International Fund for Agricultural Development

Donor Supported Rural Finance Programs
IFAD

I Background and the Evolution of IFAD's Rural Finance Strategy

IFAD's mandate regarding rural development is somehow different from those of many of the other multilateral agencies, as it is exclusively rural focused. IFAD's overall goal is to reduce poverty among the rural poor through sustainable improvements in household food security and incomes.

In order to achieve this goal, IFAD realised that access to rural finance is an essential tool for combating poverty. Consequently, the delivery of the financial services became a primary objective of IFAD in its fight to reduce poverty. The methodologies and strategies used to provide these services have evolved over time, however, as various approaches were tried, adopted, built on, or discarded.

1/ Brief historical perspective to IFAD operations

IFAD's history in supporting rural finance started in most countries with subsidized lending, mainly through agricultural development banks. Early on, the Fund also contributed to institution-building, most notably of the Grameen Bank in the mid 1970s. However, in a policy environment of financial repression and easy money, many of IFAD's early programmes failed to cover their costs and recover their loans, which made them unsustainable. Rural financial markets were grossly distorted, while outreach to the rural poor stagnated. As a result, IFAD has, together with most other donors, moved away from the old paradigm approach of the provision of large credit lines for targeted and subsidized lending. Instead it has shifted its support to rural finance systems development, institutional diversity and sustainable access of the rural poor to financial services.

In light of these experiences IFAD's policy towards rural finance was revised, and in 2000 the Executive Board approved the **Rural Finance Policy Paper**

This paper identifies the four main planks of IFAD's rural finance policy going forward, as follows:

- Building sustainable Rural Finance Institutions with outreach to the rural poor
- Fostering stakeholder participation, including the poor, in the development of rural finance
- Building a diversified rural financial infrastructure
- Promoting a conducive policy and regulatory environment

The importance of rural finance, and the access to rural finance services to the achievement of IFAD's overall development goals cannot be overstated. Two thirds of IFAD's current projects have a rural finance intervention. In accordance with IFAD's goals, most target groups are small producers engaged in agricultural and non-agricultural activities in areas of widely varying potential

2/ Rural Finance Policy Papers and the Decision Tools

Following the approval of the Rural Finance Policy, it was necessary to "operationalize" the policy into a set of guidelines/decision tools. Consequently, the **Rural Finance Decision Tools** paper was presented in December 2002 to the Executive Board. This document translates the broad directions of IFAD's policy goals into concrete operational recommendations, in order to support the formulation and monitoring of new (and existing) programmes, and to provide guidance on technical issues related to rural finance. The Document is divided in three parts:

- Part I underlines some key cross-cutting issues that characterize IFAD RF interventions[1];
- Part II addresses the specific challenges and issues faced by IFAD in the design and implementation of its RF programmes: For example: how could IFAD strengthen the implementation process while simplifying the monitoring of RF partners'operations? How could a simple reporting system on key performance indicators be set up? What type of key performance indicators should be monitored? How to move from a project approach to a contractual approach? What are the implications for IFAD's relation with its Cooperating Agencies, as well as its government counterparts?
- Part III analyzes the specific context of IFAD RF operations in each of its Geographic Divisions**.** Beyond the common RF challenges faced by IFAD as an institution, (reflected in Parts I and II), the Decision Tools are trying to capture the specific characteristics of IFAD's RF interventions in each region, as well as options for IFAD future RF interventions, based on its experience and comparative advantages.

II Implementation of IFAD RF Strategy

IFAD has adopted a decentralized approach to implementation, normally entrusted to in-country project implementation units, with regular monitoring from Cooperating Agencies (World Bank and regional development banks, as well as UNOPS). The responsibility for the project cycle rests with the Geographic Divisions, while the Technical Advisory Division, which consists of several Technical Advisors in key areas of IFAD interventions (rural finance being one of them), is providing on-going support to the geographic divisions in this context. This approach has resulted in each Geographic Division adopting different approaches and methodologies that respond to specific geographic contexts, while reflecting IFAD's overall rural finance and development goals. These different approaches represent a good opportunity to build on positive experiences obtained in one environment, and apply them in different settings.

In addition to the existing Policy Paper and the Decision Tools, IFAD has recently engaged in other initiatives that have had an important impact on its operations.

IFAD participated in the **Donor Peer Review** in June 2002, with CGAP and other donors. The review helped to highlight some of the core challenges faced during implementation and

[1] A more detailed description of the cross cutting themes developed in the Decision Tools is included as Annex I.

operations. The Letter to Management that followed this review has now been published and underlines some key areas where IFAD should focus its attention. Among them, three have important operational implications:

(i) Improving the quality and accuracy of performance reporting on RF projects (through a few carefully selected indicators);
(ii) Strengthening IFAD technical monitoring capacity in the field, (which is an important challenge since IFAD has no field office structures, unlike other donors),
(iii) Strengthening the competence of IFAD human resources in the area of rural finance, through carefully designed training both for HQ and field staff.

These are themes that are of interest to all practitioners, participants, and donors of rural finance. IFAD would be extremely interested in learning from the experiences of others, as they also try to meet these challenges.

A key IFAD' strategy is to encourage innovations in rural finance, especially those that can help deepen geographic and poverty outreach in rural areas, while keeping a clear focus on sustainability. This is the purpose of a joint initiative with CGAP, the **"Rural Pro-Poor Innovation Challenge"**
(US$ 750,000), which is the continuation of CGAP's previous initiatives in that area. This mechanism provides seed capital to institutions that are testing innovative approaches in the above context. The first round of recipients was selected in January 2003, and can be seen on the CGAP web page. IFAD also has supported the testing of instruments that would help improve the transparency of reporting on poverty outreach. In this context IFAD plans to test the CGAP poverty assessment tool in several countries, and support the diffusion of some of the poverty targeting tools from the MicroCredit Summit.

III Funding and Geographic Allocations

1/ Size of the Rural Finance Portfolio

With more than two thirds of all IFAD programmes/projects having a rural finance component, all geographic divisions have extensive experience with, and exposure to rural finance. The following table highlights this geographic outreach, as well as IFAD's overall financial commitment to rural finance. This data is as of December 2002.

IFAD's active portfolio of projects with rural finance components
(as of December 2002)

	IFAD Loan	MF Component	MF Component	% of MF operations Over total MF
	in million USD	*in million USD*	*(%)*	
PA	390.4	93.1	24%	13.8%
PF	368.1	114.9	31%	17.0%
PI	643.3	206.1	32%	30.5%

PN	395.5	153.9	39%	22.8%
PL	431.7	107.5	25%	15.9%
Total	**2 229.0**	**675.5**	**30%**	**100.0%**

Although there has been a slight diminishing in of rural finance as a percentage of total loan portfolio, over the past 2 years (34% to 30%), RF remains, and will continue to be, a major part of IFAD interventions.

2/ Type of models and approaches promoted in IFAD's RF portfolio

IFAD's RF projects are very diverse, and the approaches used vary greatly both within, and between, regions. The table below presents a brief summary of the types of institutional models reflected in IFAD RF interventions, and how each region has adopted different approaches based on the local conditions encountered:

Asia:
- Pilot programs with state owned rural development banks (RCCS in China)
- Self help group – bank linkage model: India, Nepal, Indonesia
- Grameen replication: the Philippines

Western / Central Africa:
- Specialized NGOs as operators
- Financial Services Associations (Benin, Mauritania, Guinea)
- Rural Banks: Ghana

Eastern / Southern Africa:
- MFIs: Ethiopia (including very large state-owned ones: ACDI, DECSI), Kenya (Women Finance Trust, through a grant program)
- Savings –Credit organizations of Sacco type: Tanzania, Kenya
- Financial NGOs
- Large programs to link together different types and levels of rural financial institutions

Eastern Europe / CIS:
- Savings and Credit Associations: Moldova, Albania
- Commercial Banks (including large state controlled ones): Romania
- Cooperative Bank: Armenia

North Africa / Middle East:
- State-owned Rural Development Banks
- Grass roots organizations (sanduq in Syria)
- Saving and Credit Associations (Lebanon), with refinancing from local commercial banks

Latin America:
- Commercial banks: as second-tier institutions of direct lending to certain producer groups
- Savings and Credit Cooperatives, Cajas rurales (Central America)
- Civil Associations: Venezuela
- FSA type institutions: Haiti

a/ IFAD's Rural Finance Interventions in West and Central Africa

Traditionally, in West and Central Africa, IFAD's portfolio contained mainly integrated rural development projects with agricultural credit components. Experience in this region has led IFAD to entrust the loan components of the projects to operators, or specialized decentralized financial systems, and to support the institutional transformation of credit components into formal, decentralized financial systems.

The new generation of IFAD projects in West and Central Africa can be classified in two categories:

a) *Projects to Support the Emergence or Development of a Decentralized Financial System:*

- Either by specializing local NGOs as operators for IFAD initiated models such as FSAs, or context-appropriate approaches such as the *Caisses Villageoises d'Epargne et de Crédit Autogérées,* or
- by supporting the extension of existing decentralized financial systems into areas not yet covered.

b) *National Microfinance Sector Support Programmes, with the following orientations:*

- Elaboration of national strategies and plans of action
- Institution-building for decentralized financial systems
- Professional structuring
- Bank/decentralized financial system coordination
- Strengthening supervision and control institutions
- Consultation among donors

b/ IFAD's Microfinance Interventions in East Africa

Since the early 1990s IFAD has changed its focus from supporting development banks to supporting the introduction of savings mobilization schemes and the diversification of loan purposes beyond agriculture. With this change, project approaches also underwent profound changes and tended to turn more towards promoting financial intermediation in rural areas.

This new orientation is reflected in IFAD's regional strategy[2] which aims to "enable the rural poor to overcome their poverty". The regional strategy recommends (a) helping small farmers develop their own savings and credit organizations, (b) identifying viable forms of coordination with the formal financial sector, and (c) facilitating direct access to financial institutions by some small producers for medium- and long-term investment needs.

The present IFAD RF programs are characterized by three aims: developing local rural finance institutions, improving the legal and regulatory framework, and coordinating with commercial institutions. This is the case for recently approved programmes in Tanzania (2000), Ethiopia (2001), and Uganda.

c/ IFAD's Interventions in Asia

In the Asia region, IFAD is moving away from projects that have 'microfinance components'. Instead, it is focusing on sectoral support, and strengthening grass root, indigenous organizations. This manifests itself in a variety of approaches, most of which can be classified into three general categories:

[2] Regional Strategy Paper: Eastern and Southern Africa – IFAD – Dec 2001

- self-help groups and CBO linkage (India, Nepal, Indonesia),
- support to State structures and cooperatives (China),
- NGOs and institutions, notably inspired by the Grameen Bank and solidarity group lending methodologies (Philippines, Cambodia).

IFAD interventions have often targeted remote rural areas (mountainous areas where ethnic minorities are predominant). IFAD also has developed an in-depth experience with the self-help group / bank linkage model in India, and is planning further support to test models that will strengthen its institutional and financial sustainability. Additionally, IFAD has undertaken a pilot project to support the reform of some Rural Credit Cooperatives in China, where it is trying to address some of their core issues and challenges. The main objective being to develop sustainable outreach to the rural poor.

d/ IFAD's Rural Finance Interventions in Central and Eastern Europe

IFAD supports, among others, two interesting types of programmes in the region. It favors the emergence and consolidation of *Savings and Credit Associations* at village community level, so that they can provide local financial services to rural populations that are excluded from the banking system. For Small and Medium Farms, who need medium-term investment funds and loans to access markets, IFAD provides *support to existing banks*, in order to facilitate the availability of bank financing.

Within the region, IFAD sees the potential to encourage a more in-depth assessment of the Savings and Credit Associations (SCAs) model, in particular regarding the prospects of its institutional and financial viability. As for existing commercial banks, the challenge is to provide them with the credit technology and institutional capacity to reach out to some of IFAD's client-base in rural areas (small transformation / agro-processing, individual micro-enterprises etc…).

e/ IFAD's Rural Finance Interventions in the Near East and North Africa

As is the case in the East Africa region, IFAD's intervention in RF has moved away from supporting Agricultural Development Banks and recent projects now tend to focus on small-scale reform initiatives. For example, in Algeria a recent IFAD project encourages the pilot creation of local "Caisses Mutuelles de Proximité" out of the national "Caisse Nationale de Mutualité Agricole".

Increasingly, IFAD is supporting the provision of financial services through emerging specialized NGOs. Two interesting initiatives supported by IFAD in the region may be highlighted here. In Lebanon, IFAD supports the establishment of a network of SCAs that are refinanced by two local commercial banks. In Syria, IFAD is supporting the development of a network of small credit associations in rural areas - the 'Sanduq' network.

f/ IFAD's Rural Finance Interventions in Latin / Central America

Traditionally, the credit components of IFAD's projects were set up according to the classical concept by which they were secondary to other project objectives. This model relied on privileged links with public banks that played the role of resource administrator with no financial risk, while loan approval decisions were taken by the project. The model proved unviable because of high levels of loan arrears. It had also little impact on the rural poor, since most of the loans were made to the wealthier farming community.

In recent years, IFAD has shifted towards supporting the emergence of diversified microfinance organizations that provide diversified financial services. This is being undertaken primarily in two ways: (i) by supporting the emergence and growth of financial institutions rooted in the rural world (community banks and others), and which are often member-based organizations; and (ii) by supporting the development of existing MFI operations more deeply into rural areas[3]. At the policy and sectoral level, IFAD's objective is to help promote the adoption of appropriate national policies and build more efficient cooperation among donors, and within the sector itself.

IV Examples of IFAD Field Projects:

Some examples of the various approaches mentioned above are highlighted hereunder:

Rural Micro-Enterprise Finance Project in the Philippines.

1) Basic Project Facts
Started in 1997, closed Dec 2002. Country-wide project co-funded by ADB and IFAD, entirely based on Grameen replication (162 replicators, including banks, cooperatives and NGOs). Cumulative outreach: 520,000 clients (Dec 2002), of which 98% are women, in the rural Philippines. Over 92 000 small groups, 15 000 centres and 450 branches act as intermediaries in supplying credit totalling USD 34.1 million. Loan repayment rates from clients to MFIs average 96.2 percent.

2) Matching institutional sustainability with outreach and impact
The main "movers" behind the projects have been private rural banks and NGOs establishing rural banks. They have contributed to the "commercialisation" of Grameen banking, through a vigorous mobilisation of deposits from poor and non-poor savers. Several banks have been attracted to Grameen banking in the Philippines due to its high profitability. Several now have financially sustainable Grameen operations, with rapidly increasing outreach, and have launched the idea of 'franchising Grameen' as a commercial proposition for expansion throughout the Philippines. Sectoral reforms which have lead to the removal of interest rate caps and the phasing out of subsidized credit programs have also contributed to the profitability and viability of Grameen banking in the Philippines

3) The way forward
There is scope to support further gradual expansion of financially sound MFIs to the poorest areas of the country, through equity investment, technical assistance and loan capital. Grameen technology has proven profitable but other microfinance methodology should be tested as well. There is also scope to improve efficiency of rural financial service delivery through increased competition. Last, but not least, there is need to provide adequate supervision (currently cooperatives and NGOs are not supervised).

The Maharashtra Rural Credit Project, India

This US$ 48 million project had the goal of improving and increasing access to rural financial services by the poor from commercial banks, while promoting savings mobilization. It reached about three times the original target (9,000 SHGs reached compared to 3,620 planned / more than 8,000 SHGs linked to banks against 2,000 foreseen and 135,000 members reached compared to 54,300 anticipated). Repayment rates have also been impressive (100% for SHGs)[4]. The impact in terms of empowerment of local communities was also assessed as an important benefit from the project (with SHGs becoming effective lobbyists to the local authorities in negotiating the provision of social services, or in building women's coalitions to curb domestic violence, while creating new solidarity networks). Some of the banking partners have also played an active role in promoting the linkage model, provided support to SHG maintenance (and sometimes formation), while graduating some members as individual clients.

[3] Some MFIs that developed very successful operations in urban contexts have been moving into rural areas. **With**~~, with~~ their experience, technical capacity and financial resources**, they**~~. They~~ may prove **to be** promising partners in that context for IFAD programs.

[4] Although repayment from individual borrowers screened by the Villages Development Committees was a failure, with only 75%.

There are, however, some remaining issues and challenges. For example, some of the Government sponsored programs have "pushed" high targets of new group formation[5] in some of the districts of MRCP, while largely subsidizing the lending conditions. This has sometimes weakened the internal cohesion of SHGs and jeopardized their saving discipline. Another challenge is the resilience of the linkage between banks and SHG over time, as many banks have not yet fully internalized them as part of their client base (as evidenced by their reluctance to bear part of the transaction costs related to group formation and monitoring). The above issues are related to the larger challenge to the sustainability of the SHG-Bank linkage model, from the two angles of institutional and financial sustainability (including the possible need for a transparent subsidy policy to support part of the SHG formation costs).

V. The Major Lessons Learnt From IFAD's Experiences To Date.

(i) Promote institutional diversity while maintaining clear focus on sustainability: Providing financial services in rural areas on a significant scale may not be achieved easily through the "classical" microfinance model. This challenge calls for new institutional set ups and delivery mechanisms. These may range from using (i) large branch networks of established institutions (directly or indirectly through local intermediary settings), (ii) member-based systems (i.e financial cooperatives) or (iii) very decentralized and low cost structures (village bank type). Financial services might even in some cases be provided through non financial intermediaries (in out-grower schemes for example). This variety of models calls for renewed thinking on the application of the concept of sustainability. The objective however remains the same: to provide clients with sustained access to financial services, ensure that the model has the capacity to grow over time on a sustainable basis, and that it has an appropriate governance structure.

(ii). The role of savings and other financial services, beyond credit: Although saving mobilization is important for microfinance in general, it plays a special role in rural finance. Propensity to save in different forms is often high in rural areas; a large percentage of the potential client base may value access to safe and flexible saving services more than credit. Savings may also help strengthen local ownership for decentralized and member-based organizations. However, the required conditions for promoting safely saving mobilization from the public should be carefully assessed first (legal status on the institution, supervision etc…). Other services such as remittances and transfers are especially important in rural areas, and should be actively promoted when feasible.

(iii).The importance of the appropriate enabling environment: It is very difficult to establish a sustainable rural finance programme in a legal, regulatory, and/or financial environment that hinders financial sustainability (i.e caps on interest rates), inhibits the decision making ability of management, or overburdens it with inappropriate rules and reporting requirements. Host governments have an important role to play in establishing the appropriate enabling environment for rural finance, and it is donors and practitioners' responsibility to raise these issues with the governments before proceeding with the proposed programme.

(v). The need to focus on the household income of rural clients. The typical rural household often has many more sources of income than its urban or peri-urban counterpart. This is both a risk management strategy, as well as an income smoothing mechanism given the seasonality of many crops. To understand the true nature of the types of services needed by

[5] Group members have to be below the poverty line.

the family, and the risks involved in lending, the rural finance institution needs to focus on the household income, rather than on the cash flow of the crops / activities for which the loan is being made. Demand for financial services is also a function of livelihood improvement options. These are driven by investment opportunities, including for micro-enterprises. IFAD has in that context recently approved a Policy Paper on Micro-enterprise.

VI. Advice to Fellow Donor: What to Avoid in Starting a Rural Finance Programme?

Based on its experiences in designing and supporting rural finance programmes, the advice that IFAD would give to a fellow donor regarding the three most important mistakes to avoid are as follows:

(i). Do Not Focus on Short Term Results: It is important that donors take a long term view of any rural finance programme, and understand that it may take a much longer time to achieve success in terms of outreach and operational sustainability[6]. It is also often more costly. Moreover, the implementer must not be pressured to undertake certain activities, or expansion, just to meet the donors' own goals.

(ii). Carry out a Candid Analysis of the Feasibility of the Proposed Intervention: All potential donors should ensure that the proposed area of operations is conducive for a rural finance programme before proceeding with implementation. This includes assessing whether the minimum conditions are met for a sustainable intervention, including a sufficient underlying demand for financial services, a good local credit culture, management talent that is available to run the programme efficiently. Many of the failed rural finance programmes are the result of rapidly responding to a perceived "need" for finance, without thinking through what this implies.

(iii) *Select carefully the rural finance partner and support their strategy (within the broad objectives of the donor).* Experience has shown that the success of any micro or rural finance operation is first of all due to the quality of the partner selected rather than the donor project design. It is therefore important to strengthen the ownership of the strategy implemented at the level of the partner selected, and enforce accountability through a performance-based monitoring mechanism. In rural areas, it may also be important to strengthen ownership by the local population, and therefore build clients' representation and ownership at the level of the institution.

[6] Often up to 12 to 15 years, for challenging remote areas.

ANNEX I

Cross Cutting Themes Developed in IFAD Rural Finance Decision Tools

- **Funding agricultural needs through RF programmes**: how can IFAD better address the funding of agriculture-related activities through its RF programmes? There is considerable documentation, and a strong consensus among donors, regarding the failure of past government-led and subsidised agricultural lending practices. There is much less information available, however, regarding those successful experiences in microfinance that have provided agricultural financial services on a sustainable basis, in particular to marginalized rural households. How can innovation be promoted in this field, and what are the key issues to bear in mind when doing so?

- **The role of state-owned banks and formal financial institutions in RF**: Should IFAD work with them, and how? There is a large consensus regarding the failure of state-owned banks (SOBs), and especially state-owned agriculture banks (SOABs), to provide financial services to the poor. In this context, IFAD's Policy Paper rightly advocates discontinuing the provision of large credit lines to these institutions. However, through their large rural networks, their ability to mobilize savings, and their fund transfer systems, SOABs in principle may have a strong comparative advantage in reaching very large numbers of poor rural dwellers in a cost- effective manner. In this context, is there scope for IFAD to continue working with these institutions on a different basis? How could pilot programmes be tested and what are the key conditions and requirements to be met?

- **Savings and remittances**: Savings have been called the "forgotten half of microfinance". There has been a growing awareness within IFAD of the key role played by savings in RF - especially with regard to reaching the very poor, who may lack investment opportunities but greatly value access to savings services. Research and pilot programmes (i.e. MicroSave) have shown that access to safe and flexible savings services can play a critical role in poor people's strategies for minimizing risks, can mitigate income fluctuations and build a small asset base over time. However, mobilizing savings implies risk as well as placing specific responsibilities on RF institutions, donors and governments. The Decision Tools look at the key issues that need to be addressed when supporting savings mobilization.

- **How to extend the RF 'frontier'**: how far can IFAD extend its RF operations into remote rural areas while, at the same time, promoting institutional and financial sustainability? What are the innovations that can help IFAD extend the frontiers of its interventions in rural areas?

- **Balance between funding capacity building / technical assistance, and providing loan capital:** IFAD has started moving away from projects that provide very large credit lines, and is recognising the importance of funding capacity building and technical assistance for its RF partners. However, balancing these interventions in the most effective manner still remains a challenge, and is discussed in this section.

- **The role of participation in RF programmes:** IFAD's Policy Paper places strong emphasis on the value of participation as a means to empower the poor, both in product design and in the management of rural finance institutions (RFIs). However, the concept of participation reflects very different realities, depending on the local context and type of RF institution concerned. This section analyses what participation means in the different contexts, and the way in which IFAD may reflect the appropriate level of participation through its various types of interventions.

- **RF Policy Issues**: IFAD faces major policy issues in most of its RF interventions. For example, at what point should it consider designing a national RF strategy as opposed to a more 'operational' project? How should the Fund deal with the challenges concerning the regulation and supervision of RF institutions? How could it best reflect policy issues in its RF operations?

- **Impact analysis**: IFAD is facing increasing pressure to better document the impact of its RF programmes. Are its interventions reaching the poor and the very poor? Can one assess the impact of IFAD projects on the life of its RF clients? What types of impact assessment tools exist, what are their characteristics and how can they best fit the Fund's needs and requirements for impact assessment?