

# How to do

## Lines of credit



### Inclusive rural financial services



**How To Do Notes** are prepared by the IFAD **Policy and Technical Advisory Division** and provide practical suggestions and guidelines to country programme managers, project design teams and implementing partners to help them design and implement programmes and projects.

They present technical and practical aspects of specific approaches, methodologies, models and project components that have been tested and can be recommended for implementation and scaling up. The notes include best practices and case studies that can be used as models in their particular thematic areas.

**How To Do Notes** provide tools for project design and implementation based on best practices collected at the field level. They guide teams on how to implement specific recommendations of IFAD's operational policies, standard project requirements and financing tools.

The **How To Do Notes** are "living" documents and will be updated periodically based on new experiences and feedback. If you have any comments or suggestions, please contact the originators.

## Originators

### Michael Hamp

Lead Technical Specialist, Inclusive Rural Financial Services  
Policy and Technical Advisory Division  
E-mail: m.hamp@ifad.org

### Francesco Rispoli

Senior Technical Specialist, Inclusive Rural Financial Services  
Policy and Technical Advisory Division  
E-mail: f.rispoli@ifad.org

### Jonathan Agwe

Senior Technical Specialist, Inclusive Rural Financial Services  
Policy and Technical Advisory Division  
E-mail: j.agwe@ifad.org

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## Contact

### Maria-Elena Mangiafico

Knowledge Management and Grants Officer  
Policy and Technical Advisory Division  
E-mail: m.mangiafico@ifad.org

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## List of acronyms

CGAP	Consultative Group to Assist the Poor
CPM	country programme manager
FSP	financial service provider
KPI	key performance indicator
LOC	line of credit
M&E	monitoring and evaluation
MFI	microfinance institution
MIS	management information system
MIV	microfinance investment vehicle
PFI	participating financial institution
PMP	performance monitoring plan
PTA	Policy and Technical Advisory Division (IFAD)
RFI	rural finance institution
SMEs	small and medium-sized enterprises
TA	technical assistance

## Introduction

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

IFAD focuses on developing and supporting diverse, viable financial service providers (FSPs) that increase the long-term access of poor rural people to a wide range of financial services. IFAD's commitment to promoting pro-poor rural and microfinance interventions is driven by the recognition that effective demand for these services can be met through a number of different instruments (see Box 1).

### Box 1: Six principles of rural finance

1. Support access to a variety of financial services, including savings, credit, remittances and insurance, recognizing that poor rural people require a wide range of financial services.
2. Promote a wide range of financial institutions, models and delivery channels, tailoring each intervention to the given location and target group.
3. Support demand-driven and innovative approaches with the potential to expand the frontiers of rural finance.
4. Encourage collaboration with private-sector partners and market-based approaches that strengthen rural financial markets, avoid distortions in the financial sector and leverage IFAD's resources [to benefit poor rural people].
5. Develop and support long-term strategies focusing on sustainability and poverty outreach, given that rural finance institutions (RFI) need to be competitive and cost-effective to reach scale and responsibly serve their clients [by applying the Consultative Group to Assist the Poor's (CGAP) Client Protection Principles in Microfinance (ACCION International, 2008)].
6. Participate in policy dialogues that promote an enabling environment for rural finance, recognizing the role of governments in promoting a conducive environment for pro-poor rural finance.

Source: IFAD's Rural Finance Policy, 2009

Lines of credit (LOCs) may be used as an instrument to promote financial inclusion. Typically, IFAD supplies a loan to a second-tier financial institution who then lends it to a first-tier institution. These funds are used to:

- promote the development of FSPs
- finance real sector (agriculture) investment needs
- promote private sector-led small and medium-sized enterprise (SME) development
- help to broaden and increase efficiency in the allocation of scarce resources and services to an unsaturated rural financial market
- support the country's poverty reduction agenda.

This How To Do Note highlights the philosophy and rationale for LOCs, focusing on different types of LOC arrangements, as well as their strengths, weaknesses and opportunities. It summarizes global experience with LOCs in order to clearly outline when they should and should not be used. It presents practical aspects of specific approaches, methodologies and models that have been tested and can be recommended for implementation and scaling up. The output is based on stakeholder consultations and a desk study informed by IFAD's *Rural Finance Policy* (2009) and the *IFAD Decision Tools for Rural Finance* (2010).

It aims to help guide country programme management teams, project design teams, implementing partners and other practitioners. However, it does not provide all of the answers, nor does it provide models that can simply be replicated from one context to another. Instead, it provides guidance, ideas, tools and suggestions to assist practitioners in making strategic choices about LOC interventions so that they will be appropriately designed and have greater impact.

## Key issues and questions

IFAD's involvement in a country's rural finance sector is anchored in the Results-Based Country Strategic Operations Programme (RB-COSOP) and is driven by its overarching objective to enable poor rural people to overcome poverty. IFAD has developed a *Rural Finance Policy* (RFP), together with *Decision Tools for Rural Finance* for its application. IFAD consults regularly with other partners on its proposed microfinance assistance to its client member countries.

IFAD generally discourages the use of LOCs to support retail financial institutions. Experience has shown that, in most cases, this financial instrument has failed to trigger the development of sustainable financial services. LOCs often do not meet the longer-term needs of FSPs and can even negatively impact the wider financial sector. Further, liquidity (i.e. access to loan capital) is usually not the main constraint that keeps FSPs from offering loans to poor people in rural areas. Instead, most FSPs need support for capacity-building rather than credit.

## Context and IFAD's perspective on lines of credit

When IFAD uses LOCs, they are provided to client governments (rather than the private sector). The financial package is either dedicated to stand-alone rural finance projects or unbundled to support various components of real/productive sector projects. Part of such financial assistance packages are earmarked to support loans in the form of LOCs to private or public sector-based FSPs. IFAD's LOCs are of varying amounts with varying maturities but must cease upon closure of the project. LOCs are disbursed in either local or foreign currency. Those disbursed in foreign currency are exposed to foreign exchange risks, which may need hedging to mitigate these risks; and the hedging could increase the cost of providing the LOC. The FSP is expected to on-lend in smaller amounts to clients of IFAD-funded projects. The terms and conditions for the LOC may require the FSP to assume full or partial credit risk for repayment of the loan to the government.

Long-term credit lines are very important for deposit-taking FSPs in particular. Since deposits are typically short-term and can fluctuate significantly, FSPs relying on deposits only on their liability side have serious difficulties in transforming these short-term liabilities into longer-term loans. These difficulties include liquidity management issues and issues related to norms and regulation. Any responsible FSP will aim at a reasonable diversification of its liabilities with a good mix of short-term savings and long-term refinancing. Since bond issues are hardly possible for many FSPs, LOCs are very important. With the degree of growth and development in financial markets, the importance of LOCs may actually increase rather than decrease.

However, LOC performance in development finance is mixed: IFAD, the World Bank and other organizations have underperformed when utilizing LOCs through governments<sup>1</sup> but market-oriented institutions such as KfW, the International Finance Corporation (IFC), microfinance investment vehicles (MIVs) – private or public-private partnerships – and other development financial institutions (DFIs) offering LOCs at near-market rates have performed better.

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<sup>1</sup> The European Commission, for example, has phased out direct LoCs (Europe Aid's Director General Instruction Note 3959, 4/3/2004).

The underperformance of LOCs can be traced to many factors, including the design, pressure to disburse within the project implementation period, and the rigor and experience of managers. Many IFAD-supported LOCs are managed by public sector-based managers, who are typically not as well equipped as private-sector managers to handle LOCs, usually due to political and government pressures meddling in their decisions (see Box 2).

### **Box 2: Some issues regarding lines of credit**

Liquidity is not usually the main constraint that keeps FSPs from offering loans to poor people. More commonly, FSPs do not have the capacity, products or systems in place to serve poor clients. And some FSPs are simply not interested in serving this target group.

LOCs can distort credit markets, undercutting and crowding out sustainable, unsubsidized competitors and blocking the entry of new service providers, as well as alienating other donors and FSPs.

Wholesale and retail FSPs may become less attentive to their lending practices when they have access to large amounts of low-cost capital. Wholesalers, for example, may feel pressured to disburse funds to weak institutions or in tranches too large to effectively manage, leading to increased defaults or overexpansion.

The sustainability of the products financed by the credit line is often uncertain. When access to LOCs stops, FSPs may go back to serving mainstream borrowers and stop serving the target group.

Some FSPs rely too heavily on donors and LOCs, and lack a clear exit strategy to mainstream market-based credit. When projects end, FSPs must be strong and resourceful enough to fund their own loan portfolio (de Sousa-Shields and Frankiewicz 2004).

Most FSPs need support for capacity-building more than credit and, as they improve operations, funding is usually less of a problem. Supporting institutional capacity development is a proven and integral part of integrating financial services for poor people into the formal financial sector.

If LOCs are to be useful, then they must be made available with coordinated TA and resources for capacity-building. If a project is working with an FSP on product development, for example, then the product should be researched, designed and ready to pilot before it can access capital for its launch and testing (assuming the agreed on targets were met).

## **Key issues, features and rationale**

Providing sustainable financial services for rural areas and agriculture in developing countries has proven difficult. Billions of dollars have been spent subsidizing programmes and policies to develop financial institutions to serve this neglected market. However, in most countries, decision makers, ministers of food and agriculture, and farmers are dissatisfied with the results. Critics of the market-oriented financial reforms implemented following the collapse of the directed credit paradigm claim that these reforms have failed, given that agriculture continues to receive only a small share of total formal credit and that most farmers must rely on savings or informal credit supplies to finance their operating costs and long-term investments. These critics argue for a return to more active government intervention, including the creation of state-owned agricultural development banks. But using the government as an intermediary may itself be a problem. Government-managed LOCs face challenges such as the lack of efficiency and knowledge of state apexes, political influence in selecting partner FSPs and political influences on conditions for loans to FSPs as well as loans to end-customers, among others.

### **Issues with donor-funded lines of credit**

LOCs risk distortion of the rural finance market (see Box 3). The provision of external and often below-market-rate funding risks disrupting the development of inclusive financial systems by encouraging donor dependence rather than encouraging the FSPs to develop long-term local sources of funding.

Another problem is that LOCs are designed to support the project objectives rather than the long-term stability of the FSP.

FSPs with social development as part of the core profit-oriented business are usually enticed to serve the niche clients through LOCs but some of these FSPs do not invest in an analysis of demand and risk among target clients and, thus, do not (or cannot) develop appropriate products or risk mitigation strategies.

Donors often finance pilot projects without providing funding for scaling up. To be effective, donor promoted LOCs should be time-bound. They should only be proposed when there is a gap in the market and a clear exit strategy. When the financial market develops, there should be no need for donor-driven LOCs but preference is given to linkage with sources of refinancing in the market (see Box 3).

### **Box 3: Lack of understanding of lines of credit among financial service providers**

A unilateral donor developed a relationship with rural banks in a West African country to provide microfinance loans to rural farmers. In response to a request to help finance the portfolio, the donor extended a retail funding facility with a maturity of two years to several of the rural banks. As the maturity date approached, the donor requested repayment of the loan but found that the rural banks had not made any provision for repaying it; and the rural banks did not understand the need for establishing a funding mechanism to finance repayments. Thus, the only way that the rural banks could finance the repayment to the donor was not to extend new loans to old clients as their existing loans matured. Since these loans to clients were based on social collateral rather than on tangible collateral, the non-renewal of these loans after the existing loans had been repaid would trigger a rash of loan defaults, since the only incentive for these borrowers to repay was the expectation that they would be able to access future loans on an ongoing basis. Then, if a new loan was not forthcoming, there was no incentive to repay the existing loan. This placed the donor in a difficult situation. It could either insist on repayment of the loan or possibly trigger the collapse of the rural bank, or it could roll over the loan and defer repayment, possibly indefinitely.

Since there is a substantial risk of underperforming LOCs, IFAD has limited ability to use them in projects. When used, it is essential that IFAD uses them effectively. One option is for IFAD to allow FSPs the flexibility to make LOCs as open as possible. As a result, the FSP may approach the private sector to finance LOC products, while the donors focus on building capacity and the creditworthiness of the target clients to make them attractive to the FSP.

### **When to use a line of credit**

Due to the volatility of LOCs, IFAD will only consider using the instrument under the following conditions:

- The market demonstrates a clear lack of liquidity, as demonstrated by a rigorous market assessment.
- The LOC will not undermine the initiatives of other donors or private-sector partners.
- Loans to retail financial institutions are priced at commercial or near-commercial rates to avoid undermining their incentive to mobilize deposits or access other sources of capital.

In addition, performance-based agreements are written so that the FSPs will:

- use private, professional fund managers or institutions to manage the LOC (rather than the recipient governments)
- allocate resources for the capacity-building of partner institutions to successfully manage rural finance operations and effectively use the additional capital
- have a clear exit strategy that develops linkages with other sources of refinancing and ensures that the target group will continue to access these services after the project ends.



LOCs are appropriate when they can be used to support savings mobilization and other intermediation measures. This is especially true for more rural areas where commercial players are reluctant to venture. LOCs can temporarily solve liquidity constraints if – and this is critical – the FSP has the right capacity, products and delivery mechanisms to reach its target clients. When used appropriately, LOCs can serve large numbers of clients with access to small repetitive loans.

In the final analysis, LOCs should be provided only when there is a clear understanding of the macro- and meso-level drivers. Without a supportive financial environment and a mature FSP, LOCs run the risk of causing more harm than good.

## Lessons learned

Participating FSPs should be closely vetted and should be required to:

- use this capital as part of their own strategic plan to develop new products and/or serve new markets in rural areas
- be financially sound and have the capacity to efficiently and transparently absorb and manage the credit line
- be independent of political interference and free to charge interest rates that allow cost recovery
- endorse the CGAP Client Protection Principles in Microfinance
- use key performance indicators (KPIs), share performance and outreach information with the MIX Market on an annual basis and submit the required performance indicators to the programme management unit (PMU) regularly during implementation and supervision.

A quality grading of World Bank microfinance LOCs from 1993 to 2002 (OECD, 2004) indicated that most had failed to develop sustainable financial services. The cancellation rates for World Bank LOCs were over 40 per cent. This seems to indicate that: the terms and conditions for LOCs were not well aligned with the interests of potential participating financial institutions (PFIs); qualified PFIs could not be identified; and/or other donors offered funds with subsidized interest rates, thus reducing demand for World Bank funds. Fewer than half of World Bank projects developed clear eligibility criteria for PFIs and those that did often set very low standards, such as 75 to 85 per cent repayment rates, which are far below the level needed for sustainability. For the most part, World Bank projects with LOCs have not satisfactorily monitored the performance of PFIs. Thus, stakeholders have been unable to determine whether or not supported institutions are sustainable. However, projects that reported KPIs tended to have better outcomes.

**The size of the LOC should be estimated conservatively.** From 1993 to 2002, only 40 per cent of the commitment amount was utilized. LOCs that are larger than needed create pressure to disburse funds to unqualified institutions or to disburse funds that are too large for an institution to effectively manage. It is usually better to begin slowly and commit more funds if and when the institution proves its capacity.

**The LOC should adhere to the World Bank's policy on financial intermediary lending.** Key provisions of this policy include the establishment of PFI eligibility criteria that screen out poorly performing institutions, the collection of meaningful performance information and the pricing of World Bank funds to be competitive with the market rate. The interest rates that wholesalers charge the PFIs and that PFIs charge their retail customers should provide each intermediary with an adequate margin to cover all costs, including credit and other risks, and an adequate profit margin. Subsidies are permissible, provided that they: are transparent, targeted and capped; are subject to effective control and regular review; do not give an unfair advantage to some PFIs with respect to other qualified and directly competing institutions; and are economically justified.

**The LOC should be strongly managed.** The manager of the LOC must be able to identify potential qualifying PFIs, monitor compliance with eligibility criteria and report PFI performance. Quantifiable KPIs should be identified and monitored rigorously during supervision. Indicators should include, at a minimum, the number of active clients, some indication of the poverty level, the quality of the loan portfolio, PFI profitability and PFI efficiency (Rosenberg 2004). CGAP created guidelines at the micro, meso, and macro levels to address the appropriate use of external support and subsidies without undermining the growth of the private sector (CGAP 2006).

### Lines of credit in the investment process

The investment process requires careful analysis to assure investors of the expected benefits and risk and to highlight the specific areas for investment and capacity development..

Investment involves the steps shown in Box 4.

#### Step 1: Submit application

Through the project a professional institution is recruited to manage the LOC. The fund manager, the programme coordinator and the monitoring and evaluation (M&E) units issue a call for concept notes. The call for concept notes is advertised in newspapers and other media. The call for a concept note lays out eligibility criteria, due date, format requirements and a website address with additional information. The website should have answers to frequently asked questions (FAQ) and an overview of all requirements and the process for acceptance. Programme staff are not allowed to be involved in the writing of concept notes.

#### Step 2: Process application and decision-making

Once concept notes are received, the fund manager performs a nominal check of concept notes to ensure that the deadline has been met, the applicant is eligible (licensed financial intermediary) and that formatting and content requirements have been complied with. The fund manager can request further information, if required. The content review looks at congruence with project objectives, the innovative character of the proposed activities and the proposed handling capacity of the applicant organization. The fund manager then decides which organizations will be invited to submit an investment proposal. The decision on concept notes will be taken by the fund manager. If negative, the applicant organization will be informed that it shall not be invited to submit an investment proposal. If positive, the applicant will be informed that it shall be invited to submit an investment proposal. At this point, only the fund manager decides at this level of decision-making. The fund manager maintains a register of all submitted concept notes and periodically informs applicants of their status (rejected/approved). The reasons for rejection/approval are captured in meeting minutes.

#### Step 3: Produce investment proposals

The fund manager notifies applicants on whether they are invited to submit an investment proposal. This invitation sets a deadline for submission of the investment proposal, approximately four weeks after receipt of the invitation. It includes a list of queries or concerns, if any, that emerged from the review of the concept note.

If desired, IFAD may inform the applicants that IFAD will help finance third-party assistance in preparing the proposal. Selection of third-party services is entirely up to the applicant, although the fund manager may review their professional status. Project staff are not allowed to provide advisory services or contribute to proposal writing. The fund manager may provide additional information to applicants, as needed.

#### Box 4: Steps to invest

1. Submit application
2. Process application
3. Produce investment proposal
4. Produce investment memorandum
5. Obtain Board approval
6. Monitor performance

#### Step 4: Produce investment memorandum

The nominal check of the investment proposals will assess the deadline, consistency and analysis of proposals. The review criteria will include institutional, financial and portfolio checks, and the fund manager verifies information, as needed. The fund manager works for and reports to the programme. He cannot be hired by the applicant to assist in proposal writing.

Following proposal analysis, the fund manager prepares the investment memorandum. This document, together with the proposal, is presented to the credit committee (CC) which decides to: not endorse (reject) the investment proposal; refer the proposal back to the project for further elaboration and second presentation; endorse (approve) the proposal under terms or conditions; or endorse (approve) the proposal unconditionally ("as is").

#### Step 5: Obtain Board approval

The project staff present endorsed proposals to the programme steering committee (PSC), which include the same investment memorandum, terms or conditions formulated by the CC and relevant excerpts from the CC review. The PSC can decide to approve the proposal as submitted through the memorandum, including terms or conditions formulated by the CC, or it can reject the proposal.

The PSC, therefore, cannot refer the memorandum back for further elaboration or modify the memorandum or terms or conditions by the CC. Proposals not endorsed by the CC are not open to decision-making by the PSC. The PSC receives periodic lists of rejected investment proposals (as well as rejected concept notes). PSC members are not allowed to attend fund manager or CC decision-making meetings. Upon final rejection of a proposal by the CC or the PSC, the fund manager informs the applicant, usually providing information about why it was rejected. This letter is prepared by the PSC, which at all times is entitled to peruse the original investment proposal when discussing an investment memorandum.

#### Step 6: Post-approval processing, monitor performance

Upon final approval of a proposal, the project will put together a performance monitoring plan (PMP) that details how performance will be monitored. The PMP: (i) describes narrative, financial and portfolio reporting requirements and time frames consistent with the activities of the rural finance institution (RFI); (ii) establishes the linkage between reporting and disbursement schedules; (iii) agrees on the cooperation of the investee RFI as regards the introduction and implementation of the household asset accumulation proxy; and (iv) agrees on the participation of the investee RFI in credit rating exercises to be organized by the project.

The investment agreement is composed of three contracts, all to be signed by the investee RFI: the grant agreement (using the grant agreement format), the loan agreement (using the loan agreement format) and the PMP (using the PMP format). All three contracts have to be signed by both parties before the investment agreement becomes effective and support can be released. In order to transfer grants and loan capital on a timely basis to the investee RFIs, the project's financial unit will agree on financial and planning procedures that are based on an on-rolling planning system, captured in a management information system (MIS) and in line with the strategic plan for the project.

Monitoring follows the stipulations of the PMP. The PMP includes clauses for conducting field inspections, mid-term reviews and end-of-project evaluations. The final design of the PMP format requires input from the project's monitoring and financial units. The mid-term reviews and evaluations will exclusively be performed by third parties, whereas regular monitoring of investments is a core project activity.

## Guidance for design and implementation

The need for a LOC is likely to be identified during the preparation of the RB-COSOP or during the concept phase of the project design cycle. LOCs should be rarely used. If a LOC should be used, it is recommended that there be a special internal consultation. When the need for a LOC has been established at the field level, it is suggested that the CPM contact IFAD's Policy and Technical Advisory Division (PTA) and discuss the need for the proposed LOC. The PTA would advise on how it could be structured. Only after receiving feedback from the PTA (through a clearance process) can the project design team then include the LOC in the project design. It is worth re-emphasizing that agency lines (where the FSPs manage the credit process on behalf of the donor without carrying the corresponding credit risks) are strongly encouraged. Likewise, guarantee schemes where the FSPs should carry a first loss in every loss are encouraged in order to avoid moral hazard.



Photographer: Michael Hamp  
Savings and credit self-help groups in Rajasthan, India

### Steps in the design of lines of credit

#### Step 1: Market assessment

A market assessment must show that the FSP faces a serious liquidity crunch in the short and medium term and that access to additional funds could enable it to provide services to underserved rural and agricultural sectors. While the FSPs are allowed to mobilize funds from the public, they need to reorient their staff, re-engineer internal control systems, institute better liquidity management and invest in product development. Some FSPs spend considerable resources on the transformation process, which strains available financial resources for loans. The **purpose** of the LOC is to help established FSPs to address their financing constraints for rural and agricultural lending.

As part of the assessment, identify the FSPs that have a true mission of aiding the poor. Many banks participate in donor-funded LOCs to enhance their public image and, therefore, focus on their typical borrowers rather than on underserved borrowers. Even when they do extend services to new groups, they may not be motivated to continue the services after the project ends. Banks may need to revise their operating systems and products to serve a lower-income clientele. In this case, TA may be a better incentive than a credit line, especially if liquidity is not a problem for the bank.

**Microfinance institutions (MFIs)** have a commitment to provide financial services to low-income people but many have great difficulty achieving profitability in rural areas and, thus, operate in urban areas. Many MFIs are organized as NGOs without a shareholding structure to enable them to raise equity from investors; nor are they able to mobilize intermediate savings. Therefore, they are limited to grants, loans and retained earnings. As a result, they often use a donor-funded LOC to start or expand their business. A LOC to NGO MFIs should be accompanied by measures that increase the MFI's attractiveness to commercial lenders. These measures may include TA to develop products, delivery mechanisms and systems that improve profitability, installation of a strong MIS, and an external audit and ratings by independent rating companies. Some MFIs have been established as non-bank financial institutions with a shareholding structure or transformed from an NGO structure to avoid limitations inherent in the NGO model. Experience has shown that transformation can be a long, difficult and expensive process, and it may require TA over an extended period.

**Financial cooperatives** (including credit unions) and their governance are savings-led. External LOCs can damage cooperatives by diminishing members' motivation to save and creating unhealthy borrower domination in the governance structure. These consequences have been so widespread that LOCs to cooperatives should be avoided in most cases.

**Retail credit delivery by government entities** is a challenge. It is important to note that practical political incentives of government officials run directly counter to the norms of sound practice in credit delivery. Hence, retail credit delivery by government bodies, or by entities subject to government influence, is rarely successful. The successes are cases where the lending body is isolated from political pressure on the amount or recipients of lending.

### Step 2: Analyse the financial sector problem

Liquidity is often not the constraint that limits poor people's access to loans. Indeed, the most common constraints are low interest in serving the poor, weak capacity and/or less credible and/or unbankable business plans by the poor borrowers. When performing this analysis, it is important to refer to the guidance in the *Decision Tools for Rural Finance* on macro-, meso- and micro-client-level issues to consider.

### Step 3: Assess technical assistance (TA) requirements

Funding for TA is often essential. Governments are often reluctant to borrow for TA so it is important to explain to them why TA is needed to achieve long-term sustainability. Limited government funding for TA can also be accompanied by strategic alliances with other donors that have relevant grant instruments.

The skills set of TA providers must match the needs of the organization because the training required for MFIs is not the same as that for banks or cooperatives. Insist that TA providers document the content of the assistance provided so that it can be reviewed during supervision by a qualified rural finance specialist. It is important to note that small LOCs in large projects often do not receive sufficient technical support for successful implementation. If the LOC is a small percentage of total funding, it may be regarded as less important than other aspects of the project and thus receive inadequate attention from the project design team. Even a small LOC can hinder the development of local financial markets.

### Step 4: M&E and KPIs

The establishment of a strong M&E system is critical not only to the ability of IFAD to track the performance of the facility but also to allow the country programme management team to undertake corrective actions

on a proactive basis. This will require the establishment of an effective MIS system prior to the establishment of the facility. This system must be flexible enough to enable regular portfolio management. Additionally, the MIS should also have the capacity to meet the reporting requirements of the MIX Market. Required KPIs that will need to be generated by the system include breadth of outreach, depth of outreach, portfolio quality, efficiency and sustainability.

### Step 5: Design exit strategies

The exit strategy should include other refinancing partners that continue supporting the FSPs, without leaving them dependent on donors and LOCs. Such strategies might include linkages with MIVs or refinancing through the local financial market when certain performance criteria and security requirements have been met to become eligible for market refinancing.

### Conditions for receiving lines of credit

**Eligibility criteria.** Institutions are only eligible to receive LOCs if they meet the following criteria, which may not be amended without IFAD's prior consent. To be eligible for support under the LOC, an organization must have:

- established a deposit-taking microfinance institution
- demonstrated strong commitment to provide services to smallholder farmers, pastoralists, fishers, rural entrepreneurs, women and youth
- a need for funds for on-lending based on its past growth trajectory and future plans of expansion
- a portfolio at risk (PAR) over 30 days of less than 5 per cent (at the end of the last audited fiscal year or averaging the last 12 months)
- written off no more than 10 per cent of its loan portfolio during its last audited fiscal year
- an operational self-sufficiency ratio of at least 85 per cent
- a loan tracking system able to provide a weekly report on total loan portfolio, including ageing of arrears
- up-to-date information posted on the Mix Market website and a commitment to updating such information on an annual basis throughout the period
- a report on the initial list of 13 indicators developed by the Social Performance Task Force to measure the social performance
- complied with CGAP Client Protection Principles in Microfinance, which describe the minimum protection that microfinance clients should expect from providers
- a strong commitment to ensuring that their financial services do not in any way negatively impact the environment.<sup>2</sup>

**Financing terms.** LOC funds will be provided with the following financing terms: (i) eligible FSPs will be given the funds from the credit facility at the market rate; (ii) eligible organizations cannot receive more than 50 per cent of the funds from the LOC at any given time; (iii) funds provided will be used for loaning directly to the target group; (iv) terms and conditions under which the LOC may be used shall be set forth in a bilateral agreement; and (v) financing transactions will be in local currency.

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<sup>2</sup> Refer to the Exclusion List produced by the International Finance Corporation for the activities that are not to be financed in accordance with a series of international treaties that govern environmental and social concerns.

**M&E.** FSPs will be required to provide, on an annual basis, details on the following indicators:

First-level results	Second-level results
Number of active savers (disaggregated by gender)	Percentage of portfolio at risk (outstanding balance of overdue loans for more than 30 days)
Value of savings mobilized (by gender)	Percentage of operational self-sufficiency
Number of active borrowers (disaggregated by gender)	Percentage of operating cost/loan portfolio
Value of gross loan portfolio (loans outstanding – loans written off) (disaggregated by gender)	Percentage of outstanding loans/agents (staff productivity)

## Scaling up of lines of credit

There is need to focus on the “financial system”, which covers all financial institutions, financial markets and instruments, the legal and regulatory environment, and financial norms and behaviour. Building the system requires efforts at three levels: (i) micro – understanding the financial needs and behaviour of different clientele, building financial institutions and creating financial products and services; (ii) meso – creating the infrastructure needed for financial intermediation services; and (iii) macro – creating conducive national policies and strategies, complementary non-financial services and a supportive enabling environment.

The new paradigm reverses the trend of dispersing cheap credit and instead focuses attention on creating sustainable institutions, treating borrowers and savers as clients rather than beneficiaries, developing products that clients demand, and pricing products and services to cover costs and risks. Long-term relationships with clients were encouraged through stepped loans that are small initially and are gradually increased with subsequent loans. For these reasons, donor agencies reduced the use of LOCs in favour of grants, loans and TA to assist with the design of appropriate products, institutions and policies. The new paradigm contributed to the success of the emerging microfinance industry.

Therefore, as an exit strategy for the programme, FSPs should outline a plan for deposit mobilization to demonstrate that they will be able to provide sustainable services to the target group through mobilizing deposits from their clients. At the micro level, the following issues should be considered in scaling up:

- **Sustainability.** Financial sustainability is essential if FSPs are to reach significant numbers of poor people and realize long-term social returns. This entails, inter alia, charging interest rates that cover costs in order to ensure profitability and growth. Over time, competition, improved efficiency and increased accountability for results should drive costs down and thus interest rates as well. Some FSPs take 5-10 years to become financially sustainable, although the time required depends on the country context, local market conditions, capital structure and the market segment served.
- **Efficiency.** Improving the efficiency of rural finance operations translates into higher-quality, lower-cost services for poor people. FSPs can achieve greater efficiencies and thus reduce costs by investing in a quality MIS, development of relevant products, technological improvements and well-trained staff.
- **Capacity-building.** FSPs often need capacity-building support more than loan capital. Tailored TA can help to strengthen capacity, develop relevant products and deepen outreach in rural areas. Institution building requires a long-term commitment by donors and investors, which should be balanced by a defined time limit for funding support.
- **Use of appropriate instruments.** If not properly applied, donor support for grants, loan capital and guarantees to FSPs can undermine or crowd out national or international commercial capital markets or domestic savers. For example, savings-based, community-managed loan funds have shown promise but when donors and governments infuse outside capital, they almost always fail due to poor repayment.

At the meso level, the following issues should be considered in scaling up:

- **Long-term commitment.** Developing second-tier institutions such as industry associations and apex bodies requires significant resources for capacity-building and institutional development, as well as a long-term commitment, often going beyond the typical length of an IFAD-supported project.
- **Sustainability.** Meso-level organizations serving retail FSPs often struggle with sustainability. Funding a specific objective with a clear exit strategy can help ensure that the organization receiving the support does not become dependent on IFAD funding.
- **Technical capacity.** Careful planning is needed; non-FSP meso-level institutional support often requires a different skills set and network of contacts than does FSP support. It may also require understanding a different regulatory regime.

At the macro level, the following issue should be considered in scaling up:

- **Role of government.** State authorities should be included, as appropriate, in initiatives focused on technology, capacity-building and human resource development, where they can play a promotional role in developing the infrastructure to support rural finance. At the same time, the potential for political interference that can lead to non-market-based interventions should be minimized. Governments should be encouraged to support a relaxed monetary policy, market-stimulating interest rate regimes and other policies that promote a conducive regulatory environment.

## Glossary

**A line of credit (LOC)** is a loan to a financial institution for on-lending in smaller loans to its individual customers. The objectives of such lending include: (i) promoting the development of participating financial institutions (PFIs); (ii) financing real subsector (agriculture) investment needs; (iii) promoting private sector-led small and medium-sized enterprise (SME) development; (iv) helping to broaden and increase efficiency in the allocation of the scarce resources and services to an unsaturated rural financial market; and (v) supporting the country's poverty reduction agenda (IFAD 2010).

**The financial market** refers to all financial services for all purposes from all sources used in both urban and rural areas, including credit, savings, insurance, remittances and money transfers. The providers encompass all types of formal and semi-formal institutions, including banks, credit unions, NGOs and MFIs.

The terms **rural** and **urban** refer to location. In most countries, "rural" refers to non-urban geographic areas (villages, towns and small cities) with fewer inhabitants than in larger cities and urban areas.

**Agricultural finance** refers to financial services used by the agricultural sector, i.e. farming and farm-related activities, including input supply, processing, wholesaling and marketing. Most of these activities are conducted in rural areas but large processing facilities and agribusinesses are also located in urban areas. Agricultural credit is normally provided in cash but some programmes provide in-kind loans for seed, fertilizer and other farm production inputs.

**Rural finance** is a broader category including all financial services used by farm and non-farm firms, and households located in rural areas. Many non-farm enterprises in rural areas are directly related to agriculture, such as input supply or processing firms, but restaurants, hotels, retail shops and other rural businesses also require financial services. Financial institutions that provide credit to farmers are often encouraged to serve non-farm customers as a way to diversify risks and expand their operations.

**Microfinance** refers to financial services usually involving small transactions and products specifically designed for low-income households and small businesses in both rural and urban areas. In many countries, microfinance has been concentrated in urban and peri-urban areas or in densely populated rural areas but is now moving into more rural locations to serve farm and non-farm firms, and households.



**Agricultural microfinance** refers to small transactions for poor farm households and farm-related businesses.

**Rural microfinance** covers small financial transactions for both agricultural and non-agricultural firms and households in rural areas.

**Agricultural value chain finance** refers to financial products and services that flow into or through an agricultural value or supply chain. Providing credit into or through a value chain for an agricultural commodity is viewed as a complementary approach to the financial systems approach, which is the primary focus of this note.

**Subsidy** refers to pecuniary aid, usually furnished by a government to a private business, a charity or an organization in the form of a cash grant, in-kind goods or services, or exemption from some requirement such as a tariff or tax that is normally assessed on similar businesses or organizations.

**A grant** is a gift of money or goods provided to a private business, charity, organization or government to be used for some specified purpose; in contrast to a loan, a grant is not expected to be repaid.

**An investment** normally refers to an outlay of money or capital designed to gain profitable returns in the form of interest, income or appreciation in value. International donor agencies often use the term to refer to funds spent in a project to accomplish some development objective in the country where the project is being implemented but without the expectation of a direct financial return to be earned by the agency.

## Frequently asked questions

**Q: Should IFAD fund LOCs with grants or loans?**

A: In some cases, grant funding has been used to fund the establishment of rural LOC facilities. While this approach injects a large amount of liquidity into a project at short notice, it can undercut the long-term goal of creating a sustainable rural credit system in several ways, such as weakening ownership of the FSP by the depositors/members since the proportion of the capital/savings that they have in the institution is reduced. This approach also increases the tendency for borrowers to default since neither their money nor their neighbours' is at risk. Furthermore, it is difficult to revolve the funds out of the FSP to be used for other purposes (no exit strategy). Therefore, rural credit facilities should be financed by a loan, the documentation of which includes clear terms and conditions of repayment at the wholesale and retail levels. If grants are available, it may make more sense to invest them as equity piece (first-loss buffer) in a structured MIV, e.g. Regional Micro, Small and Medium Enterprises (MSME) Investment Fund for Sub-Saharan Africa (REGMIFA), Rural Impulse Fund II or European Fund for Southeast Europe (EFSE). This is a smart use of subsidies that does not lead to market distortions.

**Q: Should IFAD cooperate with other funders who want to make LOCs available to participating FSPs?**

A: IFAD should cooperate with such funders in developing LOCs destined for on-lending to rural entrepreneurs subject to the following requirements: (i) that the other funder has a development objective similar to IFAD's, namely, to encourage the establishment of a sustainable rural finance system serving IFAD's target market clientele; and (ii) that the LOC complies with a set of combined guidelines produced jointly by IFAD and the said partner, while respecting IFAD's poverty reduction mandate and the objectives of the project under consideration.

**Q: Is there a foreign exchange risk associated with IFAD LOCs?**

A: When IFAD provides funding for a LOC, any foreign exchange risk is borne by the host government since the latter will then normally on-lend in its local currency. As such, there is no foreign exchange risk at the FSP level since it will be repaying the loan in local currency. In the unlikely case where the participating FSP elects to take the loan from the government in foreign currency but on-lends to its

clients in the domestic currency, it will be taking on a foreign exchange risk. Participating FSPs are always advised to borrow and pay back in local currency.

**Q: Should LOCs be used as a tool for disaster relief financing?**

A: Depending on what is being financed, LOCs could be a good tool for intervening in the aftermath of a disaster – both natural and man-made. However, for participating FSPs to be effective with the loans in the aftermath of a disaster, credit decisions should be taken only after undertaking good and critical credit analysis of potential borrowers. It is highly probable that disaster relief funds could easily crowd out FSPs since they could be extended and be readily available for further charity work during the recovery phase. But loans from LOCs could also be extended, provided that there is a business need in the disaster-afflicted area (e.g. for clients' market-driven financial needs that are not covered by the relief funds). Since there may be no credit bureaus to monitor the level of indebtedness of project clients, there is a risk that such clients could be exposed to the influx of FSPs occurring in the post-disaster market situation to tap into the developing business windows. IFAD is encouraged by its policies to partner with and complement other institutions that specialize in post-disaster refinancing.

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International Fund for Agricultural Development  
Via Paolo di Dono, 44 - 00142 Rome, Italy  
Tel: +39 06 54591 - Fax: +39 06 5043463  
E-mail: [ifad@ifad.org](mailto:ifad@ifad.org)

[www.ifad.org](http://www.ifad.org)

[www.ruralpovertyportal.org](http://www.ruralpovertyportal.org)

 [ifad-un.blogspot.com](http://ifad-un.blogspot.com)

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