histories and are often unattractive to financing institutions as collection from governments can be costly[51]. There are also a few positive examples of apex funds providing finance to MFIs and RFIs, including the IFAD supported Palli Karma-Sahayak Foundation (PKSF). Most apexes, however, do not provide capital on a best practice basis, due mainly to the interface of government and private sector issues noted above[52]. Box 8 provides examples of different financing needs of PFIs.

132. The most immediate limitation of IFAD's instruments is a lack of technical assistance funding. More projects in IFAD's portfolio are insisting that technical assistance take precedence over portfolio funding (credit line on-lent by governments to PFIs). Complex, sector building projects require a good deal of TA, particularly in the rural areas. On the ground, permanent TA is proving to be more valuable. USAID, for example, has experienced impressive returns on such an approach in Uganda, Peru, the Philippines, Jordan, and Mongolia among other countries. GTZ's long-term support for the *Cajas Municipales* in Peru is a celebrated example of success. The World Council of Credit Unions' USAID supported turnaround of the 1 million members *Caja Popular Mexicana* in Mexico also relied on long term, on-the-ground technical assistance. Yet, it should be noted that the majority of these examples are not primarily rural, operating in far less challenging urban and peri-urban markets, thus suggesting that on-the-ground technical expertise is even more necessary.

133. Some governments understand the need for TA and the potentially impressive financial and social returns of such investments. Most, however, require strong arguments to engage on this basis. IFAD has had seen more success in this area in recent years, but it lacks strong arguments and instruments supporting the use of TA (e.g., strong financial sector analysis, net present value models showing return on investments, provision of grants etc.).

No Field Presence

134. Even once convinced of the need for capacity building, many governments hesitate to pay for on the ground quality financial technical assistance seen as a best practice that is key to successful financial sector interventions. This approach is more critical when new, smaller, or innovative institutions are involved, or when very poor markets are being served - all conditions typically

[50] Lacking instruments also limits IFAD's vision of what financing can accomplish. Financing is not an end but a means. It can help institutions become sustainable, an important part of which, as the RFP rightly points out, is to become resource independent. Properly and consciously used, financing can leverage sustainable access to finance; some argue that this in fact should be a major goal of all IFI financing. Appropriately monitored and provided on a competitive basis, financing can also improve loan portfolio and business management. Improperly delivered and managed, loan capital can create dependencies, operating inefficiencies, and distract institutions from finding sustainable sources of finance. Lending to governments, poor supervision, and lack of qualified presence only abet potential negative impacts of lending to MFIs, including rural ones. See de Sousa-Shields, Marc and Cheryl Frankiewicz, (2005) Financing Microfinance Institutions: The Context for Transitions to Private Capital, USAID, 2005, at the following address under Theme 5, Access to Capital: http://www.microlinks.org/ev_en.php?ID=5967_201&ID2=DO_TOPIC .

[51] IFAD's recent attempt to provide a more "flexible" loan agreement addressed some broader programmatic concerns, but ultimately did not address the need for more rapid, strategic and accountable lending. More "flexible" in the context of RFIs is rapidly available funding linked to strong technical assistance.

[52] Levy, Fred, (2002) "APEX Institutions in Microfinance," CGAP Occasional Paper No. 6, January 2002, available at: www.cgap.org

associated with rural finance development. There are several levels of presence other agencies have used to oversight financial initiatives, each more proactive than the next[53].

- Regional or local offices with staff running many different programmes (e.g., USAID);
- Regional or local offices with dedicated financial programme/project officer devoted to rural finance (e.g., IFC, IADB); and
- Local office with dedicated technical service providers (often contracted: USAID, UNDP and UNCDF).

135. IFAD has recently undertaken a pilot field presence project that supported an arrangement similar to option 1 above. Instituting this approach would be a positive though less than ideal step as it would not necessarily result in full time dedicated rural finance expertise.

Cooperating Institutions and Supervision

136. CIs are a poor proxy for the kind of supervision required of finance projects. Periodic supervision reports provide some oversight, but do not replace frequent and structured reporting suggested by best practice for microfinance (i.e., monthly to quarterly analysis of RFI performance ratios). Moreover, as the IEE observes the CI's role is not one of supervisory manager but of fiduciary. This fact, along with a consistent lack of financial sector experience, and the irregular reporting link between CI and CPMs exacerbates the lack of best practice oversight and negatively affects knowledge transfer to new programme design and implementation.

Enforcement of Compliance

137. As noted earlier, the RFP observes that the responsibility for project design and implementation falls on national governments. This limits IFAD's ability to enforce project and PFI performance standards. Enforcement of an conditions is possible but is made difficult due to the political and legal issues involved, with the result that loans are not called for poor performance *visa vis* the RFP. The CLE did find that IFAD has good leverage prior to loan disbursement and that some projects had been delayed for design arrangement non compliance issues. Once disbursed, however, IFAD tends to overlook or is unable to address RFP non-compliance, often waiting until mid-term reviews to address difficulties. By contrast the UNDP microfinance policy suggests PFIs be dropped from programming for non-performance unless problems can be promptly resolved.[54]

Box 9. Investment Portfolio Technical Support
(Based on estimated annual investment disbursements and TA expenditures in US$)

	Technical Experts to Annual Disbursements	TA Budget to Investments
IFAD	1 : 82.1 million	1: 38.2 million
IFC	1 : 11.5 million	1: 10 million
USAID	1 : 22 million	Most in TA
UNDP	1: 6 million	Majority in TA

Sources: Executive Interviews

53 Many agencies take multiple approaches.
54 UNCDF Microfinance Policy page 2, http://www.uncdf.org

B. Financial and Human Resources

138. The RFP provides no direct guidance on how rural finance matters are to be managed within IFAD. The policy assumes *status quo* processes will originate, develop, and implement programming, implying that the RFP ambitious objectives can be served without dedicated permanent human and financial resources allocations.

Financial Commitments to Rural Finance

Administrative Budget

139. An assessment of the financial resources committed to rural finance was made difficult by a lack of disaggregated budget figures available to this evaluation. Evaluators found in the administrative budget only one *permanent* line item dedicated to rural finance: the Technical Advisor for rural finance in PT. This expense is the equivalent of approximately 0.012 per cent of investments in rural finance projects. As indicated by the CGAP Donor Peer Review and noted earlier in this report, IFAD has one of the weakest ratios of specialized microfinance staff to the volume of portfolio among CGAP Development partners. Box 9 shows that IFAD's *dedicated* microfinance technical experts to *permanent* annual disbursements ratio is far below the average of three other agencies involved in micro and rural finance.[55]

140. In most cases, other institutions also have a large pool of variously skilled microfinance experts in positions similar to CPMs working both in home offices and in the field (not included in Box 10). USAID, for example, has over 70 country and region offices worldwide, many of them with reasonably to highly competent financial and microfinance programme officers. These offices are supported by a microfinance technical staff of 5 in Washington. At UNDP-UNCDF, projects are now required to contract microfinance technical service provider on a competitive basis. At IFC, headquarter staff primarily originate and manage proposals, leaving technical assistance to appropriately skilled experts in one of 11 regional offices.

Box 10. Financing Rural Finance

The updated Action Plan for Rural Finance (2006) proposes a budget of US$6 million to the year 2008 is required to maintain current advances and further develop IFAD's strategic approach to developing rural finance. This includes stabilizing funding for the two current contract junior positions supporting rural finance and hiring one more senior technical expert. This will bring IFAD's technical expert to annual disbursements ratio to about 1 to $40 million or 1 to $10 million if junior experts are included. It also includes funding for ongoing partnership relationships, including the MIX and regional NGOs.

141. A significant portion of CPM and consultants' resources are spent on rural finance. IFAD can not provide data on time expenditures nor does it track consultancy expenditures by areas of technical expertise. Strategy documents and COSOPs also reflect expenditure on rural finance, but with the exception of PA's rural finance strategy, investments are immaterial compared to the level of rural finance commitment in any region. Interviews with CPMs, Directors, and Human Resources suggest, however, that time expenses are not proportionate to the funding committed to rural finance projects.

142. There are a number of one time only expenditures for rural finance training and capacity development support including grants arranged by PT (see below) and from the central human resource training budget (e.g., approximately US$84 000 for CPM and consultant microfinance training in 2005). Neither of these expenditures is sufficient to the task of significantly raising the rural finance capacity at IFAD.

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[55] This comparison uses only permanently budgeted human resources for comparison and does not recognize indirect or other non permanent items. In the case of IFAD this would include the significant time devoted to rural finance by consultants and CPMs. It must be noted too, that there is no direct comparator to IFAD's rural finance portfolio. The closest approximation found in Box 10 is UNDP which has a very strong pro poor focus.

Grant and Supplementary Funding

143. PT initiated US$6.2 million in grants to support a range of rural finance activities since 1996, of which about 70 per cent was raised after the RFP. The first of these grants cemented a critical relationship with CGAP, which has proven to be an excellent partner, offering IFAD *entre* to the table set for top microfinance development partners. In addition to ongoing support provided to all donor members, CGAP has also worked with IFAD on a number of important rural finance research projects and has organized two important Peer Reviews of IFAD's rural finance activities, both fundamental to sharpening IFAD's strategic rural finance focus.

144. Regionally sourced grants have also allowed IFAD to forge relationships with a number of other important organizations such as FAO and the MIX Market. Critically, grants have supported a developing network of regional rural finance NGOs. This network helps IFAD's PFIs to better serve the needs of their clients, leveraging in return better regional market intelligence, policy development, networking, and project monitoring and operations capacity for IFAD. Formal relations have been established with Guichdt Microfinance (PA), MicroSave and Centre International de Développement et de Recherche (PF), and the Microfinance Centre (PN).[56]

145. During the evaluative period, a total of US$16.8 million in grants (TAGs, NGO/ Extended Cooperation Programme fund, some with co-financing), or US$1.7 million on average per year were sourced by the regions to support rural finance projects and PFIs. Uses varied, though a good deal – likely over 60 per cent – was applied to project technical assistance.[57] Regionally, use of grants over the evaluative period ranged from US$1.5 million in PA to US$5 million in PF. These grants have been helpful but are modest in size compared to other institutions. IFC microfinance investments, which average about US$100 to US$120 million annually are supported with TA grant budget of US$10 to US$15 million per year, or 1:10 million. IFAD has a ratio of 1:38.2 million.

Human Resources Level and Quality

146. The one full-time equivalent PT Technical Officer has recently been joined by two junior consultants supported by the Italian Supplementary Fund and the Innovation Mainstreaming Initiative (IMI). While helpful, this level of support is still clearly much lower than comparable institutions. This small team can count on irregular support from the Thematic Group.

147. Besides these positions, regional directors and most CPMs are involved in rural finance activities. Overall, and despite numerous constraints, the *general* knowledge level of best practice rural finance within IFAD is good. Divisional Directors – to varying degrees – demonstrated sound knowledge of both the strategic potential and implications for best practice rural finance though not necessarily of the RFP. CPMs showed a greater range of knowledge, with some having moderately deep understanding of sustainable rural finance, while a few others having none and no particular interest in developing any.

148. Within each division, there are pockets of rural finance competence sufficient to avoid, at a minimum, very weak rural finance programming. It is curious to note that, while Regional Directors *understand* the importance of having divisional rural finance capacity development, there has not been a single hiring of a rural finance expert CPM, suggesting other priorities or that current rural finance capacity is sufficient or better left to PT.

149. As with other technical areas, IFAD employs a large number of expert consultants for rural finance projects. There is no central registry of consults at IFAD so an unbiased sample of rural finance consultants could not be interviewed. Of the several consultants that were interviewed or

56 Relationships for remaining regions are under consideration.
57 Data was not available in a format that allowed categorization of use. In the case of technical assistance, data was not available to determine what type of assistance was budgeted.

known by the CLE team, some can be considered of “top” international quality. Many are not. There are several reasons why IFAD is not using high quality contractors for rural finance work. Many CPMs do not have sufficient capacity to distinguish financial skill qualities. Others simply rely on “known” quantities without reference checking. Also, many top consultants do not regard IFAD to be an elite institution with which to work. This, coupled with consulting rates often below those demanded by many international consultants, results in mixed quality.

150. A working group on financial services was formed as early as October 1996. Now known as the Rural Finance Thematic Group, the group has helped PT to knit together a human resource base supportive of improving rural finance capacity. The Group meets frequently but irregularly. It has had participation from all divisions and has met 22 times since 2004. It has hosted a variety of external experts and regularly addresses significant internal rural finance questions. Participation in the group has been distributed across all regions, though PA CPMs with their published commitment to rural finance are the most active in the group (Table 2) Thematic Group participation is, however, largely voluntary and not formalized in job descriptions with agreed upon responsibilities that can be monitored and assessed. That the group does not have a specific agenda, tangible objectives and measurable outputs may be one of its strengths, as it is remains flexible and demand driven. This is also one of its weaknesses, as it has no formal responsibility to generate and disseminate knowledge.

Table 2. Rural Finance Thematic Group Meeting Participation 2004 -2006

Division	Number of Meeting Participants	Number of Individuals	Per cent Individuals by Division
ER	2	2	3.1%
OE	13	3	4.7%
PA	22	11	17.2%
PD	2	2	3.1%
PF	13	9	14.1%
PI	12	8	12.5%
PL	13	4	6.3%
PN	14	10	15.6%
PT	56	15	23.4%
Total	**147**	**64**	**23.4%**

151. Another important resource for PT is the aforementioned rural finance partner network. This grant based network ostensibly supports IFAD PFIs. It also acts to “outsource” IFAD capacity needs in rural finance, a reasonable strategy given resource constraints within IFAD. In the absence of significant internal capacity, these network relationships may prove an effective and efficient means to ensuring better rural finance at IFAD.

152. PT’s use of the MIX Market is an effective means of extending IFAD’s rural development capacity as an outsource agent for managing PFI performance data. The MIX Market work has been supported by the IMI and is set to expire at the end of 2006. This relationship will require ongoing funding, particularly if IFAD becomes dependent upon the system for long-term monitoring and evaluation of its PFIs. As noted, more resources will be required to develop an appropriate senior management information system to make full use of the MIX Market platform.

153. As with other areas within IFAD, the Office of Evaluation (OE) does not have much rural finance capacity. One OE officer has regularly attended Thematic Group meetings.

Human Resources Capacity Building

154. A lack of institution-wide capacity was noted by CGAP as an important imperative to improving IFAD's rural finance performance. Very little funding from IFAD's human resource training budget, however, has been devoted to RFP capacity building. In 2005, for example, and as noted, US$87 000 was spent sending staff and consultants to a microfinance training course in Turin. Funding was provided on the basis of interest and not distributed across regional divisions in any systemic way. No divisional budgets specifically allotted funding to rural finance training, other than time devoted by CPMs to the Rural Finance Thematic Group or to individually pursuing a personal interest in the topic. Division Directors and CPMs interested in microfinance training note that most courses are too long and they cannot spare the time -- the CGAP sponsored microfinance training course, for example, is a three week intensive course. The IEE notes that CPMs have ample scopes of work leaving little time for extra curricular learning.[58] In response, PT is proposing a shorter course covering the basics of microfinance and to be offered in-house.

C. Knowledge Management and Development

155. IFAD is an organization with a clear thirst for knowledge but not clearly organized or structured system to satisfy it. This is true to degrees for rural finance where there has been a good deal of industry leading experience captured in a range of documents. Unfortunately there is very little "learning performance" accountability at IFAD. For example, over half of the CPMs interviewed for this evaluation who had designed rural finance projects had not read the RFP or fully reviewed the Decision Tools. Many had, however, read the somewhat briefer Learning Notes. Fewer still have read industry leading publications.

156. CPMs are essentially free to learn selectively and the result yields uneven minimum levels of knowledge on rural finance. This freedom is exacerbated by a number of conditions identified by the IEE, including poor communications, consensus management, and organizational silos that work against an effective strong learning culture. If IFAD is to remain a "demand driven" knowledge management organization it must adapt to the learning habits of its professionals. The Regional Rural Finance Strategy for PA is an example. Because it was developed by CPMs from within PA, most of them are fairly conversant with the strategy, more, in fact than those familiar with the RFP. Positive and negative career incentives need to encourage professionals to adopt a culture of learning accountability that is consistent with the knowledge development needs of IFAD.

Knowledge Partnerships

157. With the support of a number of research grants, IFAD has produced a several important knowledge development partnerships supporting innovation, training and capacity building. Research partners are as diverse as the Ford Foundation, the European Union, the Inter-American Development Bank and FAO. Other organizations such as the Foundation for International Community Assistance (FINCA) and CGAP have been employed for specific research activities.[59] These partnerships have generated important rural finance learning resources, including research exemplified by CGAPs "Managing Risk and Designing Products for Agricultural Microfinance" and the on online rural finance knowledge centre the Rural Finance Learning Centre lead by FAO.

MIX Market Initiative

158. The IMI funded a project to use the MIX Market reporting tool for monitoring purposes but IFAD has come to enjoy considerable knowledge diffusion as a benefit of the project. Over 20 one-on-one information/ training sessions have been completed by PT with CPMs as a part of an

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[58] See the IEE, page 57, Figure 9.

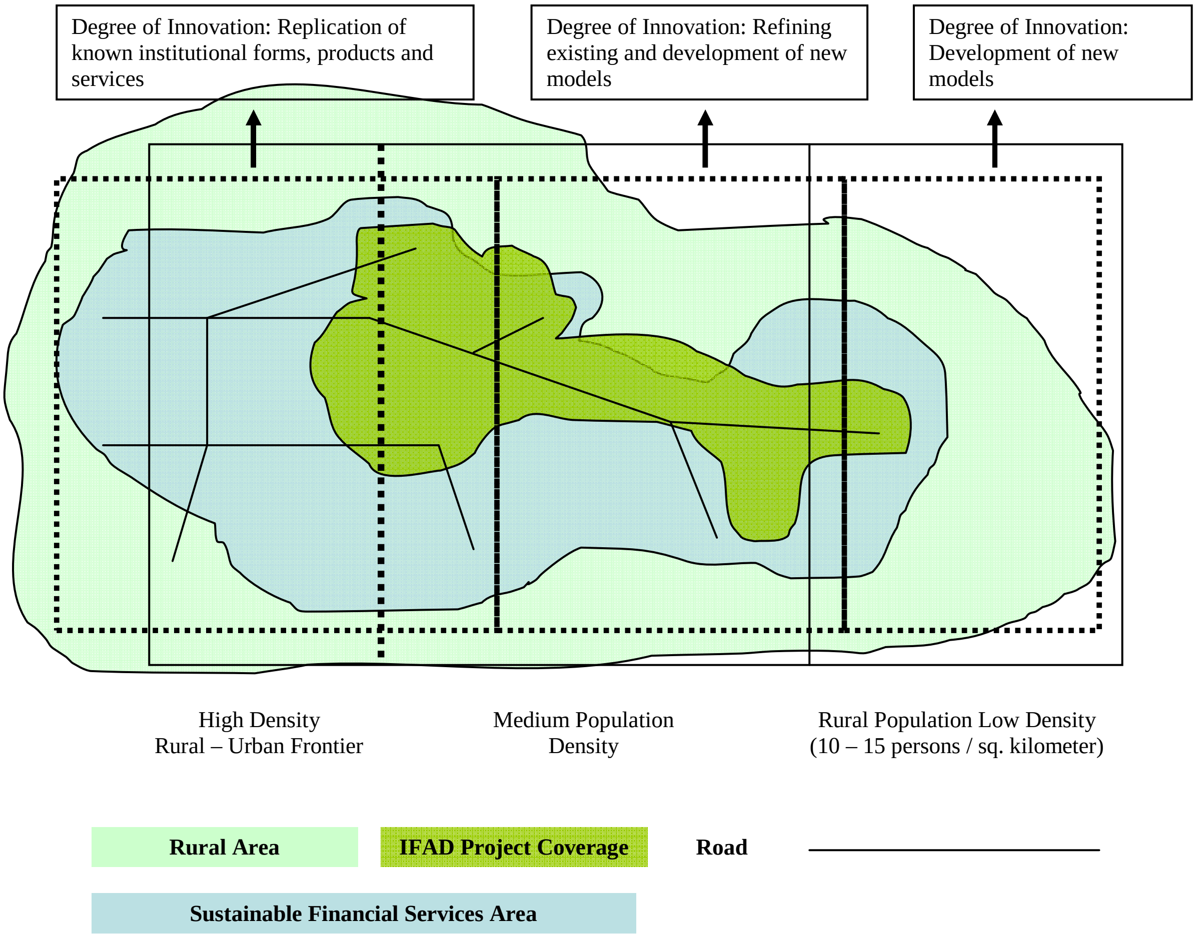
[59] See IFAD, Updated Rural Finance Action Plan 2006 – 2007, page 12 for a full list of partners.

expanding and ongoing programme to increase use of the MIX Market tool. Training has the extra benefit of exposing CPMs and others to best practice rural microfinance and agricultural finance. Consistent use of the MIX by CPMs to design and monitor projects will further enhance learning. Universal participation by PFIs on the MIX Market provides invaluable management trends analysis tool for monitoring portfolio quality.

D. Innovation

159. IFAD rural finance engages in a good deal of innovation, particularly at replicating microfinance models in rural areas (Figure 1). IFAD's core innovation contribution has focused on medium density areas and replicating successful urban pro-poor models (Figure 7). There are exceptions where IFAD has pioneered products and institutions in very poor and/or low density areas. Consistent with the industry at large, however, IFAD has made much less progress in innovating for micro agricultural financial products and services (i.e., on-farm financing) and for reaching very low density populations.

Figure 7. Innovation and Project Penetration



Managing Innovation

160. The RFP recognizes the importance of innovation in rural finance, but is largely silent on how to manage innovation and associated risks. It does not suggest a process for innovation. Financing innovative initiatives in new or low density markets has been likened to providing venture or risk capital, which relies on a host of techniques to assess investment risk. The most common techniques use comparable deals (or projects in this case) which are assessed on the basis of a number of standard variables that together define the nature and level of risk inherent in a particular deal. IFAD does not have an organization-wide risk management system, despite an IMI call to develop one[60].

161. Without a systematic approach, the innovation maxim of IFAD's rural finance activities might appropriately be "we know it when we see it."[61] This tenet is not necessarily a bad approach, if those doing the "seeing" are experts in rural finance and if corporate memory is retrievable and precise. Both conditions generally do not apply to IFAD, and the institution, as a result, can hardly be expected to take full advantage of its wealth of rural finance innovation experience.

An Unfunded Mandate Lead from the Bottom

162. IFAD's founding agreement and *modus operandi* are not very supportive of working in the rural finance sector. The RFP did not cost its implementation, but implied its requirements could be met with existing human and financial resources. In reality, the sector is technically complex and requires increasingly expert knowledge. This on its own requires systematic training, a culture of learning accountability as well as the establishment of an adequate number of technical staff positions. Furthermore, IFAD's lending instruments are not in line with best practice for working in the microfinance sector, which require direct lending to PFIs. This would enable IFAD to be more selective and insist on performance standards, both in terms of sustainability and outreach to IFAD's target group with demand-driven appropriate financial services and products. In addition, investment decisions are not based on criteria that recognize the need for taking calculated risks associated with investments into innovative rural finance operations. Grant resources are too limited for providing the technical assistance that is required for PFI capacity building. This problem is further compounded by limited and arms-length supervision and implementation support absence of field presence. All three factors limit the extent to which PFIs can be strengthened or adequate oversight can be exercised over their performance.

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60 IFAD, Initiative for Mainstreaming Innovation, Operational Framework for the Main Phase, 2004, page 5.

61 See for example IFAD's Supporting Innovation in the Field: The Role of IFAD's Support in the Sustainabilility and Commercial Transformation of FINCA's Village Banking Programmes, 2005.

VI. CONCLUSIONS AND RECOMMENDATIONS

A. Conclusions

163. **Financial Services are Important to Rural Poverty Reduction.** Financial systems have seen great changes in the past ten years that have left most developing country national financial systems generally stronger, but not typically to the benefit of the rural poor. Microfinance has emerged as a potential pro-poor financial sector counterweight to these developments, but its application to rural areas has neither been straightforward nor rapid. As a result, access to financial services is extremely limited in most rural areas, leaving millions of rural poor dependent on inappropriate and usurious services, to their own detriment and that of rural development in general. While not a panacea to poverty reduction, rural financial services go hand in hand with promoting rural development and the alleviation of poverty.

164. **IFAD – Potential Leader in Rural Finance.** IFAD's pioneering rural finance work has faced great challenges helping to establish pro-poor financial systems. It is also the sector for which IFAD has a relatively comprehensive set of ingredients (the RFP, rural finance action plan, decision tools, regional partnerships, monitoring tools, etc.) that can make up a strategic approach to sector development. Past experience, the impressive volumes of IFAD lending, the existence of the RFP and commitment to improved development effectiveness leaves IFAD potentially the most important global actor in rural finance. It is, certainly, the only one solely focused on rural areas. However, for the time being, IFAD is leading mostly in terms of the sizable level of its overall investment in this sector.

165. **RFP – Meeting Best Practice Standards in Some Areas, not in Others**. The RFP has proven to contain a number of elements that are best practice, although some areas of the Policy lack clarity and need to be improved to meet latest best practice standards. The RFP provided a general framework to develop regional and country strategies and project design, but without setting clear policy directions for expected norms and standards. The RFP is not sufficiently normative and prescriptive. The permissive character and ambiguity of the RFP resulted in an only limited, albeit increasing reflection of RFP principles in regional and country strategies and contributed to projects that are not fully compliant with RFP requirements. Two other main shortcomings of the RFP lie in the absence of a costing for its implementation and a requirement to retrofit ongoing projects to meet RFP standards.

166. **Progress towards Implementing the RFP.** In meeting the four challenges of the RFP, IFAD-assisted projects performed moderately well across all dimensions. PFI sustainability was achieved in the case of 24 per cent of partner institutions – a low percentage, but comparable to that of some agencies that work in less challenging urban areas. The diversification of financial products and services and financial intermediaries showed positive, but modest results. Against the challenges of stakeholder participation and promoting conducive regulatory frameworks, little change in performance has been noted. IFAD's rural finance assistance is meeting the RFP goal of serving rural poor (albeit not the poorest of the poor which is in line with best practice) and by serving 60 per cent women.

167. **Explaining Improvements.** Modest advances made by rural finance projects towards greater RFP conformity can be ascribed to a number of factors, which include (i) Decision Tools which set out frameworks of best practice; (ii) the CGAP donor peer reviews and subsequent rural finance action plans, which brought greater attention and focus to the strategies for improving rural finance operations; and (iii) IFAD's increasing general knowledge of best practice in rural finance, supported by publications and efforts to improve capacity. The continuous trend in improving project design and progress made in resolving some project implementation issues provides a good platform from which IFAD can address a number of outstanding issues that will further improve the performance of its rural finance assistance.

168. **Resources Limitations Account for Modest Improvements.** The modest positive trend was impeded by a number of significant factors including insufficient resource allocations, in particular from the administrative budget, to ensure an adequate amount of technical in-house expertise in rural finance. IFAD is well below par in this area compared to other international agencies active in microfinance. Human resources, though improving, still fall short of what is needed in qualitative as well as quantitative terms to provide the necessary support to the sizable and complex IFAD rural finance portfolio. Moreover, while the CLE recognizes the collective effort to improve rural finance activities at IFAD, by concentrating the responsibility for rural finance into the responsibility of a single staff (i.e., rural finance technical expert in PT) the institution now faces significant key person risk. Support for rural finance activities has been built on highly personalized relationships, which now needs to be institutionalized. Funding has also fallen short of requirements for the provision of TA, which is a key factor in the success of many microfinance projects.

169. **Fundamental Changes Necessary for Significant Performance Improvements.** Finally, there are a number of barriers to the effectiveness of IFAD assistance for rural finance. These barriers stem from IFAD's founding agreement and entail, inter alia: mandatory lending to government rather than directly to PFIs, limited IFAD field presence and constraints on IFAD to provide direct supervision and implementation support. The forthcoming policy on supervision and implementation support is likely to change the limitations on IFAD in this respect, but whether these changes are sufficient to address the requirements of technically qualified rural finance expertise in the field remains to be seen. Unless these changes are made, IFAD's rural finance assistance is at risk of continuing to perform below expectation and, more importantly, to endanger the meager financial resources of the rural poor, if unsustainable financial service providers are supported.

B. Recommendations

170. The following recommendations seek to build upon ongoing improvements to rural finance projects to ensure that further progress can be made to meet best practice standards which will benefit IFAD's target group – the rural poor – by providing them with access to sustainable rural finance services. The recommendations propose two options: the first, pursuing modest and incremental changes; the second, more rapid expansion of sustainable pro-poor financial services to the rural poor.

Option 1: Help More Poor People but Slowly

171. Incremental change can bring IFAD's rural finance projects into greater compliance with the RFP and can be achieved with a small number of relatively simple alterations to current operating processes and organizational arrangements. The recommendations proposed under this Option must be considered the bare minimum in terms of changes that need to be made to protect IFAD investments in rural finance operations. If the recommendations under Option 1 cannot be accepted and implemented, IFAD will need to reconsider its exposure in the rural finance sector and scale back new project approvals.

172. **Recommendation 1: Clarify the RFP Norms and Standards and Supporting Instruments.** IFAD must clarify the normative prescriptions of the RFP. This can be done through a complete revision of the RFP or through an overview laying out the main points of the RFP in simple and clear terms. In either case, the document should be brief and prescriptive. The Decision Tools and other resources supporting the RFP should also be updated and improved to achieve simplification and greater clarity. A sector analysis framework (in line with CGAP best practice standards) should be introduced and made mandatory prior to taking investment decisions to ensure right choices are made for investing IFAD's scarce lending and grant resources.

173. **Recommendation 2: Ensure Rural Finance Operations Meet RFP Norms and Standards.** IFAD Management needs to send a clear signal both internally to project designers and externally to borrowers that policy norms matter and must be met. To do this, Senior Management and the EB must begin to apply the norms and standards of the RFP by rejecting projects found not to be in compliance

with the RFP. This is perhaps the single most effective and efficient means to improve rural finance project quality. IFAD's forthcoming quality assurance mechanism needs to be designed to include minimum standards for rural finance projects. The extent to which projects meet these standards needs to be reported to Senior Management and the EB prior to the approval of new projects.

174. **Recommendation 3: More Systematic and Earlier Provision of Technical Expertise in the Design Process.** IFAD must improve quality assurance earlier in the design process when investments in project design are relatively small. It can do this by testing RFP compliance during or even prior to formulation. TRC reviews must also be made at this stage and recommendations must be addressed and approved before design moves to appraisal. To avoid conflict of interest, the rural finance expert on PDTs should not write the TRCs.

175. **Recommendation 4: Build Greater Capacity.** A means to improving RFP effectiveness is to build greater internal technical capacity at all levels in IFAD. The Rural Finance Action Plan includes provisions for staff development, which needs to be reviewed, expanded with appropriate, short-term training opportunities, and with requirements that set an "accountability for learning" framework, which recognizes the need, obligation, and allocation of time for developing the needed technical competences and skills. This capacity building must be understood as a continuous process, rather than one-off training course. The need for commitment to building technical competencies and skills for rural finance is even more pronounced, if IFAD were to decide to become an industry leader in the sector (see Option 2).

Option 2: Help a Larger Number of Rural Poor, Faster with a Greater Chance of Sustainability.

176. The above recommendations do not imply significant process change or budget implications. However, choosing Option 1 would be an extremely disappointing response to the needs of the rural poor for appropriate financial services. Option 1 would also fall short of recognizing the significant unmet demand for appropriate rural financial services – and the potential leadership role that IFAD could play. Other development agencies play important roles in the microfinance sector, but without reaching into rural areas in the ways IFAD does. By contrast, IFAD's sole mandate is to work with and for the rural poor, and has approved significant amounts of loan money and mobilized co-finance into rural finance. Hence, this second option aims at a more rapid expansion of sustainable pro-poor financial services through a series of actions aimed at resolving fundamental constraints at a number of levels. These recommendations must be enacted together with recommendations under Option 1 to achieve the objectives of this option.

177. **Recommendation 5: Decide to Take a Leadership Role and Define a Strategy to Get There.** The updated RFP should provide the normative framework for rural finance operations (recommendation 1). In addition, IFAD will need to decide on a strategy for becoming a leader in the sector, including (i) positioning itself vis-à-vis other partners in the sector; (ii) defining regional priorities that translate the principles of the RFP into meaningful objectives for each of the regions (these regional strategies have to be developed by the regional divisions to ensure complete understanding of key challenges to rural finance in the region, and full ownership and implementation of the rural finance strategy for each region); and (iii) committing to making changes such as those detailed below that will ensure the quality of rural finance operations.

178. **Recommendation 6: Allocate Commensurate Resources to Rural Finance and Reduce Key Person Risk.** The CLE demonstrated that IFAD's human and financial resources dedicated to a rural finance portfolio of the size that IFAD has approved are minute in comparison to other development agencies. Being dependent on one full-time technical expert risks loosing a good deal of institutional capacity and of corporate knowledge, should this key person leave. The CLE recommends creating a rural finance unit, consisting of a total of up to four new professional rural finance experts, each with a cross-section of additional specializations over their rural finance expertise (e.g., rural finance ***and*** gender). In addition, administrative budget resources are required to fund essential work, such as

regional partnerships, and continued work on the MIX which is currently funded from grant resources with limited timeframes.

179. **Recommendation 7: Develop More Relevant Instruments, Better Delivery, and Stronger Supervision.** IFAD needs to change its lending policy to allow for direct lending to PFIs and must be able to deliver a range of technical support services to build PFI capacities (ideally, on-the-ground dedicated rural finance expertise). These services should be sourced competitively and use performance-based grants/contracts to ensure TA is effectively used. Such new instruments will demand closer supervision and technical support than is currently available from PMUs and CIs. The forthcoming change in supervision and implementation support modalities need to ensure that requirements for working in the rural finance sector are addressed.

180. **Recommendation 8: Gain Greater Relevance through a More Efficient and Effective Process.** IFAD's project cycle greatly affects the relevance and effectiveness of rural finance projects, simply due to the length of time it takes to develop and launch projects. The CLE recommends bringing the IFAD project cycle (at least for rural finance projects) down to one year.

APPENDIX 1

Rural Finance Background

A. Current Issues and Trends

1. Research has demonstrated that microfinance services, though not a panacea for poverty reduction, tend to increase earnings and that woman, often the major client base for micro/rural finance institutions, tend to invest additional earnings in improved health and nutrition and schooling for their children. Consequently, the importance of assisting in setting up or developing a microfinance and rural finance system that is accessible to the poor has been recognized as an important instrument in the fight against poverty. In the evolution of financial service provision for the poor, evidence is building that microfinance is an effective tool in poverty alleviation. The widening menu of financial service products also appears to increase customer satisfaction. Meanwhile, rural and agricultural finance – some of the remaining challenges in effective financial service delivery to the poor – are slowly seeing some best practices emerge.

2. **Challenges of Rural Finance.** Overall, the microfinance and rural finance sectors suffer from weak institutional capacity due to poor governance and operating systems and low skills of managers and staff. These weaknesses, while not applicable to all countries and micro or rural finance institutions (M/RFIs) originate in general areas of weaknesses:

(i) **High Risk, Low Profit.** Low population densities, isolated markets, and high incidence of poverty mean that transactions are small (low volume and low value) and often associated with high transaction costs, leading to low profit margins. In addition, the absence of traditional collateral (in particular land title/deeds) and high covariant risks of farming and seasonal income fluctuations, irregular cash flows and limited opportunities for risk diversification of borrowers means that M/RFIs are exposed to higher risks than other financial intermediaries.

(ii) **Poorly Designed Interventions.** In the past, the main programming response to this array of constraints was supply-led credit delivery by state-owned agricultural or development banks offering subsidized loans directed at specific groups. This approach quickly depleted funds, distorted financial markets (the "crowding out effect" of subsidized providers[62]), and put pressure on the Non Performing Loans (NPL) per cent in the banking sectors. Programme designs did not endeavor to overcome underlying constraints to advance the field of rural finance. This approach is also referred to as the old rural finance paradigm which dates back to the 1960s and 1970s.

3. **Regional Differences.** In addition, the industry developed differently in the each region and faces a diverse range of challenges: inadequate physical and financial infrastructure to penetrate rural areas (especially in Africa); low business and financial skills of potential clients (especially in Latin American and Caribbean countries); policy constraints on financial and agricultural markets that limit profitability (especially in Africa, Asia and the Pacific); and dominance of state-owned banks operating on non-commercial principles (especially in East Asia, the Pacific, the Middle East, and North Africa)[63].

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[62] CGAP, 2003, Financial Services for the Rural Poor, Donor Brief No. 15, August 2003.

[63] Steel, William F. and Stephanie Charitonenko, 2003, Implementing The Bank's Strategy To Reach The Rural Poor, Washington, D.C.: Agriculture & Rural Development Department Rural Private Sector, Markets, Finance, and Infrastructure Thematic Group, Report No. 263, Rural Financial Services, The World Bank.

4. **Evolution of the Rural Finance Sector.** Concepts and approaches to developing rural finance services are rooted in the development of the microfinance sector. Starting from the 1970s, microfinance has evolved from membership-owned saving groups to sophisticated informal and formal banking systems. Transferring these concepts from the microfinance to the rural finance sector is challenging, because microfinance movements have worked well in urban and peri-urban areas with higher levels of population density and greater access to at minimal infrastructure. Nonetheless, lessons learned from the microfinance experience and latest thinking in terms of financial systems approaches continue to contribute to the emergence of the new rural finance paradigm[64]. The new approach emphasizes the role of efficient rural financial intermediation in sustainable income generation and poverty reduction, calling for an assessment of market efficiency, including rural financial markets, and a determination of the underlying causes of inefficiencies. As a result, the assistance of development partners, including that of IFAD, is shifting from an input-supply understanding to a more complex and comprehensive financial systems' approach (Table 1).

Table 1. Evolution of Rural Finance Concepts

Credit as an Input	**=>**	**Financial Services for the Rural Poor**
Agricultural and state-owned banks	=>	Pro-poor rural financial institutions
Supply-led agricultural credit	=>	Demand-led rural financial services
Large, multi-sector projects	=>	Discrete sizeable rural finance components or 100per cent stand alone projects
Emphasis on design and loan agreement	=>	Better understanding and monitoring of rural financial institutions and implementing partners
One-off credit, time bound to length of Project	=>	On-going relationship with financial intermediaries to build permanent capacity through grants and loans
Subsidized interest rates, depleting capital	=>	Cost-recovery/commercial interest rates, revolving capital
Delivery managed through project management units (public)	=>	Delivery managed by specialized financial intermediaries (private)
Generalists, technical know-how not incorporated in design	=>	Specialist, technical input early on in concept and design stages
Accountability for activities: size of target group and number of loans	=>	Accountability for performance: clear indicators on efficiency, financial viability and outreach

Source: CGAP Donor Peer Review, 2005.

64 Nagarajan, Geetha and Meyer, Richard, 2005, Rural Finance: Recent Advances and Emerging Lessons, Debates and Opportunities. Reformatted version of Working Paper No. AEDE-WP-41-5, Department of Agricultural, Environmental, and Development Economics, the Ohio State University (Columbus, Ohio, USA) http://aede.osu.edu/resources/pubs/php.

5. **Continuing Agenda.** Successful agricultural microfinance providers have married the core principles of the microcredit movement with the technical expertise required to assess the agricultural competence of potential borrowers. For instance, adaptations need to be made to commonly used microcredit methodologies such as offering loan terms and conditions that better accommodate the more cyclical cash flows of farming households and the more demanding timing of credit needs for crop or livestock activities. Moreover, recently, a renewed focus on restructuring agricultural development banks and other sizeable institutions – making use of existing infrastructure – is also proving feasible now, through applying knowledge gained as rural finance has evolved. Technological innovations, linking loans to contractual farming arrangements, and buying index-based insurance are also recent promising innovations designed to tackle this still challenging area in microfinance[65].

B. International Initiatives and Funding for Microfinance

6. The understanding that microfinance is an important, albeit not sufficient, tool for poverty reduction has led to a number of international movements and conferences. A recent important initiative in the area of rural finance was the conference, entitled "Paving the Way Forward for Rural Finance," in June 2003, Washington DC. Other recurring fora, where rural finance is discussed to a greater or lesser extent include: the Microcredit Summit Campaign, the annual meetings of the development banks, the Annual Financial Markets and Development Conference of the World Bank and IMF.

7. Institutions that are involved in microfinance and/or rural finance include (i) banks and industry associations, such as Rabo Bank, AFRACA, Asian Regional Agricultural Credit Association (APRACA), the World Council of Credit Unions (WOCCU); (ii) bodies of the United Nations (UN) system, such as the UN Capital Development Fund, and Food and Agricultural Organization (FAO); (iii) research institutions such as International Food Policy Institute (IFPRI); and (iv) International Finance Institutions (IFIs) such as African Development Bank (AfDB), Asian Development Bank (AsDB), IFC, InterAmerican Development Bank (IADB), and World Bank. IFAD belongs to the UN system and is an IFI. Among the IFIs, IFAD is one of the smaller financial institutions, although the Fund is mandated to focus on rural poverty reduction and invests only in agriculture and rural development, including rural microfinance. All other IFIs have much broader sector coverage.

[65] CGAP Occasional Paper, 11 August 2005.

IFAD Funding for Rural Finance

Table 1. Rural Finance Allocations Per Region and By Timeframe Projects Approved between 1996 and 2005
(Loan amounts in US$ million)

Divisions	1996-2000			2001-2005			1996-2005		
	Number of projects	IFAD Loan amount for RF	% of Total	Number of projects	IFAD Loan amount for RF	% of Total	Number of projects	IFAD Loan amount for RF	% of Total
PA	19	55.3	11.7	18	25.6	7.3	37	80.8	9.8
PF	15	45.2	9.6	13	77.4	22.1	28	122.5	14.9
PI	30	185.9	39.5	25	154.4	44.0	55	340.3	41.4
PL	22	75.3	16.0	9	16.9	4.8	31	92.2	11.2
PN	21	109.4	23.2	22	76.6	21.8	43	186.0	22.6
Total	107	471.0	100.0	87	350.9	100.0	194	821.8	100.0

Note: This table includes only lending amounts for rural finance (RF) approved by IFAD. It does not include additional funding generated from co-financiers, or funding for other project components.

PA = West and Central Africa; PF = East and Southern Africa; PI = Asia and Pacific; PL = Latin America and Caribbean; PN = Central and Eastern Europe and Newly Independent States and Near East and North Africa

Table 2. IFAD Funded Projects with Rural Finance Components Approved between 1996 and 2005
(Number of projects)

Divisions	1996-2001			2001-2005			1996-2005		
	Closed	Ongoing	Not yet active	Closed	Ongoing	Not yet active	Closed	Ongoing	Not yet active
PA	2	17			15	3	2	32	3
PF	1	14			11	2	1	25	2
PI	12	18		10	15		22	33	0
PL	5	17			4	5	5	21	5
PN	4	17		1	12	9	5	29	9
Total	24	83		11	57	19	35	140	19

Note: Figures refer to the project status at the end of 2005. The project status of projects may have changed during 2006.

PA = West and Central Africa; PF = East and Southern Africa; PI = Asia and Pacific; PL = Latin America and Caribbean; PN = Central and Eastern Europe and Newly Independent States and Near East and North Africa

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