DECISION TOOLS IN RURAL FINANCE

September 2002
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<tr>
<td>ADA</td>
<td>Appui au Développement</td>
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<tr>
<td>AFCAP</td>
<td>Microfinance Capacity Building Programme in Africa</td>
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<tr>
<td>AIMS</td>
<td>Atlantic Institute for Market Studies</td>
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<tr>
<td>BAAC</td>
<td>Bank for Agriculture and Agricultural Cooperatives</td>
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<tr>
<td>BCEAO</td>
<td>Central Bank of West African States</td>
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<tr>
<td>BEAC</td>
<td>Bank of Central African States</td>
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<tr>
<td>BNDA</td>
<td>Banque Nationale de Développement Agricole</td>
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<tr>
<td>BRI</td>
<td>Bank Rakyat Indonesia</td>
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<tr>
<td>CAPAF</td>
<td>Programmes de Renforcement des Capacités des Institutions de Microfinance en Afrique Francophone</td>
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<tr>
<td>CARD</td>
<td>Centre for Agriculture and Rural Development</td>
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<td>CB</td>
<td>Community Bank</td>
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<tr>
<td>CBO</td>
<td>Community-based Organization</td>
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<tr>
<td>CECAM</td>
<td>Association d’Epargne et de Crédit Autogérée de Marovoay</td>
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<tr>
<td>CEMAC</td>
<td>Central African Economic and Monetary Community</td>
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<tr>
<td>CERISE</td>
<td>Comité d’Echanges de Réflexion et d’Information sur les Systèmes d’Epargne-credit</td>
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<tr>
<td>CFPB</td>
<td>Centre de Formation de la Profession Bancaire</td>
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<tr>
<td>CGAP</td>
<td>Consultative Group to Assist the Poorest</td>
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<tr>
<td>CIDR</td>
<td>Centre International d’Etudes et de Recherches</td>
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<tr>
<td>CI</td>
<td>Cooperating Institution</td>
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<tr>
<td>CIRAD</td>
<td>Centre de Coopération Internationale de Recherche agronomique pour le développement</td>
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<tr>
<td>COBAC</td>
<td>Central African Banking Commission</td>
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<td>CRG</td>
<td>Rural Credit of Guinea</td>
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<tr>
<td>CU</td>
<td>Credit Union</td>
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<td>CVECA</td>
<td>Caisse Villageoise d’Epargne et de Crédit Autogérée</td>
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<td>DTs</td>
<td>Decision Tools</td>
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<tr>
<td>FECECAM</td>
<td>Fédération des Caisses d’Epargne et de Crédit Agricole Mutuel</td>
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<tr>
<td>FIE</td>
<td>Freedom from Hunger</td>
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<tr>
<td>FSA</td>
<td>Financial Services Association</td>
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<td>GRET</td>
<td>Group de Recherche et d’Echanges Technologiques</td>
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<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
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<tr>
<td>GNP</td>
<td>Gross National Product</td>
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<tr>
<td>IFPRI</td>
<td>International Food Policy Research Institute</td>
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<tr>
<td>IPC</td>
<td>International Project Consult</td>
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<tr>
<td>IRAM</td>
<td>Institut de Recherches et d’Applications des Méthodes de Développement</td>
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<tr>
<td>MERCOSUR</td>
<td>Common Market of the South</td>
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<td>MFI</td>
<td>Microfinance Institution</td>
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<tr>
<td>MIS</td>
<td>Management Information System</td>
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<tr>
<td>NGO</td>
<td>Non-Governmental Organization</td>
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<td>PAR</td>
<td>portfolio at risk</td>
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<tr>
<td>PARMÉC</td>
<td>Projet d’Appui sur la Règlementation sur les Mutuelles d’Epargne et de Crédit</td>
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<tr>
<td>PBC</td>
<td>People’s Bank of China</td>
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<td>PMO</td>
<td>Project Management Office</td>
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<tr>
<td>PMU</td>
<td>Project Management Unit</td>
</tr>
<tr>
<td>PRODEM</td>
<td>Fundación para la Promoción y el Desarrollo de la Microempresa</td>
</tr>
<tr>
<td>RCPB</td>
<td>Réseau des Caisses Populaires de Burkina Faso</td>
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<td>RCC</td>
<td>Rural Credit Cooperatives</td>
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<td>RF</td>
<td>Rural Finance</td>
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<td>RFI</td>
<td>Rural Finance Institution</td>
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<td>RFP</td>
<td>Request for Proposals</td>
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ABBREVIATIONS & ACRONYMS
(cont’d)

RSP  Regional Strategy Paper
ROSCA  Rotational Savings and Credit Association
SACCO  Savings and Credit Cooperative
SCA  Savings and Credit Association
SEEP  Small Enterprise Education and Promotion
SFCLs  Small Farmer Cooperatives Ltd.
SOAB  State-owned Agriculture Bank
SOB  State-owned Bank
SUM  Support Unit for Microfinance
TA  Technical Assistance
USAID  United States Agency for International Development
VBP  Vietnam Bank for the Poor
WAMU  West Africa Monetary Union
PREAMBLE

The present Decision Tools (DTs) reflect the decision to “operationalize” IFAD Policy Paper on Rural Finance. They are the result of an intensive consultative process within and outside of IFAD. The terms of reference for the document were discussed and reviewed with the Thematic Group on Rural Finance. A questionnaire was then sent to all Country Portfolio Managers (CPMs), asking for key information on their rural finance (RF) portfolios - the major constraints, issues and potential of those RF interventions, what was seen to be IFAD’s comparative advantage in RF, and also what CPMs considered to be the key issues to be reflected in the DTs. Following this questionnaire, interviews were organized with management and CPMs at divisional level, where the specific characteristics of the regional RF strategies and programmes were discussed (those regional contexts are analyzed in Part III of the present document). Finally, the draft document was reviewed and discussed with management and staff during a two-days workshop in May 2002.

The purpose of the document is to ‘operationalize’ the broad policy directions highlighted in IFAD’s Rural Finance Policy Paper while, at the same time, reflecting the thrust of the Strategic Framework for IFAD (2002-2006), and its translation into the regional strategies.

The Rural Finance Decision Tools should be considered as a technical document in support of decision-making for CPMs and project staff / consultants. It is not meant to be a checklist of compulsory requirements, but rather a reference document to help translate the broad directions of the Policy Paper into concrete operational recommendations. In that context, the present document is designed to assist the formulation and monitoring of new (and existing) programmes, and to provide guidance on technical operational issues related to rural finance.

The document will be published in a ‘reader-friendly’ format, thus enabling the reader to directly access the chapter or section he/she requires in seeking some conceptual analysis and practical operational guidance. Moreover, since the paper cannot provide in-depth responses to all the questions raised, each section has links to the most relevant web-sites for accessing more detailed references, papers and case studies. Finally, the Fund may decide to put this document on the IFAD website, in which case relevant sections could be accessed through key words, such as ‘impact’, ‘participation’, ‘regulation’ etc...).

Finally, this paper is a living document, which will be updated / improved as the field of rural finance evolves and as new principles and practices emerge. The document will also be expanded with technical annexes on lessons learnt from IFAD specific RF models, reflecting IFAD’s impetus on knowledge management development.
INTRODUCTION

The Rural Finance Decision Tools are designed to reflect IFAD’s decision to ‘operationalize’ its policy towards Rural Finance (RF), as contained in the Rural Finance Policy Paper that was approved by the Executive Board at its Sixty-Ninth Session held in April 2000. The RF Policy Paper identifies the four major policy themes as:

- **Building sustainable RF 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 decision tools have been designed to reflect the operational implications of achieving the above themes. Some of the issues dealt with in the document refer directly to one of the above titles (such as ‘participation and RF’), while others do so indirectly (i.e. ‘the balance between the provision of technical assistance and loan capital, which has a major impact on the building of sustainable RF institutions’). In other cases, such as in the chapter on Impact Analysis, reference is made to one of the core objectives of the Strategic Framework.

This text also incorporates the outcome of IFAD’s recent Strategic Framework Approach for 2002-2006, and its development into the subsequent regional strategies, as elaborated by each Regional Division.

The above considerations explain why the Decision Tools are structured around three main sections:

- Section I deals with cross-cutting issues and challenges that apply to IFAD’s RF Policy in general.
- Section II looks more closely at the formulation and implementation mechanisms for IFAD RF projects, and identifies ways and means of addressing some existing challenges and limitations in that regard.
- Section III develops the region-specific characteristics of rural finance. It provides a brief description of the current status of RF in each region, followed by the major types of IFAD RF interventions. It also highlights some operational considerations for IFAD’s future RF interventions, based on its experience and comparative advantage in each region.

The contents of each section are as follows:

**Part I: Cross Cutting Issues**

IFAD’s rural finance programmes are characterized by several key cross-cutting issues, which are briefly described below:

- **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, SOBs 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?
Part II: Design and Implementation Considerations

Part II addresses the specific challenges and issues faced by IFAD in the design and implementation of its RF programmes. It starts by looking at the formulation process: what are the minimum conditions to be met for the formulation of an RF intervention, how should potential RF partners be identified and selected, and at what stage of project design?

Part II then addresses the multiple challenges related to project implementation: how could IFAD streamline and improve the implementation process while simplifying the monitoring of RF partners’ operations? How could a simple reporting system on key performance indicators be set up at the national level? Finally, this section looks at some of the operational implications of the above on IFAD relations with its Cooperating Agencies, as well as its government counterparts.

Part III: Specific Context of IFAD RF Regional Strategies

Beyond the common RF challenges faced by IFAD as an institution, (reflected in Parts I and II), the Decision Tools also have the objective of capturing the specific characteristics of IFAD’s RF interventions in each region, including the broad policy directions reflected in the Regional Strategies that were presented to the Governing Council in February 2002.

Part III, therefore, reflects for each region:

- The major characteristics of micro and rural finance,
- IFAD’s various RF experiences and models and
- Operational considerations for IFAD future RF interventions, based on its experience and comparative advantages.
I. CROSS-CUTTING ISSUES
A. Agriculture Finance

1. What is Specific About Agricultural Finance?

1. Financing agricultural activities reflects specific characteristics and constraints that explain the difficulty for microfinance institutions to meet this demand.

2. Family farms need to constantly innovate, modernize and improve their productivity. Their financial needs, therefore, involve various types of loans:
   - **short** term loans: to finance the crop year (inputs, labor), fattening on pasture, storage, initial processing of agricultural products, etc.;
   - **medium** term loans: for farm equipment;

3. The demand for loans can be considerable. The characteristics of this demand (type of service, amounts, loan repayment schedules, types of guarantees available, etc.) are extremely diverse and vary according to the agro-ecological zone, the more or less diversified and intensive production systems, the type of stakeholders (men, women, youths establishing their own farms, agricultural entrepreneurs, farmer organizations, etc.), and the degree of market integration, etc... (see Appendix 1: Diversity of Agricultural Financing Needs by Agro-ecological Zone in West Africa).

4. Agriculture financing is characterized by a high level of risk: both climatic and economic (price fluctuations, difficulty to sell harvests, etc.). These risks are often covariant: they effect all borrowers in a given zone at the same time (drought, floods, epizodic diseases, etc...). Covariant risks are therefore harder to manage through microfinance’s habitual mechanisms to secure loans (solidarity groups). All these constraints are intensified in the areas where IFAD is present; namely disadvantaged areas without staple food crops and where infrastructures and markets are often under-developed.

5. Another differentiating factor is that farm budgets are closely integrated with household budgets, and financing for agricultural and non-agricultural activities, consumption, and household investments are closely linked. Among a household’s various economic activities, agricultural activities are often less profitable and more hazardous than non-agricultural activities.

6. In most countries, agriculture finance has mainly focused on export crops. The liberalization of agricultural economies has led to a reduction in the amount of credit available for agriculture, and microfinance institutions have often been called upon to fill the gap.

7. Financial services for farming households also need to include savings products that allow them to develop their farms’ self-financing capabilities, as well as simple insurance services.

2. What Does Microfinance Contribute to Agriculture Finance Today?

8. Contrary to preconceived notions microfinance, in all its diversity, already contributes to the financing of agricultural activities (see Appendix 2: Estimated Volume of Agricultural Financing by the MFIs in the WAEMU Zone in 1997). Nevertheless, this contribution remains largely insufficient compared to the volume and diversity of agriculture financing needs in the current context of liberalization of farm economies in developing countries.

9. Microfinance loans are mostly of short-term maturity, while the supply of medium- and long-term loans is generally insufficient to meet the demand. Several reasons explain this weakness: the profitability of the activities financed may be insufficient to cover the cost of the loan (for example this is often the case with animal traction in staple crop farming, ); MFIs lack access to stable, medium- and long-term funds and prefer to secure a return on their funds through rapid rotation in short-term loans; MFIs do not have the appropriate technology to track and support medium- and long-term loans, etc. Yet, innovations are being made, such as mutualist rent-to-own systems and equipment loans guaranteed within production sectors (see Appendix 3).
10. No one MFI model is better suited to agriculture lending than any other. But systems that foster feelings of ownership among their members (credit unions, cooperatives, village banks, etc.) enjoy a higher success rate than is the norm, and contribute most strongly to agriculture financing (see Appendix 2 on West Africa). Conversely, entrepreneurial MFIs are less present in the agriculture field. This situation can be explained by the former MFIs’ closeness to their members (a number of credit unions and cooperatives were created by farming populations in order to meet their financing needs: FECECAM in Benin, Kafo Jiginew in Mali), and by their decentralized loan disbursement and monitoring procedures that make it possible to know borrowers well and treat applications individually. These types of MFIs, however, remain very vulnerable to covariant risks especially when they are small and very local.

11. Certain innovations in securing agricultural loans seem promising; including agricultural warrants, loan delegation, jointly-managed guarantee funds, mutual guarantee associations, etc. These security mechanisms make use of new types of contracts between the various partners in agricultural activities: producers, farmer organizations, processors, traders, etc.

12. Today, microfinance experiments that significantly finance agriculture are concentrated on production in secure areas (often irrigated areas). Some services developed to meet agriculture finance needs have been successfully provided by microfinance institutions. However, they are usually focused on specific activities that bring strong added value to producers, and are being used in contexts where the predictability of incomes derived from such agriculture activities is quite high (cash-crops in irrigated areas).

13. The issue of agriculture finance has also been raised to meet the needs in staple crop production areas. In those areas, the basic rule should be to focus on the funding needs of the many household activities (which permits more effective risk mitigation) and not to fund only specific agriculture investments, due to the risks involved. This rural finance approach is also more likely to meet the needs of the rural poor, as it enables them to use microfinance services flexibly, helping to diversify their sources of income and better cope with adverse circumstances.

14. In general, agriculture finance could be developed by MFIs on a larger scale only if farming itself became a more profitable and safer economic activity. Beyond the need for certain predictability on the income generated from the agriculture activity (i.e. the need to stay away from funding staple production in rain-fed areas) it is also important to assess the safeguards that exist on the economic activities themselves, (price policy, organization of markets and producers, etc.)2. This implies coordinating policies and donor actions as well as forging new alliances between the various rural stakeholders: farmer organizations, MFIs, support services, etc.

3. Recommendations for Increasing MFI Contribution to Agriculture Finance

15. Steps that can be taken to improve both the quantity and quality of financial services to the agricultural sector include the following:

a) Meet Solvent Demand

16. This general recommendation is particularly appropriate in agriculture financing. Credit can only provide effective economic leverage if the activities financed are profitable. Credit should be used very prudently (and

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1 For example, the post-harvest credit provided by credit union networks in Madagascar has helped producers to almost double the value of their crop (by enabling them to sell it three to four months after the harvest season). Due to the profitability of this service to their clientele, those CUs have been able to provide this financial services at market cost (including the refinancing costs from local commercial banks, plus the operating margin of the CU and loan provision). This is one example of a very profitable agriculture microfinance service provided by credit unions operating in rural areas, which brings strong value to their clients.

2 Taking the same example as above, very wide fluctuations in the price of rice has been observed in that country, due in large part to massive imports from Asia in recent years. The absence of a strong national market and producers associations, combined with those import policies, have made the funding of rice production by CU networks much more risky for the farmers.
alternative interventions considered) in areas where agriculture is based exclusively on staple food crops, with rain-fed practices, where market integration is low, and non-agricultural activities are not very well developed.

b) Improve MFI Knowledge of Agricultural Activities

17. As MFIs become more professional, they often hire specialized staff who lack detailed knowledge of the agricultural sector. To develop the appropriate financial services and adequate loan portfolio monitoring capabilities, detailed knowledge of the characteristics and constraints of agricultural activities is needed. This knowledge must include technical aspects (production systems, farmers’ practices, etc.), as well as a clear understanding of local economic and social realities. This knowledge then helps to identify the most suitable financial services, elaborate guarantee systems that are as effective as possible, and identify potential causes of systemic failures.

18. In addition to the above knowledge requirement, an information system on changes in local agricultural activities is also needed. Creating and maintaining systems of this sort within MFIs can be costly. Contracting with other institutions active in the area (farmers’ organizations, development projects, support services, etc.) can enable a more effective sharing of costs and further encourage exchange of information.

c) Diversify Loan Portfolios

19. MFIs that fund exclusively agricultural portfolios are extremely vulnerable to external shocks. Loan portfolio diversification strategies, therefore, need to be developed to mitigate this risk. A diversified credit portfolio and a wider range of products would, moreover:

- better match the actual needs of households, be they agricultural, rural, social, consumer, or emergency in nature;
- provide real economic choice to producers who may invest in the activities that are, in their opinion, the most profitable (thus increasing their sense of responsibility for their loans); and
- make it possible, above all, to spread risks over different agricultural productions and rural activities, thus limiting to some extent the impact of covariant risks in agricultural production.

d) Support Innovations on Services and Ways to Secure Loan Portfolios

20. This implies that MFIs need to:

- develop adequate knowledge of their environments;
- include their members in identifying and testing innovations;
- allow their staff and members to access information on innovations tested elsewhere. This will require undertaking study visits, facilitating internet exchanges when possible, participation in networks, the development of information centers on innovations for professional MFI associations, and sector support programmes; and
- have the means in house to innovate; including the right mix and number of staff, pilot funding to design and test new products etc…

e) Develop Ties with the Formal Financial System to Access Funding Sources Needed for Agriculture Financing

21. MFIs’ own funds are often insufficient to cover agricultural needs. Links with the formal financial sector can provide specific solutions (improve the volume of funds available, the availability of long-term funds, etc.). This is highlighted in the above example of Madagascar, where credit union networks have accessed commercial loans to fund post-harvest loan campaigns in favor of small rice producers.

f) Disconnect Financing from Agricultural Support and Supervision

22. To a large extent the failures of past agriculture financing systems can be attributed to the strong ties that existed between the two functions of funding and agricultural technical support, encouraging lessened
entrepreneur responsibility and a low level of specialized skills among MFI agents. Today, it is clearly acknowledged that MFIs should not provide agriculture support and supervision to their clients.

23. Technical support, however, can make agriculture loans more profitable for farmers and safer for MFIs. These ones therefore should seek to develop contractual relationships with other organizations active in rural areas, which could play this role (support services, NGOs etc.).

\textit{g) Disconnect Financing from Farmer Representation}

24. This recommendation concerns more specifically MFIs that have emerged from the agricultural sector (credit unions, cooperatives). Combining farmer representation with financial services can generate governance failings and management problems. Consensus is progressively building on the need to making the financial role autonomous through specialized institutions (MFIs) that are independent of the founding farmer organizations.

25. However, this autonomy raises the issue of a possible “financial mission drift” by the MFIs, away from the farmer organizations that initially created them. Innovations exist in this field to preserve farmers’ representation in the supervision of MFIs: at the Board of Directors, for example using the college of administrators principle \textit{(see Appendix 4: CECAM Madagascar)}. Within such supervision structure however, it remains important that a correct balance be maintained between the representation of borrowers and savers. Borrower domination may entail some risks, including practices that may benefit borrowers in the short-term, while jeopardizing the MFI long-term sustainability (for example: lower interest rates on loans, larger loan amount compared to saving requirements etc…).

\textit{h) Strengthen Ties between MFIs and Farmer Organizations}

26. When MFIs did not grow directly from an agricultural environment, relationships between MFIs and farmers’ organizations are often marked by little mutual knowledge of each other’s activities and roles and a high level of distrust. Loan interest rates are often the focal points of contention between these two types of institutions.

27. Strengthening ties between these institutions can help better match services to the local needs and can improve loan security. Diverse approaches may be used: exchanges favoring better knowledge of each other and each others’ approaches, use of MFI services by farmer organizations, joint participation in a credit bureau, etc

28. Beyond the local level, such ties should also be strengthened among the various bodies in charge of elaborating agricultural and financial policies.

\textit{Internet Resources}


- International Food Policy Research Institute (IFPRI) http://www.ifpri.cgiar.org/

- Natural Resources Institute (NRI) http://www.nri.org/work/nfe-ctf.htm
B. Financial Sector Reform and the Implications for Rural Finance Programmes: The Role of State-owned Banks (SOBs)

29. IFAD’s experience with state-owned banks (commercial and agricultural development banks) differs among the various regions. The Fund has moved away from SOBs in East and West Africa because of poor project performance and the closing of most of these institutions. In state-controlled environments, such as China, the SOBs remain major partners within the rural context, where there is little alternative. In North Africa, the Middle East, and Latin America, cooperation still exists, but is progressively declining.

30. This general withdrawal from operations with SOBs on the part of IFAD (apart from very specific contexts) is understandable, as SOBs generally failed to reach the Fund’s target groups on a sustainable manner. Subsidized credit has focused the supply of loans to well-off farmers; borrowing conditions and collateral requirements have excluded the poor, and the type of services offered were frequently inappropriate to their needs. As a result, IFAD’s Rural Finance Policy Paper rightly argues against providing large credit lines to those institutions.

31. Despite the above-mentioned shortcomings, SOBs may offer in-principle comparative advantages for reaching very large numbers of poor people in a cost-effective manner. These banks generally have large retail networks in rural areas with trained staff, fund transfer facilities, and the ability to mobilize savings. Carefully designed technical assistance and capacity-building pilot programmes could help harness those comparative advantages for reaching the rural poor with financial services on a sustainable basis. Such pilot programmes would typically be based on the provision of technical assistance, and should not provide for any large credit line (due to the reasons mentioned above, and since such facility would have no added value and relevance in that context).

32. IFAD needs in that context some guidelines in order to identify the circumstances under which it might work with SOBs. The first step should be to recognize that the Fund does not usually have the capacity, political clout or mandate to support large-scale SOB reforms. The corporatist interests ingrained in these institutions, and their monopoly in providing funds and subsidies for the agricultural sector, make it unrealistic for a donor such as IFAD to be the prime partner or driving force for creating institutional changes in SOBs. The World Bank may be better placed to assume this role.

33. However, it may be possible to set up a ‘space’ within SOBs where pilot experiences would be launched, with the objective of testing a new rural finance approach, based on sound microfinance practices. The key challenge, though, would be to attract the interest and support of SOB senior management for piloting such approaches. The following steps should be adopted

- **First, assess the overall institutional and financial status of the SOB:**
  
  It is important to have an overview of their financial and strategic status before deciding even on a pilot project. Some SOBs may be on the verge of closing down, or being totally restructured. They may be facing institutional and financial problems of such magnitude that would defeat the purpose of a pilot experience, since there would be no potential for up-scaling within or through the institution.

- **Second, choose one of the two possible options for developing a partnership:**
  
  - **SOBs as retailer RF institutions:** In this case, assess whether the key conditions for launching a pilot RF programme are met. The prerequisites here are (i) to get confirmation of senior management’s full

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3 Most of the generic recommendations below would also apply to private commercial banks, as potential partners for IFAD’s RF programs. However, they are not specifically mentioned here, since most private commercial banks in developing countries have limited branch networks in rural areas and, for that reason, have not been to date important partners for IFAD.
support to a pilot programme based on sound practices; (ii) to ensure its autonomy within the bank’s operations; and finally (iii) assess senior management’s interest in upscaling the initiative, if successful.

- **SOB acts as a wholesaler (refinancing institution towards local RFIs):** There are contexts in which a SOB may have a stronger comparative advantage for assuming a refinancing role vis-a-vis local RF networks rather than being a retailers in competition with them. This role is relevant when the lack of access to loan capital for local RF institutions has been an important hindrance to their capacity to expand.

a) **Assess SOBs’ Financial Situations and Performance**

34. The following indicators should be examined to evaluate the financial position of SOBs, and their capacity to reach IFAD’s target group:

- Sustainability indicators: profitability, loan repayment rate, portfolio at risk, dependence on subsidies, etc.
- Outreach indicators: penetration and quality of services delivered to the target market, volume of activity in target areas
- Personnel and physical infrastructure: staffing, experience and involvement in rural areas
- Liquidity: The capacity of the SOB’s funding base to service IFAD’s target group.
- Calibre of Management: Whether the SOB is managed by a well qualified, professional staff, especially those staff who would be responsible for the IFAD client base.
- Reporting Systems: The ability of the MIS system to track and report on the performance of the institution and the loan portfolio.
- Independence of Management: Whether and to what extent the SOB is subject to political interference.

b) **Assess the Conditions that Influence SOB Activities and that may be Conducive to Improving their Operations**

- Are macroeconomic and sectoral policies favorable? Does structural adjustment with macroeconomic financial liberalization favour change? Is the agricultural sector healthy and dynamic?
- Is there a strong coalition in favour of SOB restructuring?
- Is there an effective framework for prudential regulations, legal recourse to enforce financial contracts, and efficient supervision?

c) **Assess the Alternative Solutions for Rural Finance**

- What is the current role assigned to SOBs?
- Are SOBs likely to be closed within a few years time, and which institution(s) may take over in the case of closure?
- What are the alternative mechanisms that IFAD clients use to access financial services? Can these be built on and/or adapted.
- What are the main roadblocks that discourage other financial institutions (including financial cooperatives) from expanding into rural areas.

**IFAD’s Potential Work with SOBs**

35. Once the above general review has been carried out, IFAD has two main options: assess the possibility of developing a retail capacity within a SOB (through a pilot rural finance project) or consider the wholesale function. The following analysis underlines optimum conditions to start a pilot retail programme with an SOB. They do not reflect however some specific constraints in certain countries / contexts in which IFAD intervenes, and where a more incremental approach may need to be adopted regarding the criteria mentioned overleaf.
a) Retailer

i) Political commitment

36. A key condition for pilot testing a microfinance programme with an SOB would be that the CEO and senior management (as well as Board members, when relevant) are deeply committed to the process of exploring microfinance. Their commitment can be assessed through discussions during project identification/formulation on their readiness to modify the SOB structure where the pilot would be implemented. One issue that should be checked is the tenure of top management and Board members: in the case of SOBs where top positions are often filled by civil servants, whose tenures may be short. This would weaken the ability to secure the right support.

37. The degree of commitment may also be measured by the resources the SOB will bring to the table to fund the pilot experience, including its readiness to assign promising young managers to take charge of the pilot programme, and delegate an adequate number of qualified staff for the programme implementation.

ii) Key Criteria as Prerequisites for a Pilot Microfinance Experiment

38. The strong political support from top management should be reflected in the agreement to secure minimum, essential conditions for the pilot operations (these have been essential factors in successful pilot experiences with SOBs).

- Interest rates that permit full cost recovery. Spreads range, typically, from between 15% - 24% of average loan portfolios;
- Effective collection efforts based on efficient MIS (typically with target of annual loan loss rates at less than 4 percent of the average annual portfolio);
- Enforced accountability for all staff through performance-based incentive schemes;
- Concrete mechanisms to reduce administrative costs and enhance loan recovery,
- Substitution of traditional collateral-based lending by incremental credit relationships, as basis for micro-lending,
- Elimination of project-based loans in favor of cash flow and character-based assessments,
- Rapid loan approval and disbursement processes to stimulate incentives for on-time repayment in order to get repeat loans,
- Broad-based client groups across sectors to ‘distribute’ portfolio risk.

iii) The Need for Autonomy and Direct Accountability Within the SOB Structure

39. Microfinance operations have their own dynamics. They need to be able to process vast amounts of information quickly, to have decentralization of virtually all operational decisions, a different type of loan officer, and more friendly client interface and accountability. These characteristics distinguish microcredit from most other banking operations. Given the above, microfinance must be able to operate with a high degree of autonomy within the SOB structure, and be administered separately from other banking services. Although microfinance services may be extended through the existing retail network of SOBs, they would most probably require separate staff, MIS, operating policies, and organizational structure.

40. Above all, a successful microfinance operation would require that staff be held directly and immediately accountable for their individual performance (loan repayment, growth in client and loan volume, profitability of branch-level operations, and generation of savings in those cases where this is appropriate). These accountability mechanisms include paid incentives, connected to base pay, indirect incentives such as staff travel and training, promotions, and ultimately, the ability to sanction non-performers.

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4 This section is closely inspired from CGAP working paper: “Should your commercial bank do microcredit?”, General Guidelines.
5 Typically, in a microfinance pilot program, at least 6 talented managers should be assigned, including a general manager plus managers covering the following functions: operations, MIS, HR, credit, product development/ marketing management.
iv) **Internal Organization of Microfinance Operations: Various Scenarios**

41. A microfinance pilot experiment can be organized in different ways: as a division within the bank, as a product line with its own staffing, as a loan processing subsidiary, or as an entirely separate entity. Whatever the structure adopted, however, the SOB’s MIS system must be able to track and report on the activities and results of the microfinance unit separately from its other activities.

v) **The Need to Set High Performance Standards**

42. The microfinance pilot programme would need to set high standards in terms of loan portfolio quality and profitability, if it is to succeed. This means that the programme aims at full cost-recovery (i.e. charging interest rates that are typically higher than the rates of any of the bank’s other loan products). An important issue in this context is whether or not the government and the bank’s political supervisors will allow such policies, once the programme becomes publicized. Otherwise, will the programme be disrupted, due to political pressure?

vi) **Time-frame of the Pilot Experiment Before Considering Up-scaling Within the Institution**

43. Most of the successful microfinance institutions learned the critical elements related to their success through trial and error. SOBs should follow a process of experimentation, adjustment, and repeated trials before they launch their microfinance services throughout their system. This means that the bank should allow the microfinance project at least two to three years of operation for design, testing, adjusting, and re-testing, before considering large scale implementation.

vii) **Conclusion**

44. Finally, the successful introduction of microfinance technology and capacity within a SOB may have a major impact in terms of increasing access to financial services for poor people in rural areas. Bank Rakyat Indonesia changed from an inefficient SOB in 1983-84 to a national network of village units that service millions of clients in rural areas. Other projects including BAAC in Thailand, and more recently Banco do Nordeste in Brazil- are also displaying very strong potential.

45. However, experience shows that only a very small minority of SOBs may be ready to experiment with micro and rural finance on the above basis. Setting up very clear and strict criteria up-front, based on the above considerations, should be seen as a prerequisite by IFAD before considering any such programme. Otherwise, there is a real danger for IFAD to fall back into the flaws of its past programmes with SOBs.

b) **The SOB Acts as a Financial Intermediary**

46. In other contexts, IFAD may consider working with SOBs on a wholesale basis alone, and avoid involving them as financial retailers. This is true when:

- Access to loan capital from a commercial bank is an important constraint for local MFI s in expanding their activities. The CVECAS in Mali (pays Dogon) have successfully used refinancing from the BNDA (Banque Nationale de Développement Agricole) in that context.

- SOBs have few branches outside the capital city and are not equipped to provide retail lending to microfinance clients (West Africa);

- SOBs do not meet the criteria and conditions for launching a successful microfinance pilot experiment (see above);

- SOBs show little interest in retailing activities, nor do they have a comparative advantage to do so.

47. As financial intermediaries, SOBs would lend funds to local microfinance institutions operating in rural areas. The scope for a financial partnership will depend on how much trust there is between the two types of institutions, the financial performance obtained, and the availability of resources on both sides. A lasting lending
relationship usually depends on good management and financial results, and reporting on financial data that the local microfinance institutions are able to show to the lending bank.

48. However, caution should be used in reviewing this refinancing need and the following factors should be taken into account: (i) the impact of external resources in the MFI savings mobilization strategy (when it can mobilize savings); (ii) the MFI actual need for external capital versus capacity building; (iii) the absorption capacity of the MFI for external capital and its ability to maintain high portfolio quality over time; and (iv) the options for long-term funding of the MFI portfolio.

49. Specific issues will need to be taken into account when considering such refinancing. For example, the pricing loan capital should be higher than the cost for the MFI to mobilize savings (interest rate plus related administrative costs). Also, a major increase in the MFI loan portfolio (as a consequence of external funding), may tip the MFI’s governance in favor of borrowers against savers: the potential consequence of this evolution will also need to be carefully monitored. Many savings-based institutions have been badly damaged, and sometimes destroyed in their structure and operations, by the massive injection of external capital from donors.

50. IFAD’s potential role under this approach could be to strengthen the understanding and trust between the two institutions. This can be achieved through the provision of technical assistance and training, the preparation of market surveys, assisting in the preparation of business plans and by providing some limited resources at the initiation of the partnership.

Internet Resources

- Inter-American Development Bank (IADB)
- Microfinance Gateway
  http://www.microfinancegateway.org/
- OSU Rural Finance Program
  http://www.agecon.ag ohio-state.edu/ruralfinance/
C. The Role of Participation in Rural Finance Operations

1. The Different Participation Modes

51. Participation, in the present context, usually refers to client involvement in the operation of RFIs at various levels of intensity and complexity, according to the type of model under consideration.

52. Consequently, client participation usually falls into one of the following categories:

- **Participation in the design of products and services.** This involvement can be classified as *market research* and involves clients in the identification and design of products that are suited to the client’s needs. Such participation should be implemented in all microfinance system models. The relevant tools and supports are client satisfaction surveys, dropout surveys, and studies of households’ seasonal incomes and expenditures, which makes it possible to target needs and their frequencies (see Section on Impact with the description of the AIMS, MicroSave tools, and Market Research Toolkit). These could then be followed up with pilot testing of new products with selected clients, to judge the appropriateness of the products in operating conditions.

- **Participation in some of the operational aspects of service delivery.** In order to maximise the outreach of the programme, and to minimise the operating costs, various methodologies outsource duties and responsibilities to the clients themselves. Participation of this type is required where models use ‘solidarity group’ methodologies under which groups play a role in ‘screening’ members, an administrative role in filling out some documents, or even a role in initial savings collection and repayments for their group members. This participation reduces credit officers’ workload and lowers transaction costs for MFIs.

- **Participation in MFI Decision-Making Process,** in cases of ‘self-managed’ models where client representatives cover most of the institutions’ managerial tasks. This is the case in highly decentralized models, such as self-managed village banks (CVECAs) or financial services associations (FSAs), which are often active in disadvantaged areas where volunteer work is an effective way of making the system viable. These tasks include credit decisions, expense authorisation and interest/dividend disbursements. In some cases it may be difficult to get clients to take on these tasks, due to the cost in terms of time and additional risk involved. Hence, the willingness and interest of clients to undertake these duties should be explored at an early stage of formulation.

- **Participation in MFI Ownership and Governance Activities:** this type of participation is most common in client-owned MFIs, and membership-based MFIs (credit unions, FSAs, CVECAs, village banks). The participation normally takes the form of Board Meetings, specialized committees and oversight functions, and annual general meetings.

2. Client Participation: Potential and Limits

53. Client participation contributes to RFI sustainability through:

- Helping ensure the pertinence of products and services
- Creating ownership of the system, responsibility, loyalty and trust on the part of clients
- Contributing to the reduction in overheads, due to volunteer work and proximity information
- Provide a capital base through equity: shares, savings
- Mobilizing support for the MFI’s objectives
While client participation and support to the RFI is crucial to its ultimate success, there are certain drawbacks inherent in such participation, which can negatively impact the RFI itself as well as the clients themselves. These include:

- **Conflict of interest**: These can occur at all levels of the RFI and includes collusion between elected members and agents for special loans to favoured individuals, increased *per diem* expenditures, reduction of loan interest rates by elected officers, most of whom are also borrowers, non–collection of certain loans etc.

- **Conflict over power and authority** between elected members and technical staff in credit unions, where staff ignore the interests of the membership as a whole.

- **Borrower domination**, motivated by loan needs: Borrowers may press for lower interest rates on loans, to the detriment of savers, or village elders taking all the loans for themselves.

In that context, the promotion of participation should be addressed within the larger context of good governance, in order to ensure appropriate supervision of the RFI management and operations, and prevent such developments as the ones mentioned above.

### 3. Promotion of Suitable Participation that Strengthens RFI Sustainability

In IFAD’s RF programmes, focus should be placed on promoting client participation, while taking into account their interest in, ability to and benefit from such participation. One should keep in mind that sustainable access to financial services (credit and savings) that are designed specifically to meet those clients’ needs, often remains a primordial objective for them that participation should help to achieve. This being said, the degree of participation will depend on:

- the level of self-promotion and solidarity in the RFI client-base itself, their past experience in participatory activities ion, and their willingness to participate;

- the poor people’s level of literacy and education, vis-a-vis the undertaking of administrative and managerial tasks;

- the availability of the people’s representatives and their willingness to devote time to undertaking repetitive tasks on a voluntary basis;

- the MFI institutionalization schema: Is it membership- or client-based?

The type and scope of participation should always be adapted to each specific situation, to the capacity and will of local actors, and to the institutional setting of RF partners (credit union, financial NGO, non-bank financial institution etc…).

Regardless of the context and system chosen, *client participation in defining products and financial services* always seems to be both feasible and desirable as it ensures that supply closely matches demand, and that products will be adjusted to clients’ potential and constraints.

*Client participation in management* should only be envisaged when it corresponds to an expressed desire (for example, farmers’ organizations) and is within the capabilities of the membership to provide. Moreover, it must have the specific aim of limiting the system’s intermediation costs, therefore making it possible to extend outreach to very poor and remote areas.

*Client participation in equity financing and/or debt mobilization* undeniably increases the sense of ownership and responsibility vis-à-vis the system and is to be encouraged where and when financially feasible. The debate remains open, however, with regard to the potential problems generated as a result of conflict of interest resulting from clients’ dual role - both as shareholders and service-users - especially if the shareholder role allows them to influence the system’s operational decisions (interest rates, conditions, modalities).
60. In designing and implementing microfinance programmes, IFAD should always endeavour to optimize the potential provided by the constructive and voluntary participation of beneficiaries. This will help ensure that needs of the target populations are met, and will help prevent the development of any flaw in the sustainability process resulting from artificial and forced participation.

61. The link between participation and empowerment may be further investigated in the context of IFAD RF projects. Empowerment of the poor may be achieved by their participation in operational responsibilities at the local level in certain contexts (very decentralized systems)\(^7\). Empowerment can also be strengthened by the sense of ownership in the RFI, thereby ensuring that the RFI is managed for their long term benefit. This may happen not only with mutualist systems, but also with financial NGOs that have been transformed into licensed institutions. In these cases, part of the equity (from donors) could be transferred to clients, through an appropriate holding structure (such as ACLEDA in Cambodia or CARD in the Philippines).

62. Finally, the empowerment gained through access to appropriate financial services will be reflected in many aspects of local social organization, and through strengthened negotiation capacity vis-a-vis external actors. This aspect of empowerment may be assessed through impact studies (the AIMS tool proposes a specific instrument in that context).

**Internet Resources**

- **Consultative group to assist the poorest (CGAP)**
  www.cgap.org

- **Fonds International de Développement agricole (FIDA)**

- **Microfinance Gateway**
  http://www.microfinancegateway.org/

\(^7\) This type of participation may also be seen as a constraint, with a high opportunity cost, in other contexts (time, absence of remuneration etc…).
D. Savings and Remittances

63. Recent research has confirmed that savings are key financial services for the poor in general, and for the rural poor in particular.

64. In this regard, both researchers and practitioners have specifically noted that:

- There is a strong demand by the poor themselves for safe, accessible and flexible savings services.
- The poor can save, and saving is a crucial factor in reducing their vulnerability and in their efforts to overcome poverty.
- Clients’ feeling of ownership is stronger in those institutions that deal with savings mobilization and this may have a significant effect on their behaviour in loan repayment.
- Such institutions can diversify their resources through savings mobilization, thereby reducing their dependency on subsidies or donor funds.
- Local savings may be cheaper resources than commercial funds and can therefore help the institution to reach profitability at a certain stage of its development. On the other hand, though, the cost of managing savings is more expensive than managing a bank line of credit, and it carries a higher level of liquidity risk.

1. Pre-conditions for savings mobilization

65. Before embarking on savings mobilization, some socio-economic environment pre-conditions should be met. These include: overall security in the area; a low and steady inflation rate, (to avoid the risk of negative real interest rates being offered on deposits); a reasonable level of monetisation in the economy, thereby permitting the saving in monetary instruments.

66. Once the above requirements are met, other pre-conditions need to be considered. These concern the MFI itself and its capacity to mobilize savings safely:

- **Strong governance and Professional Management:** These factors are even more important when a RFI mobilizes savings, since the levels of technical skills are higher (liquidity management) and the fiduciary responsibilities are greater.
- **Strong and reliable MIS,** as well as internal control and financial systems. The provision of accurate, timely information is absolutely critical when RFIs mobilise savings. Managing deposits is reflected by in a higher volume of less predictable transactions. It also requires a close and accurate monitoring of individual accounts - a key to maintaining client trust.
- **Ensure that the MFI NEVER uses deposits and savings to cover operating expenses.** In the case of support to an MFI that mobilizes savings while not having reached operational self-sufficiency (for example, a recently-established credit union), it is imperative to ascertain the availability of grant funding from donor sources to cover the excess of operating expenses over income.
- **A history of strong loan portfolio quality management.** Since savings will be used in large part to fund the loan portfolio, it is extremely important that loan portfolio losses are minimal.

67. Finally, the need for effective supervision from regulatory authorities needs to be assessed.

- In countries where there is an existing legal and regulatory framework for microfinance, an MFI will have to be licensed and supervised by Central Banks before it is allowed to mobilize savings (except for small and very decentralized systems that only mobilize members’ deposits).
- Although supervision is necessary for ensuring the security of deposits, Central Banks frequently lack the capacity and the instruments for effective supervision. In addition, some MFIs may have difficulty in bearing the cost of meeting the information requirements related to supervision. In this context, the challenge is to help the government develop a combination of strategies that can best protect depositors,
while adapting to the specific constraints of microfinance. One principle should be that while the reporting requirements of the MFI may vary according to activity, size, legal structure etc, the level of accountability must be consistent across the entire sector.

68. Unless the above conditions are met, it is recommended not to encourage MFIs to mobilize local savings from their clients or from the public.

2. **Design of demand-driven savings’ products**

69. Traditionally, the group lending methodology implies some form of compulsory savings from the client, while the individual lending methodology requires compulsory savings less frequently. Compulsory savings when required, are contributed either prior to loan disbursement or subtracted from the loan capital, or as sums deposited on a regular basis after disbursement. Often, 10% of the loan amount is required as mandatory savings and is supposed to guarantee loan repayment.

70. Questions are now being raised whether in the long run, compulsory savings serve either the client or the MFI. This approach to savings is not conducive to encouraging a savings habit among clients. They simply consider it as one of the requirements for accessing loans, and not part of their own saving strategy. As they rarely contribute more than the minimum amount required, savings mobilization usually does not progress over time, and such savings are frequently withdrawn at the earliest possible opportunity. Paradoxically the same clients often continue to save outside the system, either in ROSCAs or in kind, the latter of which can be very risky.

71. Experience has shown that it is the mobilization of voluntary savings that can have the strongest impact on poor people’s lives. It is also the best approach for providing the MFI with a significant amount of funds to diversify its resources, and contribute to financial sustainability.

72. To mobilize voluntary savings, however, the MFI has to design products that fit the demand of its clients. In order to design attractive savings products, the MFI would need to:

- Verify if there is a savings mentality within the local culture.
- Ascertain whether potential clients trust the local currency and are prepared to use it as an instrument for savings.
- Get a clear understanding of the household budget and its cash flow pattern, especially for rural households with important seasonal variations;
- Develop an in-depth knowledge of the households’ economic and risk management strategy and their coping mechanisms;
- Analyse the existing formal and informal savings mechanisms, with their ease of access, advantages and constraints;
- Involve the clients in the design of a product that can meet their needs.

73. Typically, a savings product designed to meet client satisfaction would reflect:

- **Safety**, which involves physical protection (a solid safe in a guarded building) and sound procedures and management skills.
- **Flexibility**, which means open-ended possibilities to choose the amount and the duration of saving patterns. For the more flexible products, clients should be able to withdraw money rapidly and at any time.
- **Accessibility**, reflecting availability of funds close-at-hand, thus avoiding transport costs for deposits or withdrawal.

74. Poor clients are usually not very sensitive to interest rate incentives, especially in places where alternative savings services are not available to this segment of clientele.

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8 Some informal savings systems actually charge clients for the services they offer, since clients value security over earnings.
75. Nevertheless, there may be some trade-offs between safety, flexibility and accessibility when operating in a very decentralized situation, especially when there are no banks nearby for MFIs to deposit their extra liquidity. In these cases, the MFI may choose to offer a less flexible product (term-deposit for instance), which is easier to manage and may be partially transformed into loans locally, in order to avoid a surplus of cash in local safes at certain periods of the year (harvest time).

3. Implication of Savings Mobilization: Recommendations for IFAD

76. Supporting RFIs to mobilize deposits is a high-risk and serious matter. The donor doing so assumes at least a moral responsibility of assuring the poor that their savings are secure. This gives IFAD a moral obligation to verify that the RFIs it supports have the necessary managerial and technical skills, and also meet the criteria mentioned above. Hence, these RFIs need to be carefully selected and assessed before entering into partnership with them.

77. Few donors are equipped to support savings mobilization initiatives. In comparison with supporting credit projects alone, savings mobilization requires closer and more intensive monitoring, together with understanding a set of dynamics that are entirely different. Consequently, donors involved in supporting savings mobilization should have both the structure and the capacity to: (i) identify and mobilize the appropriate technical expertise in support of MFI partners and closely monitor their progress. (ii) undertake a long-term commitment involving significant risk and some funding, mostly directed towards technical assistance. (iii) Ensure that the MFIs understand and abide by any legal and regulatory requirements and (iv) confirm that the MFI has an appropriate MIS system to effectively manage savings.

78. Regarding possible entry points for supporting savings mobilization, IFAD may be involved in the following manner:

- Coordinate donor discussions with governments and central banks in relation to the policies, laws and regulations needed to facilitate mobilization of small deposits and protect small savers. For example, (interest rate deregulation could have a critical impact in enabling MFIs to offer appropriate interest yields on deposits, or at least to protect them against the erosion of inflation). This creation of an “enabling environment” is best undertaken in conjunction with other multilateral institutions, such as the World Bank.

- Use grants for capacity building of regulatory and supervisory bodies, for research and development of savings products and market study tools, for information dissemination of best practices in deposit mobilization and institutional development for retail institutions wishing to create liquidity pools.

- When funding a savings mobilization institution, a very useful contribution on the part of IFAD would be to help this institution to better understand the costs and risks of mobilizing savings, and the determination of appropriate pricing for deposit services. Costing and pricing of savings services remains a major challenge for many RFIs. The testing of costing and pricing modules such as the one developed by MicroSave has proved to be of vital importance for some MFIs (or formal institutions such as Postal Savings Banks), helping them to assess the profitability and viability of those services within their own institutions.

- Support pilot experiments to increase the outreach for savings services: Providing voluntary deposit services to remote and very poor clients has remained a major challenge in rural finance. Very few institutions have been able to do so on a sustainable basis. IFAD may provide a valuable contribution in helping to “extend the frontier” of rural finance in that direction, through funding promising pilot projects and initiatives. The recently approved “Pro-Poor Rural Finance Innovation Fund” set up by IFAD and the Consultative Group to Assist the Poorest (CGAP) may offer an appropriate instrument for supporting such initiatives.

For further development, see “Developing Deposit Services for the Poor: Preliminary Guidance for the Donors” by the Savings working group of CGAP – March 2002
4. Remittances

79. In some disadvantaged areas, emigration remittances are a major source of income for households. There are both seasonal emigration patterns, to nearby regions and towns, and the more long-term emigration to foreign countries. Transfer of money by long-term emigrants back home, is a very valuable financial service and it can add up, in many cases, to a large volume and number of transactions.

80. In countries where banks are present in all major towns, transfers can be made effectively, even if it is at a high cost. In countries where banks are concentrated in the capital cities and postal banks are not operational, there are no such services to meet the needs of emigrants, who want to send their money back home while avoiding excessive transfer costs to families.

81. For those MFIs operating in remote rural areas, this represents a very meaningful and lucrative market if they can come up with an attractive transfer service for emigrants. It represents a way to attract new rural clients, and will encourage the development of new savings products for this category of wage earners and their families. Additionally, it will boost and diversify the sources of revenue for the institution through service charges while contributing to the economic development of poor rural areas by converting 'local-external' resources into productive investment in the local economy.

82. Working out appropriate solutions to this demand is definitely a major challenge for RFIs operating in poor regions everywhere. But with a creative approach possibly including partnerships with banks in the various countries, local transfer mechanisms, and specially designed long-term savings products, the remittances from emigrants can have a substantial impact on the underlying performance of the RFIs and their clients.

83. While the benefits to both the RFI and the client base can be substantial, the risks and requirements associated with handling this service should, however, be very carefully assessed before an RFI enters this market (legal status, security and transport of funds, management and staff capacity, internal control, MIS etc…)

Internet Resources

- Microfinance Gateway
  http://www.microfinancegateway.org/

- MicroSave Africa
  www.MicroSave-Africa.com

- OSU Rural Finance Program
  http://www.agecon.ag.ohio-state.edu/ruralfinance/

- Savings and Development
  http://www.fgda.org/
E. How Far Can IFAD “Extend the Frontier” of its RF Interventions in Rural Areas?\textsuperscript{10}

84. It is very difficult to generalize with regard to necessary conditions for sustainability in remote rural areas because microfinance promoters maximize their chances of success on a case-by-case basis. They do this by judiciously combining the various local factors that have been identified for reducing cost and increasing revenue, while maintaining reliable, high-quality operating systems. So as to minimize the recurrent costs associated with the constraints faced in remote areas, innovations are crucial in order for rural finance institutions (RFIs) to achieve sustainability.

85. Based on experience, a number of practical recommendations can be drawn up regarding (1) minimum conditions required for a successful rural finance intervention, as evaluated in pre-feasibility studies, (2) adaptability of services, defined in feasibility studies, and (3) innovations to be promoted with action-research programmes.

1. How can IFAD Assess the Minimum Conditions Required to Justify RF Interventions? What Are the Main Constraints Facing Rural Finance in Remote Rural Areas?

a) General Prerequisites for Microfinance

86. There are some general prerequisites for implementing microfinance projects in any given country. These include a basic political and macro-economic stability (absence of very high inflation); basic security (enabling relatively safe transportation and use of funds), a minimum degree of monetization of the local economy and a minimum population density that will support a viable rural finance institution (RFI).

87. The feasibility of any rural finance intervention should be carefully assessed in the light of the above criteria. In that context, the decision to fund a rural finance intervention should be based on a clear prospect for the Rural Finance partner to be able to reach, within the agreed timeframe, the twin objectives of outreach and sustainability.

b) The Main Constraints for Microfinance in Remote and Disadvantaged Areas

88. These are identified as follows:

- low population density: gathering a critical mass of clients means inevitably reaching many villages and thus dispersing the network. Experience has shown that the minimum population density to ensure potential sustainability for a RF structure should be around 10 to 15 inhabitants per square kilometer. The total operation’s area would need to cover at least 200 villages with about 300,000 total inhabitants.
  (a) Are sufficient clients reachable at reasonable transaction costs?

- low level and precariousness of monetary income: diversifying risks (agricultural risks, saturation of local markets, etc.) necessitates identifying, with the clients, a large range of activities and especially activities that can be conducted independently of climate variations.
  (b) What are the main activities? Are they all related to agriculture? What are the main risks?

- Non-existent, inadequate or defective infrastructure (roads, electricity, telephones, education system, etc.): transaction costs (for transport, in particular) are higher. Rural finance programmes will face extra costs to make up for those deficiencies.

\textsuperscript{10}This section in largely inspired from a study commissioned by the United Nations Capital Development Fund to the Centre International d’Etudes et de Recherches (CIDR) on “How to push the frontiers of microfinance into remote rural areas” (1999).
What will it cost to compensate for the low level of infrastructure?

- **The difficulty in hiring and retaining skilled, professional staff:** Rural populations suffer from higher levels of illiteracy than do urban populations, thus complicating the recruitment of trained staff. Furthermore, trained, urban-based staff is often reluctant to move to rural areas.

How can RFIs attract and retain professional management?

c) **Analysis of Geographic and Economic Conditions**

89. Microfinance obviously is not the solution to problems in areas where monetary transactions are scarce and where access to capital is not an appropriate response to people’s most urgent needs. Three types of surveys would help to provide a better understanding of the issues involved:

- **Analysis of household budgets:** What are the main sources of income? What is the share of monthly income and expenditure compared to the share of barter and personal consumption requirements? What are households’ money requirements and what are the levels of disposable income? When? How often? How does money circulate within households?

- **The current supply of credit:** What are people’s experience with monetary transactions? From where do the potential clients currently obtain credit when it is needed?

- **Analysis of local markets:** How many local markets are there in the area? How frequently do these markets take place? How many people travel to them? How much money circulates there? What goods are traded? Where do they come from?

d) **Social and Cultural Conditions**

90. In poor and isolated areas, social mobilization and well-respected cultural values can be drawn upon to minimize costs and accelerate implementation. It is essential, therefore, to accurately identify the social and cultural assets of an area at the outset. Issues that need to be covered include:

- Analysis of the presence of traditional informal organizations, or organizations that have grown out of successful development programmes (indicative of social cohesion, and of the population's readiness to get mobilized, so as to overcome hostile external conditions).

- Analysis of collaborative practices, experience in resource management, and the rules they have been able to establish over time.

- Analysis of the strength of cultural values such as honor, solidarity, integrity, and service to others, which can limit the costs associated with fraud, misappropriation, deliberate delinquency, and/or fixed wages.

91. In order to assess these assets, in-depth studies need to be conducted on:

- **Villages:** the history of the village and village initiatives. What kinds of problems have these initiatives been able to solve? How did the village organize itself? How are important decisions made in the village?

- **Groups and informal organizations:** the origin of their establishment, their achievements, funds accumulated, form of management, experience with credit, future prospects.
2. How Can RF Institutions Adapt their Operations to Reach their Target Client Groups in Remote Rural Areas?

92. In remote areas, not all approaches necessarily produce convincing and sustainable results. The components that impact the success or otherwise of a RF programme, and therefore need to be decided upon on an individual basis include:

a) **Methodology**

93. It is strongly recommended that, at some stage, future and potential clients become involved in selecting the methodology to be utilized, at least in order to be sure that it suits their needs and is capable of providing them with the appropriate services.

94. Experience has shown that, in these types of remote contexts, MFIs need to:
   - Identify mechanisms for decentralizing a considerable portion of the decision-making responsibilities, and transferring various management tasks to the clients and their organizations. A centralized structure would be too expensive, and could not be controlled over the distances involved;
   - see themselves as autonomous regional enterprises. Establishing mechanisms for adjustment from one region to another is not easy. While it is possible to mobilize a great deal of effort to sustain a regional structure, such effort is weakened by dilution on the national scale;
   - seek contractual relationships with national financial institutions (banks or mutualist networks) to meet refinancing needs in order to supplement local resources. This would help provide access to commercial resources from outside the area on a sustainable basis. In order to encourage relations between banks and eliminate any mutual distrust, it is important to improve MIS (Management Information System) systems, publish audited financial reports, and classify the MFIs according to certain criteria, using a rating system.

b) **Selecting the Right RFI / Operator, and Designing Appropriate Partnership**

95. The success of overall RF operations calls for a certain level of skills and experience, so the MFI will manage its affairs and produce innovative ideas with a high degree of confidence. It is better to abandon an attempt to create or support a RFI rather than to launch one in a difficult area with an unqualified partner / operator.

96. Clearly, the RF partner should not be chosen solely on the grounds of prior presence in the area, but rather on the basis of convincing results that demonstrate its ability to conduct microfinance activities professionally under such conditions. In the absence of a professional rural finance operator in the area, IFAD will have to find incentives to induce the chosen operator to consider extending activities to the area in question.

97. IFAD should consider assigning the task of conducting the feasibility study to the RF partner, so as to build commitment to the programme. This study will serve both to compile information for relevant decision-making, and to establish the contractual basis for partnership. After an appropriate level of review, the study could form the basis of a long-term commitment on both sides.

98. The establishment of mutually agreed performance and activity indicators will provide the basis for evaluating progress towards the sustainability objectives.
c) **Resources to Be Made Available**

99. In remote and vulnerable regions, the progression of rural finance programmes from start-up to full sustainability can take up to ten years (and sometimes more). In certain circumstances, where positive factors compensate for other shortcomings, this process may take eight years. The need to spread support over two project phases should be anticipated. Care should be taken to ensure that there is no interruption between phases. The expected duration should be incorporated in a ‘generic contract’ even if administrative procedures do not allow donors to commit financially beyond a certain statutory period.

100. Investing in remote areas also requires larger financial outlays: additional training needs to be provided, while more time is needed for developing tools and approaches suited to the environment. Moreover, the equipment and hardware need to be sturdier in order to withstand the more challenging climatic and environmental conditions.

101. *A posteriori* calculations show that the cost of establishing a rural finance network in a remote area is likely to be about 80 percent higher than establishing such a network in more accessible regions (source: CIDR\textsuperscript{11}). Donors can play a major role in supporting the establishment of such RFIs by setting up appropriate financial tools to provide longer term support, such as “funds for securing loans that can be transformed into capitalization funds” developed by an Non-Governmental Organization (NGO) from Luxembourg, ADA, with the RCPB\textsuperscript{12} network.\textsuperscript{13}

\[ \text{\textsuperscript{11} Centre International d'Etudes et de Recherches} \text{\textsuperscript{12} Reseau des Caisses Populaires du Burkina Faso} \text{\textsuperscript{13} Bernard Adams, 1998. \textit{La garantie bancaire dans le contexte des Caisses Populaires et des Caisses Villageoises au Burkina-Faso.} (www.adacermilux.lu/frame_ada.html).} \]

\[ \text{d) Services to Reach Target Groups in Remote Rural Areas} \]

- Diversifying services and financial products helps RFIs to spread their risk while serving a broader range of clients in the target group. Diversification can be obtained by (1) expanding the range of products and services suitable for the household needs (credit and savings), and helping households to better manage their own risks and vulnerability; (2) broadening the clientele (to include men, women, youths, and/or groups such as local associations etc.); and/or (3) establishing operations in more favorable regions (to compensate for the risks of the remote areas). Such diversification, however, necessitates changes in operating procedures and, often, improvement in the agents’ ability to analyze risk. Hence, any diversification strategy must be supported by appropriate staff training.

- An important step in this process is to pilot test financial services before rolling them out on a larger scale. This will help ensure that they are well suited to the requirements of the RFI client base as well as to the RFI itself.

- Savings are likely to be particularly important in rural areas and the demand thereof should be carefully assessed (see section below on Savings: I.E)

3. **Innovations RF Institutions Need to Consider for their Interventions in Remote Rural Areas to be Sustainable**

102. The are three major areas of innovation that need to be explored by RFIs seeking to reach sustainability in remote rural areas. They are related to (i) outreach mechanisms, (2) management, and (3) governance. These are briefly analysed below:

\[ \text{a) Outreach Mechanisms} \]

- How can rural finance institutions secure loans with new forms of guarantees? The diminishing reliability of joint liability (due to conflicts between group members, pressure from influential...
borrowers, social differentiation, fictitious groups, competition with other MFIs removing the threat of exclusion from access to credit) may call for a closer look at other forms of guarantee.

- How can rural finance institutions extend outreach with new contractual relationships? Relationships between RFIs and their clients may be handled at village level, using for example ‘village contracts’. Under this approach, the credit agent who generally deals with individual clients may manage a village contract as the sole legal entity, through simplified monitoring procedures while the individual members manage the internal affairs of the group. This enables the credit agent to multiply his/her loan portfolio considerably. (i.e Rural Credit of Guinea – CRG).

b) Management

- How can RFIs control costs? Normally labour and transportation costs represent more than 60% of the total administrative costs of RFIs, and the need to control them is clear. Innovative approaches should be used to facilitate a high degree of client involvement and division of labor between borrowers’ representatives and paid technicians, in line with their respective areas of competence.

- How can rural finance institutions increase revenue? Interest rate constraints may remain strong (due to competition from charitable organizations not concerned with sustainability, limited profitability of investment opportunities for clients etc…); innovation should focus on increasing the volume of loans, through progressively larger loan amounts per loan cycle, and through diversifying of services and clients.

- How can RFIs improve their agents’ productivity? RFIs should focus on simplifying procedures and on staff training. Close monitoring of and acquaintance with the clients is important in this regard.

c) Governance

- How can RFIs draw on a society’s social cohesion to compensate for the area’s economic handicaps? Some of the existing customs and structures that can be used in this regard are: traditional groups used to working together and practicing joint management, solidarity and social cohesion resulting from years of collective struggle against a hostile environment; the authority of the elders, and village-related decisions taken collectively in a village assembly, etc..

- How can RFIs implement checks and balances systems, mobilise social pressure and introduce incentive mechanisms? The profit-sharing mechanism used in CVECAs (“Caisses villageoises d’épargne et de crédit autogérés”, as self-managed village banks) is an interesting example.

- How can RFIs foster high levels of participation and a strong sense of ownership? These are prerequisites for ensuring success and reducing costs. Moreover, certain tasks that do not require travel are better performed by villagers than by paid staff (loan applications, for example). Participation and a sense of ownership (or identification) on the part of clients are also essential elements in building loyalty.

**Internet Resources**

- *Fonds International de Développement agricole (FIDA)*

- *Special Unit for Microfinance (UNDP/UNCDF)*
  http://www.uncdf.org/sum/

- *Sustainable Banking with the Poor (World bank)*
F. How to Balance the Pros and Cons Regarding the Provision of Loan Capital Versus Funding Capacity Building and Technical Assistance

103. For a considerable period of time IFAD targeted its lines of credit on the rural poor for use in financing agricultural production and the purchase of capital equipment. These lines of credit were channeled through banks, or integrated rural development projects. The repayment rates and social impact of those instruments have been very mixed, causing the Fund to revise its approach. Today, IFAD is placing more emphasis on strengthening the capacities of autonomous MFIs in rural areas and, hence, faces the challenge of adjusting its financial tools accordingly. This inflexion point raises the question of what are the needs at each stage of the MFI’s development cycle when it comes to institutional strengthening and loan capital and what proportion of programme budgets may be envisaged for each type of support.

104. The appropriate balance between institutional strengthening / technical assistance and loan capital should also be defined in the context of building strong partnerships with rural finance institutions, whereby IFAD’s support mix would be provided based on the RFIs’ own development plans, and would reflect their commitment to meet mutually-agreed minimum performance benchmarks. IFAD support should also reflect, whenever possible, close donor partnerships where each party would seek to maximize the impact of their respective intervention (for example, bilateral donors’ ability to provide grant funding to support RFI institutional strengthening).

1. MFI Needs According to Level of Maturity

105. The general phases of development for most MFIs are the start-up, growth, maturity and institutionalization phases. The needs of MFIs vary, though, at each stage and depending on their levels of maturity and development. These phases and the types of assistance required are discussed below:

Start-up phase:

106. During the early years, MFIs need grants, above all, so as to be able to build their capacities, develop their organizations, perfect their products and services, and install the tools and functions required for their operations. Even if they mobilize client savings, they usually need capital also - in the form of grant funds or loans at low rates - to strengthen their loan resources. At this stage, however, specialized technical assistance is the decisive factor in providing young structures with the basic knowledge they need to start growing.

Growth phase:

107. During the growth period, MFIs extend their outreach, widen their geographic coverage, and increase their transaction volumes. Grants become crucial for developing and equipping new branch offices, training new agents, and acquiring the appropriate MIS systems. Since the MFI is not able to cover its full operating costs through the income generated by its portfolio, subsidies to cover these costs are still very much justified.

108. Loan capital requirements are considerable during this stage, and may be fulfilled in different ways. Some MFIs may fund most of their growth from mobilizing savings (credit unions), or may need to combine internal and external resources. In this latter case, access to external capital should be facilitated while taking into account (i) its impact on the MFI strategy to mobilize savings, (ii) its cost and impact on MFI profitability, and (iii) the long-term funding of the MFI loan portfolio.

109. Point (iii) raises the following issue: If loan capital is provided from donor funding (or from a subsidiary loan agreement between the Government and the MFI, in the case of IFAD), the availability of such funding in the long-term needs to be assessed. The repayment schedule of the subsidiary loan from the MFI to the government must be harmonized with the mobilization of alternative resources (through equity, savings or other sources), in order to avoid disruption in the funding of the loan portfolio. A powerful incentive would be to transform a government subsidiary loan into equity, based on the MFI's ability to meet minimum performance standards (i.e in terms of client outreach, portfolio quality and operational self-sufficiency). This equity would be
subscribed in the name of local stakeholders (clients, or MFI staff for example), as a way to strengthen local ownership.

During this growth period, some MFIs may become sufficiently strong to start accessing loan capital from banks on a commercial basis. This scenario may require support from donors (or specialised entities) in the form of guarantees, to facilitate refinancing relationships between commercial banks and those MFIs. However, this approach needs to be considered with caution, since overall donor experience with guarantee funds has been rather negative since it can encourage moral hazard on the part of the lending banks.

**Maturity and Institutionalization Phase:**

At the institutionalization stage the MFI has achieved the necessary economies of scale for long-term sustainability, and has developed a successful business model. At this stage institution-building support is key to guiding its choices, upgrading its procedures, adopting the most appropriate legal vehicle, reviewing its overall internal organization, and preparing for transformation.

This transformation may require strengthening the MFI equity base by bringing in new shareholders or investors who also can provide additional technical expertise. At this stage, dependence on donor loan capital should end, since the newly-registered MFI has the possibility of raising financial resources in the local financial markets (debt or equity), or through deposit mobilization.

Overall, keeping the right balance between funding capacity building and the provision of loan capital is a great challenge, especially for IFAD whose principal funding instrument is long-term lending to governments. *The ideal option would be to maintain a certain flexibility in supporting an MFI, without strict earmarking of funds towards capacity building and loan capital, but rather to identify several minimum performance criteria that would condition the continued support from IFAD to this MFI.*

The inclination for governments to use IFAD resources for extending loans to MFIs for on-lending (as opposed to providing technical assistance) is real and may be understandable. However, this approach should be challenged, by emphasizing the following arguments:

- The primary need and challenge for MFIs in developing countries remains access to grant funding for capacity-building and institutional strengthening. Sources of loan capital are usually less scarce, and can be accessed from governments, or from large donor programmes. It is moreover possible to build-in as much “discipline” and conditionalities for accessing grant funding as it is for providing loan capital (i.e. through minimum performance standards).
- Efficient use of grant funding for capacity-building can help an MFI reach sustainability and convert to a licensed institution. With such a licence, this MFI may be able to leverage up to 12 times its equity in the local financial markets (or through savings mobilization). This tremendous leverage of initial donor grant-funding should be brought to the attention of governments.
- When a lending facility in favor of MFIs is set up within an IFAD project, clear and transparent criteria for accessing this facility should be agreed upon at Appraisal. Access to loan funds should be conditioned on (i) not having a negative impact on the MFI’s saving mobilization strategy (if applicable), (ii) the absorption capacity of the MFI and its ability to maintain high portfolio quality, (iii) and the MFI’s long term strategy for funding its loan portfolio and its compatibility with using external resources.

**2. What Does Capacity-Building Include?**

Capacity-building and institutional strengthening may include the following forms of support:

**Human Resources**

- Design of staff hiring policies and procedures
- Staff training plans
- Elaboration of training modules for staff

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14 It should obviously not be used to increase government’s equity participation in those MFIs.
• staff assessment and motivation support

Operations
• organizing branch offices
• organizing headquarters and headquarter divisions
• procedural manuals: administration, accounting, operations, internal control
• management of information systems
• internal control systems

Methodologies and Tools
• techniques for mobilizing savings
• loan analysis and management
• Marketing research and client surveys evolving into marketing plans
• Outreach to rural areas and villages

Product Development
• savings product design
• credit product design
• new product design: insurance, leasing

116. Technical assistance may help adjust methodologies, tools, and/or products, and provide training/support for loan agents and executives. It can also include the supply of computer equipment and software (MIS systems); or support the launching of pilot operations in rural and poorly served areas.

3. Appropriate Technical Assistance & Skill Transfer Contracts

117. Each stage of MFI development necessitates a differentiated approach to capacity building. This support and advice should not be provided by generalists, and even less by local, non-specialized NGOs. Reliance on short, generalist visits with no continuity is likely to increase confusion about focus, accumulate incoherent tools, and slow progress towards growth and institutionalization. In that context, IFAD should make use of specialized and experienced technical assistance whose expertise is proven and acknowledged internationally.

Choosing Technical Assistance or a Specialized Technical Operator

118. This technical assistance may be provided either by a specialized consultant through short field visits, or by the long-term local presence of a technical advisor. The consultant, or advisor, may be hired by IFAD directly; or work for a specialized organization (consulting firm, specialized NGO). Finally, they can be in-house advisors from an existing RFI or Bank who can provide the additional skills needed for the development of the structure, or they can be external contractual operators hired for the development of a new RF network.

119. Faced with the challenge to help build new RF networks or strengthen local or nationwide RF institutions, IFAD may need to recruit a national, regional or international RF partner (operator) to assume the above responsibilities. In this situation, it is important to set the right selection framework to attract the best expertise, and make the RF partner accountable for the results. Where tendering is used for such recruitment, the following framework of a Request for Proposals (RFP) may be used (with adaptations as needed) for selecting potential applicants. Such RFP needs to include both technical and financial proposals:

120. The technical proposal submitted by the applicants should include:

• Brief description of the RF operator, its microfinance projects or programmes (underway and planned) and the administrative, financial and technical support services it can provide.
• An outline of the broad strategy proposed for the project. This will include descriptions of the methodology and outreach mechanisms, type of services envisioned, estimates of outreach (number of clients) and the time horizon for reaching sustainability. A description of the exit strategy should also be
provided, including an indication of the local structure(s) that will take over after project completion (with legal status, governance etc...).  
- Proposals for the use of the project funds (as per the budget), with a breakdown between loan capital/TA and capacity building, and operating costs.  
- The proposed human resources to carry out project activities (CVs and references).  
- Preliminary work plan or business plan, including a time line.

121. In order to rank the proposals for final selection, the following scoring methodology may be used. On the basis of a scale of 100 points, each proposal would be evaluated as follows:

- the microfinance operator’s experience at successfully managing a sustainable RFI: 30 points;
- the proposed strategic and operational strategies proposed for implementation. These strategies should include descriptions of how operational and financial autonomy will be achieved, and the exit plan: 35 points;
- the qualifications and skills required for the supervision and management team proposed for the project: 35 points. (The actual competence and experience of the operating staff assigned to the project are key selection criteria. They are, in fact, the best guarantor of the quality of the assistance to be provided).

122. In addition to the above-mentioned scoring approach the financial effectiveness of the proposal should be evaluated.

- In order to introduce incentives for cost-effectiveness, proposals would also be ranked financially. Experience has shown, however, that it is advisable to give more weight to the quality of the technical proposal presented, as opposed to its cost. What should be carefully assessed in that context is the volume of total assets planned at project conclusion (loan portfolio, number of staff trained, physical RF infrastructure set up) as well as the loan portfolio quality, the project efficiency (portfolio per loan officer etc) and the range of services provided. These are compared to the cost of the proposal. The loan portfolio projections, however, need to be treated with strong caution, as RFPs may project results that are unrealistic given the known operating environment (to make the proposal more attractive). The financial proposal may account for 30% of final grading, while the technical proposal may count for 70%.

123. All applications from structures that do not have experience as microfinance operators/practitioners or that have not developed specialized microfinance departments, should be excluded. In order to avoid prolonged technical assistance due to insufficient transfer of skills to local stakeholders, the transfer stages and indicators should be contractually binding and monitored.

4. How to Address Different Country Perceptions on the Need to Fund Capacity-Building

124. In some countries, governments clearly perceive the very strong need for MFI capacity building, and may be ready to allocate a large part of their rural finance programmes’ budgets to fund both capacity-building and technical assistance. In these cases, IFAD could launch its projects and programmes according to the above modalities.

125. In other countries, however, governments may hesitate to follow the above course, especially when they fund their RF programmes through donor loans. In such cases, IFAD may want to condition the commitment of its resources to its ability to mobilize additional grant funds from other donors to cover the capacity building and technical assistance needs of recipient RFIs.

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15 At this stage, it would not be feasible to request detailed feasibility studies and business plans, especially if there is competition between several potential partners. The purpose is rather to select the (of the several) RF partner(s) for the project, based on a generic proposal (however with a clear methodology and quantitative targets). The winner(s) would thereafter be asked to complete a detailed strategic plan (those would typically reflect elements of the in-depth feasibility studies, as mentioned in Section I.A).
16 The number of points given in the example below are illustrative, and are meant to show how the relative weight and importance of each section may be defined, when reviewing a proposal.
### Internet Resources

- **Ada & CEREM-LUX**  
  [http://www.adaceremlux.lu/](http://www.adaceremlux.lu/)

- **Fonds International de Développement agricole (FIDA)**  

- **Microfinance Gateway**  

- **USAID Microenterprise Innovation Project (MIP)**  
G. Policy Issues

126. Policy issues relating to rural finance are of major importance to IFAD’s interest, for many reasons: (i) they reflect the up-stream dialogue and impact sought from on-the-ground RF projects, (ii) they may impact the growth, institutionalization and sustainability prospects of RFIs (i.e. interest rates caps directly affect sustainability), and (iii) in a country where the microfinance industry has reached a critical stage, the existence of a coherent national government strategy may help strengthen this sector and prevent possible disruption.

127. Policy dialogue with governments on RF may actually achieve a major impact when IFAD intervenes on pilot RF programmes with a large-scale national institution (in China, for example).

128. The three sections below reflect policy areas of major importance to the Fund’s operations and provide some general guidelines for possible IFAD interventions in those areas. However, before entering into policy related interventions, IFAD should assess whether it is best positioned to do so, and how it may cooperate with other donors and technical partners who may have the comparative advantage of a strong field presence or a specific technical expertise. At the same time, IFAD’s policy support role may also be important in helping to ensure that the needs and constraints of rural finance institutions are fully taken into account in national policy dialogue (they are often overlooked by regulatory authorities, who tend to focus more closely on urban financial institutions).

1. Consultation and Definition of National Strategies for the Microfinance Sector

129. Faced with a rapidly growing and still fragile microfinance sector, governments are increasingly aware of the need to support and regulate this area of financial intermediation. This concern has led to the definition of ‘national microfinance policies’ which may be implemented within the framework of specific sectoral support programmes, or as components of poverty alleviation programmes. This approach is being launched or is underway in several countries, notably in Africa (Niger, Burkina Faso, Mali, Mauritania, Cameroon, Madagascar, etc.). The overall objectives usually include professionalization of the microfinance sector and support to organization, for example, through the emergence of professional associations.

130. The challenge in defining—a national scale—a “national microfinance strategy” is twofold: (i) increasing coherence among the various national stakeholders, and (ii) providing constructive support to consolidate and strengthen the sector. Successful examples (such as in Mali) underscore the need for prior, wide-scale consultation on the part of all stakeholders (MFIs, NGOs, Ministries, etc.). In that context, setting up an effective framework for dialogue is a slow and complex process. It includes coordinating a sector that is largely informal and poorly known, mobilizing various public authorities that are not used to working together, and establishing control mechanisms in contexts where access to and dissemination of information are already difficult. It is therefore essential to conduct an analysis of the sector before implementing a national strategy.

131. The following types of interventions may be initiated to support national microfinance strategies, with the focus of IFAD’s support placed on the needs of RFIs:

- supporting the definition of a national policy, with regional consultation through workshops or seminars (including visit of other programmes and study tours);
- adapting legislation, regulations, and licensing and control procedures;
- supporting services based on the sector’s needs: databases, documentation centers, applied research, training for RFI management and staff, setting up networks, etc. via specialized providers or via the creation of streamlined, national or regional service centers;
- providing suitable financial tools to support the expansion of networks and their services (equity funds, bank refinancing, etc.);
- supporting innovation and action-research by RFI (products, outreach mechanisms);
- strengthening the sector’s regulatory structures: (i.e. tools to help manage the development of competition such as credit information bureaux, etc.).
- assistance in improving communications between rural areas for the transmission of data.
2. Interest Rates and Fiscal Policy

132. The issue of liberalizing interest rates is vital for MFI viability. In many countries, the government wishes to control the rates charged by financial institutions and the Central Bank sometimes imposes interest rate caps (West Africa, some countries in Asia such as Vietnam, China or Laos, etc.). Although these policies may be well-intentioned (“helping poor people access affordable financial services”), it is now widely acknowledged that imposing caps on interest rates is counter-productive: it limits supply, favors the better-off clients and excludes the poor from accessing a service they often badly need.

133. Some countries with interest rate caps may show a certain degree of tolerance for exceeding those caps, or may even acknowledge the need for higher rates in microfinance. A useful initiative for IFAD, and other donor programmes, could be to convince governments to lift those caps directly. This would void the need for MFIs to charge a confusing battery of fees and expenses so as to achieve their targeted interest rate yield on loans.

134. What is important in such policy dialogue is to argue what would be the impact on the rural poor. Experience has shown over and over again that sustainable access to simple financial services, rather than the cost of those services, is seen by poor people as a key contribution to improving their livelihoods. The perspective of being denied such access because of government-imposed interest caps on loans may not be seen as a favor, but rather as an injustice.

135. Fiscal policy vis-à-vis microfinance institutions (and, notably, the possibility of MFIs obtaining tax waivers, at least during their initial years of operation), is also an important aspect of policy dialogue. Such waivers can help MFIs reduce their interest rates and improve outreach to their clientele, while maintaining the same sustainability targets. Where these concessions are part of a long-term government strategy they can play a useful role to the sector. But if introduced on a short-term basis, they can be disruptive since they create a short term subsidy to the lending institution that encourages the setting of unsustainable lending rates.

3. Regulation and Supervision

a) Why Regulate Microfinance?

136. Regulating microfinance is justified by the State’s determination to protect savers. Regulating the microfinance sector, however, raises the fundamental problem of conflict between two types of need:

- the requirements of the regulatory authorities who seek normalization and simplification of practices (e.g. limiting the number of legal status, grouping isolated structures in networks to facilitate control, etc.); and
- the requirements of the sector itself, which defends a plurality of approaches and methodologies as a condition for responding to the diversity of situations and needs.

b) The Risks of Hasty Regulations

137. The often very rapid growth of the microfinance sector, which usually presents itself as a new, informal and complex segment of the financial sector, contributes to government’s desire to regulate it. In addition, some MFIs frequently push for an appropriate legal framework to facilitate their institutionalization (i.e disproportionate minimum capital requirements may prevent them from becoming licensed institutions).

138. While desirable in principle, the definition of a legal and regulatory framework should be set only after careful consideration, in order to reflect the sector’s current and future needs. It should be considered when the microfinance industry has reached a certain level of maturity in the country, with some MFIs ready to opt for deposit mobilization from the public and transformation into licenced entities. Conversely, premature regulation may result in putting constraints on the diversity and dynamism of local microfinance initiative, with the risk of stifling innovation and hampering the future growth of this sector.

139. The most frequent example is the “regulation by the legal status adopted by the RFI” (e.g Companies are regulated by the Companies Act while co-operatives are regulated by a co-operatives act.). In some countries
MFIs have to adopt one specific legal status in order to operate. For example, the mutualist financial organization is the only legal vehicle recognized under the West African Monetary Union’s PARMEC\textsuperscript{17} law. Such frameworks can be very constraining for MFIs that do not meet the required status, and may hamper diversity and innovation. They may also force existing institutions to adopt a legal framework that is not suited to their governance structure.

140. Finally, having specific regulations for different types of financial institutions increases the risk of dividing a financial sector into several categories, each having its own regulatory authorities. In East Africa, for example, two of the financial sector’s sub-sectors have a different type of supervision - MFIs come under the authority of the Central Bank, whereas cooperatives come under the authority of the Ministry of Agriculture. There may be some benefit to regroup supervision under the structure that would have the comparative advantage and expertise to undertake this task.

\textbf{Slow and Consultative Establishment of a Flexible Regulatory Framework: Cambodia}

In Cambodia, microfinance was launched by NGOs at the start of the 1990s. Today, there are almost 90 MFIs, among which two institutions (EMT and ACLEDA) have earned noteworthy and sustainable positions in the market (over 70,000 clients each). These two institutions have obtained legal status (EMT as a microfinance institution and ACLEDA as a commercial bank); 8 other institutions should be licensed by the Central Bank in 2002. This rapid development was unquestioningly encouraged by the fact that no government body questioned the freedom to set interest rates or established constraining regulations precociously. The authorities’ interest in the microfinance sector grew, starting in 1995, and it is now a government priority. The process for defining an appropriate regulatory framework was the object of in-depth discussions with the major donors and microfinance stakeholders. The banking law was passed by deputies in November 1999; a simple decree derived from the banking law was approved at the end of 2000 which sets the prudential norms, limits on activities, and supervision conditions for microfinance, in a flexible manner.

c) \textbf{What Type of Regulation and Supervision is Appropriate?}

141. It is important to acknowledge the vast diversity in the status of MFIs (NGOs, co-ops, banks, or other types of formal financial institutions) as well as in their size. It seems clear that many MFIs will not be able to become viable institutions, and even less, be regularly supervised by bank supervision authorities (who are often not even able to supervise large banks efficiently).

142. The above indicates that all MFIs cannot be treated in the same way. It also implies the need to:

- establish regulations in order to integrate and facilitate the growth of the largest institutions - in particular those wishing to mobilize deposits from the public (beyond mandatory micro-deposits taken from loans). However, it is necessary to allow sufficient time for the compliance by small MFIs that are not yet able to meet supervisory requirements. The obligations placed on institutions must match their volume of activities (notably mobilization of savings) and their level of sophistication.

- consider the appropriateness of further developing the idea of regulation ‘by activity’ rather than by legal status. The intention is to focus more on elaborating norms for practicing financial intermediation (e.g. installation conditions, ownership of capital, financial reporting requirements, respect for prudential standards, etc.) and less on the definition of specific legal status. For example, this is the principle for rural Indonesian banks, which can choose from among a variety of legal structures: a private limited company, cooperative, or other forms that are specific to Indonesia.

- Passing laws is a cumbersome process; governments could often simply issue decrees (which have the advantage of being easier to modify, if needs be).

\textsuperscript{17} “Projet d’Appui à la Réglementation des Mutuelles d’Epargne Crédit” [legislation to regulate the savings and credit operations of non-banking institutions].

29
\( d) \quad \textit{Make Supervision Effective in Practice} \)

143. Even with an appropriate legal framework, the supervisory norms of the Central Bank - often inherited from the formal banking sector - can be unsuitable for microfinance institutions. Characteristically, the supervision of a large number of MFIs can be a very intensive and time-consuming process, bearing in mind, also, that those institutions represent a very small percentage of the country’s financial system’s assets. The supervision modus operandi, therefore, needs to be adapted to the specific characteristics of the microfinance sector, as well as the actual monitoring capacity of the CB. This is an important challenge, since supervision by the CB implies \textit{de facto} its responsibility for the soundness of the MFIs supervised - something that can have major consequences in the case of bankruptcy.

144. To make supervision operational, it is necessary to:

- work on defining an appropriate methodology ('risk-based', different from that used for classic banks);
- train supervisory staff;
- encourage MFIs (regardless of size) to set up internal procedures and rules to improve performance and governance, and be able to report to the regulatory authorities. These efforts can be facilitated by dissemination of information in parallel with the establishment of national regulations, MFI staff training, etc.

145. In this regard IFAD should focus its efforts on the impact any policy that is adopted will have on the rural financial sector.

\[ \textbf{Internet Resources} \]

- Consultative group to assist the poorest (CGAP)
  www.cgap.org

- Institutional Reform and the Informal Sector (IRIS) University of Maryland
  http://www.iris.umd.edu/

- International Food Policy Research Institute (IFPRI)
  http://www.ifpri.cgiar.org/

- OSU Rural Finance Program
  http://www.agecon.ag.ohio-state.edu/ruralfinance/

- Pact's small enterprise and microfinance programs
  http://www.pactpub.com/
H. MFI Impact Analysis

1. Evolution in Approaches to MFI Impact Analysis

146. As emphasized in the Strategic Framework 2002 – 2006, IFAD has put great emphasis on monitoring the catalytic impact of its intervention, both at the field level and in relation to its policy dialogue and advocacy role. This also applies to the field of rural finance, where the prime objective of IFAD programs is to improve the lives of the rural poor, by providing them with sustainable access to a variety of financial services, including savings. In that context, being able to better assess the impact of its RF programs on the lives of the rural poor has become an important priority for IFAD.

147. The rapid development of microfinance, the hope it inspired as a tool for poverty alleviation, and the magnitude of funds invested, led very early on to questions regarding its impact. In the narrowest sense, impact assessment of actions or activities consists of understanding, measuring, and assessing their effect. In the case of MFIs, impact analysis is the study of interactions (cause-and-effect relationships) between MFIs and their surroundings. This question is a complex one. The effect of MFIs can be direct and indirect, felt at different levels (by individuals, households, various institutions, villages, the local economy, the region, and even the country) and in different fields (economic and social impact, impact on health, etc.). Methodological difficulties are considerable: the fungibility of credit (it is often difficult to determine specifically what loans were actually used for, once the funds entered household budgets), and difficulty in attributing effects (is the observed effect due to the credit or to other factors present in the milieu?). The approaches and methods of analysis currently in use have evolved in response to this complexity.

148. The first impact assessments at the end of the 1980s endeavored to prove impact by a combination of scientific methods, tools and rigor. These studies, usually conducted by university teams, required large survey schemes; and turned out to be long, costly, and not very practical for use by microfinance operators.

149. Another movement developed minimalist approaches to impact assessment, based on the following assumption. If an MFI grows and has satisfactory repayment rates, its clients must be satisfied with its services - thus, it can be said to have a positive impact. Impact assessment, therefore, consists mainly of analyzing the growth dynamics, client retention rate and performance of MFIs without investing further in in-depth client studies.

150. This second approach showed its limits as soon as the microfinance sector was confronted with crises. Arrears, client drop-outs, bankruptcies, and increasing competition led MFIs to ask themselves how well their services matched the needs of their target populations, and what were the potential causes of the break downs in the system.

151. Impact assessments today no longer seek to prove impact specifically. Rather, they try to identify the types of clientele that approach the MFI, understand how clients use its services, and identify client needs and constraints, in order to improve the services of the particular MFI. In addition to providing knowledge, impact assessments - in their various forms - can become tools to steer MFIs policies and innovations (on new product or outreach mechanisms, for example).

152. Assessment methods also have evolved in recent years. Today, the orientation is towards less cumbersome, more operational, and less costly methods that can be mastered more easily by operators, who can either conduct the assessments themselves or be closely involved in their implementation by local experts. A relatively wide range of tools now exist for this task, based on classical impact assessment and marketing approaches (clientele and market analysis). Even if the goal is no longer to prove impact, scientific rigor remains necessary for these tools to provide as faithful an image as possible of quite a complex reality.

153. Today, particular attention is given to impact monitoring. These are approaches that enable MFIs to conduct on-going monitoring of a limited number of impact criteria.
2. Examples of Impact Assessment Methods & Tools

154. The following examples highlight some methods and tools that can respond to IFAD’s specific concerns regarding the impact of its RF programmes. The following tables give a brief description of methods and tools and their advantages and limits.

a) Client Poverty Measurement Methods

<table>
<thead>
<tr>
<th>Name</th>
<th>Assessing the Relative Poverty of Microfinance Clients: a CGAP Operational Tool</th>
</tr>
</thead>
<tbody>
<tr>
<td>Origin</td>
<td>CGAP</td>
</tr>
<tr>
<td>Objective</td>
<td>A rapid, reliable, simple and inexpensive tool to assess the relative poverty of MFI clients; it determines the standard of living of households that have access to MFIs, compared to that of non-clients.</td>
</tr>
<tr>
<td>Method</td>
<td>Comparing new MFI clients to non-clients in the same area. Elaborating on a relative poverty index that shows the poverty status of households in relation to the sample as a whole. Various dimension of poverty are taken into account: family structure, food, housing, other goods</td>
</tr>
<tr>
<td>Implementation Mode</td>
<td>Rapid surveys of a sample of clients and non-clients. Data analysis using SPSS software (multivariate statistical analysis)</td>
</tr>
<tr>
<td>Who Can Conduct the Survey?</td>
<td>Assessors from outside the MFI Local researchers Possibly the MFI itself, if it has staff trained in statistical analysis</td>
</tr>
<tr>
<td>Duration</td>
<td>Two months for the survey, 6 months to obtain results</td>
</tr>
<tr>
<td>Cost</td>
<td>10 to 15 thousand dollars</td>
</tr>
<tr>
<td>Comparative Advantages</td>
<td>Simple, rapid, inexpensive, easy-to-use (manual available on CGAP Web site) Makes it possible to take into account several dimensions of poverty Makes it possible to assess the MFI’s poverty outreach in the given area.</td>
</tr>
<tr>
<td>Limits</td>
<td>Applies to new clients only and not to the MFI’s entire client portfolio; Gives a view of relative poverty compared to the national average (comparison between different areas is difficult);</td>
</tr>
</tbody>
</table>

Source: C. Lapenu

<table>
<thead>
<tr>
<th>Name</th>
<th>Poverty Measurement Tool Kit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Origin</td>
<td>Micro Credit Summit</td>
</tr>
<tr>
<td>Objective</td>
<td>Identify the ‘poor’ target population; distinguish different categories within the ‘poor’ population (‘very poor’, ‘medium poor’, etc.)</td>
</tr>
<tr>
<td>Method</td>
<td>Methods implemented in a given village; two indexes are used to place the households in the village within a local poverty scale: 1) Cashpor House Index for Rural Asia 2) Participatory Wealth Ranking</td>
</tr>
<tr>
<td>Implementation Mode</td>
<td>Index elaborated for a given area, based on the ‘housing quality’ criteria. Different characteristics of houses are taken into account (size, quality of the material used for the roof, walls, etc.) Each household is graded according to the quality of the home. The households with well-off homes are excluded by an initial selection. The households with poor homes are then the object of a rapid survey of their production means (land, equipment, means of transportation, etc.) Index elaborated for a given village: an assembly of resource persons, assisted by facilitators: ▪ Establishes a map of the village ▪ Lists the households in the village ▪ Ranks the households according to wealth categories ▪ An index is calculated, based on the criteria used by the group to rank poverty.</td>
</tr>
<tr>
<td>Who Can Conduct the Survey?</td>
<td>MFI team, with a supervisor (branch-manager level) and loan agent facilitators. Initial training is required in using the method.</td>
</tr>
<tr>
<td>Duration</td>
<td>Example: Poverty Wealth Ranking survey of a 500-household village: one supervisor + 3 facilitators (7 person-days)</td>
</tr>
<tr>
<td>Cost</td>
<td>7 person-days + 50 dollars</td>
</tr>
<tr>
<td>Comparative Advantages</td>
<td>Makes it possible to quickly draw up a list of the poor Low-cost, can be used by the MFI Poverty ranking elaborated locally, with the population. The preparatory work with the groups makes it possible to generate a great deal of information on the area.</td>
</tr>
<tr>
<td>Limits</td>
<td>Very local criteria, impossible to compare different zones. Not-applicable in areas where housing is not an investment, or areas that have benefited from housing support programmes. Does not take into account the non-material aspects of poverty. Local poverty ranking, impossible to compare different zones Group discussion facilitation is fundamental; poor facilitation can fully compromise the reliability of results</td>
</tr>
</tbody>
</table>

Source: A. Simanowitz, Micro Credit Summit
b) Methods Inspired by Marketing - The PRA method – MicroSave Africa

<table>
<thead>
<tr>
<th>Name</th>
<th>Participatory Rapid Appraisal for MFIs</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Origin</strong></td>
<td>MicroSave Africa</td>
</tr>
<tr>
<td><strong>Objective</strong></td>
<td>Allow practitioners to understand the complexity of households’ financial, economic and social environments: better understand households’ demands and constraints, how the MFI is seen by users and non-users, etc.</td>
</tr>
<tr>
<td><strong>Method</strong></td>
<td>Qualitative method based on discussions with groups of resource persons</td>
</tr>
<tr>
<td><strong>Implementation Mode</strong></td>
<td>The PRA tool provides discussion guides for 15 subjects including, for example:</td>
</tr>
<tr>
<td></td>
<td>▪ Seasonal nature of income, expenses, savings and credit</td>
</tr>
<tr>
<td></td>
<td>▪ Seasonal nature of migration, temporary work, goods/services provided by the poor</td>
</tr>
<tr>
<td></td>
<td>▪ Life cycle profile to define cash needs over time</td>
</tr>
<tr>
<td></td>
<td>▪ Venn diagram analysis on groups/organizations and their roles</td>
</tr>
<tr>
<td></td>
<td>▪ Poverty ranking, etc.</td>
</tr>
<tr>
<td><strong>Who Can Conduct the Survey?</strong></td>
<td>Specific training by MicroSave Africa is needed to implement these tools</td>
</tr>
<tr>
<td><strong>Duration</strong></td>
<td>Example: survey implemented in Bosnia: 10 days, 4 people + significant time for preparation and training</td>
</tr>
<tr>
<td><strong>Cost</strong></td>
<td>Person-days + cost of MicroSave training</td>
</tr>
<tr>
<td><strong>Comparative Advantages</strong></td>
<td>Makes it possible to generate high-quality qualitative information rapidly, on condition that the staff are well-trained and have mastered the group discussion techniques</td>
</tr>
<tr>
<td><strong>Limits</strong></td>
<td>Does not make it possible to improve impact</td>
</tr>
<tr>
<td></td>
<td>Considerable investment in training is needed (but not lost for the MFI because this type of method can be used on a day-to-day basis and integrated in the MFI’s steering tools)</td>
</tr>
</tbody>
</table>

Source: MicroSave Africa; B. Brusky

c) Overall Impact Assessment Methods

<table>
<thead>
<tr>
<th>Name</th>
<th>Learning from Clients: Assessment Tools for Microfinance Practitioners</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Origin</strong></td>
<td>AIMS – USAID, in collaboration with SEEP</td>
</tr>
<tr>
<td><strong>Objective</strong></td>
<td>Impact and clientele analysis tools to prove impact and improve MFI programmes</td>
</tr>
<tr>
<td><strong>Method</strong></td>
<td>A combination of five tools:</td>
</tr>
<tr>
<td></td>
<td>1. Main impact</td>
</tr>
<tr>
<td></td>
<td>2. reasons for exit</td>
</tr>
<tr>
<td></td>
<td>3. loan use/savings strategies</td>
</tr>
<tr>
<td></td>
<td>4. client satisfaction</td>
</tr>
<tr>
<td></td>
<td>5. client empowerment (women)</td>
</tr>
<tr>
<td><strong>Implementation Mode</strong></td>
<td><strong>Tool #1: Main Impact</strong></td>
</tr>
<tr>
<td></td>
<td>37 questions make it possible to test impact hypotheses. The questionnaire is submitted to two groups (one client group and one comparison group). The comparison group consists of people who have joined the programme (characteristics similar to those of clients) but not yet received loans.</td>
</tr>
<tr>
<td></td>
<td><strong>Tool #2: Reasons for Exit</strong></td>
</tr>
<tr>
<td></td>
<td>Quantitative tool applied to clients who have left the programme. The goal is to identify when and why these clients chose to exit the programme and to identify the programme’s strengths and weaknesses. To be used regularly in the framework of the information system or occasionally during assessments.</td>
</tr>
<tr>
<td></td>
<td><strong>Tool #3: Loan Use/Savings Strategies</strong></td>
</tr>
<tr>
<td></td>
<td>Qualitative tool, in-depth individual interviews regarding loan use. The goal is to compare how loan use and allocation evolve over time and obtain data on impact at individual, household, and collective levels.</td>
</tr>
<tr>
<td></td>
<td><strong>Tool #4: Client Satisfaction</strong></td>
</tr>
<tr>
<td></td>
<td>Qualitative tool, focus group discussions to obtain better understanding of clients’ opinions of the programme and their suggestions.</td>
</tr>
<tr>
<td></td>
<td><strong>Tool #5: Client Empowerment (Women)</strong></td>
</tr>
<tr>
<td></td>
<td>Targets women. In-depth interview to assess the impact of women’s participation in programme. The five tools can be used together or separately.</td>
</tr>
<tr>
<td><strong>Who Can Conduct the Survey?</strong></td>
<td>Local teams with experience in surveys and data analysis.</td>
</tr>
<tr>
<td></td>
<td>MFI staff with experience in surveys and data analysis.</td>
</tr>
<tr>
<td><strong>Duration</strong></td>
<td>250 to 300 person-days are needed, results obtained in approximately three months</td>
</tr>
<tr>
<td><strong>Cost</strong></td>
<td>Approximately USD18,000 for a complete assessment by a strictly local team; higher cost when international assistance is used</td>
</tr>
<tr>
<td><strong>Comparative Advantages</strong></td>
<td>Provides an overall approach to impact (tool 1) and in-depth analysis of several themes relatively easy implementation at limited cost, accessible for practitioners</td>
</tr>
<tr>
<td><strong>Limits</strong></td>
<td>Generic tools that need to be adapted to specific contexts and MFIs the goal of ‘proving impact’ is not reached, due to classical methodology difficulties</td>
</tr>
</tbody>
</table>

Source: AIMS
e) Overall Impact Assessment Methods (Continued)

<table>
<thead>
<tr>
<th>Name</th>
<th>Impact Analysis Based on Population Typologies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Origin</td>
<td>French approaches to impact CERISE (IRAM, CIDR, CIRAD, GRET)</td>
</tr>
<tr>
<td>Objective</td>
<td>The purpose of these studies is to gain a better understanding of the impact of an MFI on the various population categories in a given area and analyze the ways in which these categories use loans.</td>
</tr>
</tbody>
</table>
| Method | Household and institution survey – combination of approaches:  
- Survey of member and non-member households; systematic analysis of household operations (strategies, constraints, etc.); data treated by population typology  
- Institutional analysis |
| Implementation Mode | Population typology as per a combination of levels of wealth and activity systems (multivariate analysis)  
Comparison between access to and use of financial services by the various population categories can be combined with:  
- Qualitative surveys of a smaller sample of households to deepen analysis of household strategies, constraints, and credit use  
- Monograph on the MFI  
Possibility of deeper study using diachronic surveys (repeated at regular intervals) to follow a reduced sample of households (monitoring household budgets, cash flows, etc.) |
| Who Can Conduct the Survey? | Local teams that are skilled in surveys and data analysis |
| Duration | Varies – according to the combination used. For the basic survey, data collection = 60 to 80 person-days; analysis = 60 to 80 person-days |
| Cost | Approximately $20,000 for a strictly local team |
| Comparative Advantages | Enables detailed analysis by population category and deeper understanding of household strategies and the use of the MFI’s services in function of their specific constraints |
| Limits | Does not help in improving impact; the diachronic monitoring is a way of extending methodological limits further (fungibility, attribution). |
| For More Information | Cerise@globenet.fr |

Internet Resources

- Consultative group to assist the poorest (CGAP)  
  [www.cgap.org](http://www.cgap.org)

- International Food Policy Research Institute (IFPRI)  

- Microcredit Summit  

- Microfinance Gateway  

- Pact's small enterprise and microfinance programs  

- USAID Microenterprise Innovation Project (MIP)  
II. DESIGN & IMPLEMENTATION CONSIDERATIONS

Part I analyzed a number of important cross-cutting issue. However, IFAD faces the challenge of reflecting those principles and recommendations in the reality of its project cycle and operations. Part II provides a broad analytical framework in that context, starting with the identification / formulation stage of projects and continuing with project implementation.
A. Identification & Formulation of Rural Finance Projects

1. Introduction

155. In this section the various stages of identifying, formulating, implementing, operating and monitoring a rural microfinance programme will be identified and the various management procedures for each stage will be discussed. Additionally, certain key ratios and performance guidelines will be highlighted to enable the reader to track the ongoing performance of the programme.

156. The key element in establishing a successful rural finance programme, though, is achieving broad agreement on the objectives and goals of the project and ensuring that the strategy adopted (model chosen, services chosen, partner(s) and institutional structure) is relevant, and adapted to the needs of the target population, and the local environment.

2. The Major Stages in Project Elaboration

a) Understanding the Context, is an Indispensable Prerequisite: Elements to Take into Account at COSOP stage

157. The first task is to assess whether or not IFAD should support a rural finance intervention.

158. There are few absolute conditions that would justify not to intervene in rural finance. They are generally agreed to be very high inflation, major physical security problems, a pattern of constantly changing and very low population density, a local economy that is mostly based on barter with little monetization, and a very poor credit culture.

159. Over and above these minimum criteria, it is important to study the context of the planned intervention. This will help to assess the elements that could support or hinder the growth of RFIs at country level, as well as helping IFAD orient its choices in terms of sites, partners, approaches and methodologies to be adopted.

160. At this stage, the objective should be to focus on the key elements that may affect the development of rural finance, and on issues that could be seen as constraints to RFI viability and institutionalization. These should include the following:

<table>
<thead>
<tr>
<th>Indicative List of Issues to be Assessed</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Country/Zone – general information</strong></td>
</tr>
<tr>
<td>climatic constraints</td>
</tr>
<tr>
<td>safety (in the specific zone: may be considerably different from the rest of the country)</td>
</tr>
<tr>
<td>population density</td>
</tr>
<tr>
<td>accessibility and communications (infrastructure level)</td>
</tr>
<tr>
<td>presence of other development projects (how do they operate? competition?)</td>
</tr>
<tr>
<td><strong>Economic Conditions</strong></td>
</tr>
<tr>
<td>macroeconomic stability</td>
</tr>
<tr>
<td>general orientation of national policies (poverty alleviation, agricultural policy, etc.)</td>
</tr>
<tr>
<td>inflation and exchange rates</td>
</tr>
<tr>
<td>monetization of the local economy</td>
</tr>
<tr>
<td>the major income generating activities</td>
</tr>
<tr>
<td><strong>Legal Context</strong></td>
</tr>
<tr>
<td>appropriateness of the legal and regulatory framework for microfinance institutions.</td>
</tr>
<tr>
<td>interest rate caps or other restrictive conditions</td>
</tr>
<tr>
<td><strong>Social Analysis</strong></td>
</tr>
<tr>
<td>existence of informal finance</td>
</tr>
<tr>
<td>level of social structuring (villages, for example)</td>
</tr>
<tr>
<td>different ethnic groups / languages</td>
</tr>
<tr>
<td>level of political interference in credit decisions</td>
</tr>
<tr>
<td><strong>Supply of financial services</strong></td>
</tr>
<tr>
<td>and analysis of the national finance sector: public and private, formal/ semi-formal/informal services in the country, and in the potential zone of intervention</td>
</tr>
</tbody>
</table>
161. The above issues should be analyzed in a synthetic manner, without going into an overly detailed analysis. Conversely, enough time and resources should be used to identify who could be the potential rural finance partners in the project area (or in the country) for the IFAD intervention.

b) Clarify Objectives and Expected Results: Elements to Take into Account in Project Formulation

162. It is necessary to define clear principles and broad objectives for the project, based on the analysis of the local operating environment and IFAD’s goals. The following issues may be reflected in this formulation process:

- **Scale of Intervention:** is this a national intervention or a more focused operation (or a combination of both)?
- **Before considering a national intervention (i.e defining a national strategy in support of micro / rural finance), IFAD should first assess what the impact of such program is likely to be**, and whether it has a comparative advantage to embark upon it, as opposed to other donors (who may have a stronger field presence). In many instances, innovative field interventions may yield stronger impact in expanding access to financial services by the poor. They may also provide a very useful contribution to policy dialogue at the national level, highlighting promising rural finance models and underlining the enabling conditions that should be set up by governments to encourage their growth. In that context, the criteria for assessing under what circumstances, and in what manner, IFAD may want to consider a national-scale programme as opposed to a more focused, rural finance operation, are described in Section 1.F (Policy Issues).
- **Global Strategy:** If IFAD chooses a more operational approach (support to a RFI), what are the broad project objectives in terms of overall strategy, the possible zone of future intervention, the general outreach / client base envisaged by the project and the potential future RF partners?
  
  It may be desirable, at the formulation stage, to focus on providing general principles and orientation. For example, the project may define an open target population, while stating IFAD’s interest in helping the RFI to further extend the frontier of its intervention into remote rural areas. IFAD will more likely reach the twin objectives of outreach and sustainability if adequate flexibility is maintained at the formulation stage. For example, such flexibility could permit a RFI to further consolidate its operations in peri-urban areas, before expanding into rural areas. A major benefit of this type of flexibility will be the stronger accountability of the RF partner in implementing its strategy, thereby providing IFAD and the government the possibility of negotiating with them minimum, accountable performance standards (see below).
- **Institutionalization and sustainability of the RFIs / networks to be supported.**
  
  In line with the recommendation contained in IFAD’s Rural Finance Policy Paper, it is important that the principle of institutionalization and plan for achieving financial sustainability by the RFI be clearly stated and agreed at the formulation stage. Institutionalization may take many different shapes and forms, and need not be clearly specified at this stage. But its principle should be stated at formulation (as the capacity of the RFI to continue expanding operations after the project closure, with clear governance and management structures).
- **The Selection of the Appropriate Model**
  
  In rural finance, the specific operating conditions, even within the same country, makes it tricky to try to ‘replicate’ a specific ‘model’. The success of a RFI would depend primarily on using a methodology that is appropriate to a specific clientele in a specific context. Such methodology would need to be adapted before being applied to another social, economic, and cultural setting.

c) How Far Should IFAD Go in ‘Designing’ an RF Project?

163. This is a crucial issue for any microfinance donor. The situation varies considerably, depending on (i) whether donors fund their interventions through grants or loans, (ii) the type of relationship with government

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16 Historically, one should admit that the major success-stories in micro and rural finance were not due to the existence of national strategies, but to the vision and efforts of industry leaders who proved that it was possible to provide, on a massive scale and a sustainable manner, financial services to the poor.
partners, and (iii) the project implementation modalities specific to that particular donor and (iv) the overall goals and strategy of the donor itself.

164. In the case of IFAD, the following considerations should be taken into account:

- Project formulation documents usually cover several types of interventions, in which rural finance is only one of the components. In the case of projects focused on RF only, there is usually a large menu of interventions (from operational to policy), and provision is made for the possibility to support a variety of RF partners or activities.
- Specific RF partners may be referred to in the formulation report, but direct negotiations on actual support and funding usually would not be finalized at formulation stage. This would take place in the context of subsidiary loan agreements, after the project has been approved and IFAD loan negotiations finalized.
- Under the above conditions, it is difficult to envisage a detailed description (at formulation stage) of the precise scope of support to be provided at the level of individual RFIs. The formulation report would, however, describe the project context, analyze its rationale and objectives, and also the various project components, with related budget.
- This absence of a detailed ‘design’ offers both opportunities and challenges. In principle, it provides the opportunity to maintain a certain flexibility in the future selection of RF partners, and in the type of support that the project may provide (capacity building, technical assistance etc…). It also highlights two challenges: (i) to assess, at formulation and appraisal stages, the capacity and interest of the potential RF partners to work with the project; (ii) ensure that the broad budget categories in the project document reflect the actual needs of those institutions (see below).
- The budgets attached to formulation reports are quite detailed and describe planned expenses by standardized categories (Investment costs: equipment, TA, training, credit / Recurrent costs: salaries, operations and maintenance). This raises three types of questions: (i) the formulation mission needs to define budget expenditures before the final selection and negotiations with partner RFIs have been held. (ii) The RFIs may face a great variety of needs that are not necessarily reflected in the standard budget expenditure categories. (iii) The needs of RFIs may evolve during project implementation. The question is how to ensure flexibility in re-allocating funds to where they are most needed through budget revisions (for example, increasing capacity building while diminishing a credit line). The following examples illustrate how the above challenges may be reflected in practical terms:

(i) For a donor, it is particularly effective to support a RF partner on the basis of the institution’s own long-term strategy and business plan. This is true for both existing RF institutions, or for a new network being set up by an operator. Negotiating donor support on the above basis has the following advantages: (a) It strengthens ‘ownership’ of the project by the RF partner (funding is based on their vision and not on the donor’s views and design). (b) it enables the donor to negotiate clear conditions for its continued support (such as minimum performance standards on the part of the RF partner). If such negotiation cannot be undertaken before project approval; the formulation / appraisal reports should at least clearly highlight the process under which the selection and negotiations with future RF partners will take place during project inception.
(ii) For a “young” RFI, donor funding is needed to cover part of its operating costs. An effective way for a donor to support such an institution is to provide funding (on a decreasing basis) to cover its operating income shortfall, until the institution breaks even, based on its income & expense projections. The key question, though is whether there is sufficient flexibility to do so within the present budget categories?
(iii) Access by a RFI to loan capital should be conditioned on a number of criteria (i.e impact on savings mobilization if the RFI mobilizes deposits, absorption capacity, ability to maintain high portfolio quality etc…). Similarly, the same RFI may need more intensive TA support at certain stages (for a more performing MIS, specialized training, or pilot testing of new products). Since these developments are impossible to predict, the balance between budget categories is likely to change – sometimes even drastically - during the course of project implementation.
165. **Conclusion:** For projects in which rural finance is only one of several components, or for projects that intend to support a variety of RFIs, it may not possible - at formulation and/or appraisal stages - to provide a final list of RF partners\(^\text{19}\). Nor may it be possible to provide detailed funding proposals based on those RFI strategies and business plans. The formulation and appraisal report, however, may reflect the following:

- Outline the selection process, and highlight the conditions and criteria that will be used to choose RF partners, at project inception. This could be done, for example, on the basis of a ‘Request for Proposals’, under the conditions described above.
- Provide a list of potential RF partners (national, regional or internationally based), that have expressed in-principle interest in working with IFAD in the context of the project.
- Make provision for maintaining a certain flexibility in the budget allocation, to best meet the evolving needs of RF partners.

166. Conversely, for projects that identify one major RFI as a sole project partner, it should be possible to have the said institution produce a strategic development plan with precise commitments and performance standards, in close partnership with the donor, and before project approval.

\(d\) **Choosing the Appropriate Partners: Factors that Need to be Taken into Account**

**Criteria for the Identification of Potential Partners**

167. Whoever the potential RF partner may be, its assessment by both IFAD and the government should be anchored in the three-fold standards of its competency/capacity, its sustainability and its client outreach perspective. Accordingly, the key elements to be analyzed would include:

- RFI’s vision: does it match the project’s objectives (from the outreach and sustainability perspectives)?
- the target client base and the suitability of the services offered
- the financial services offered and the results obtained (for existing RFIs);
- the potential partner’s specialization (or lack thereof); in the case of several activities, the degree of autonomy of RF operations vis-à-vis the other activities undertaken;
- RFI competency: has it been demonstrated locally or elsewhere?
- The operational and financial sustainability of the partner

168. For existing financial institutions (RFIs or banks), it will be necessary for IFAD to conduct an institutional assessment beforehand, so as to get a clear understanding of their strengths and weaknesses, both financially and institutionally. The factors to be assessed will include:

- vision and strategic objectives;
- client outreach: the type of clientele of the RFI, and the depth of its poverty outreach
- institutional factors: legal status, background, capital structure and governance, management, human resources, organizational structure;
- systems: management information system, internal control and audit system;
- the services offered, the clientele they reach, and the state of the market;
- financial results: income statement and balance sheet, profitability, efficiency, loan portfolio analysis, analysis of the interest rates and the cost of funds, and liquidity and equity management.

169. CGAP’s *Format for Appraisal of Microfinance Institutions*\(^\text{20}\) is a particularly useful tool to conduct this type of institutional appraisal. It may be used as a standard instrument, prior to the selection of a potential RF partner. Moreover, it may be complemented by *CGAP’s Poverty Assessment Tool*\(^\text{21}\), which has

\[19\] Although it may be possible to provide a list of potential RF partners, who may have been approached for fact-finding and expression of potential interest in the project.

\[20\] accessible at [www.cgap.org](http://www.cgap.org)

\[21\] also accessible at [www.cgap.org](http://www.cgap.org)
been designed to help donors evaluate the depth of poverty outreach of MFIs (relative poverty of their client-base compared to regional and national situations).

170. The following two situations may arise, however, during the identification of potential RF partners:

▷ What should one do if the potential partner in the area seems weak?

171. Relying on existing RFIs is not always the best solution. Experience has shown that reforming an existing weak RFI is likely to be more risky, time consuming and costly than supporting start-up operations with a strong RF partner from outside the project area.

172. However, if it is decided to undertake an intervention with a partner that has a number of weaknesses, it would be key that these are accurately analyzed, and that a plan of support be negotiated with them. (i.e. through a medium-term framework contract with an experienced operator). If the weakness reflects poor management and lack of leadership / commitment, IFAD should not support such partner. If, however, the weakness lies with poor systems and internal capacity (but with a management committed to change), the scope for successful reform may be much greater. In such case, it would be important to monitor and ‘test’ the partnership by planning clear assessment and validation stages during project implementation.

▷ What if there are no partners in the area?

173. The first option should be to reconsider the planned intervention, or provide flexibility to formulate a RF programme in another rural area. It may also be possible to call on potential partners on a national or sub-regional level to undertake the programme (MFIs/banks that wish to expand their operations into that particular area, NGOs present in nearby region, etc.).

e) Entrusting the Selected Partner to Present its Own Strategic Plan

174. Once the RF partner has been selected through a competitive bidding process (for example through the submission of a Request for Proposal: see above Part I, Section F.3), it is possible to further refine with them the strategic plan or business plan, and identify the areas in which donor support would be most needed. This could pave the way for a dialogue between the project staff and the RFI, to validate the proposal, and ensure its coherence with the project’s overall objectives and priorities. The framework of analysis described in Part I, Section A (need for a more detailed feasibility study) would apply in this case.

175. The following questions should be raised before supporting a specific RFI funding:

- the adequacy of the proposal in relation to the broad project objectives (i.e. poverty outreach and rural focus);
- the quality of the planning for financial self sufficiency, and the required timeframe;
- the likely prospects of institutionalization in due course;
- the recognition of potential governance issues and the ways of addressing them;
- The identification of the risks, and the quality of the plan to manage them.

f) Reaching a Contractual Agreement with the RFI Partner

176. Section I.F.3 noted that an effective way to increase the RFI / operator’s accountability for results and impact, is through a contractual relationship. This provides the partner with a large degree of autonomy in the choice of approach and methodology, while ensuring that the proposal is in line with IFAD’s overall objectives and priorities, as defined in the project document.

177. Moreover, the monitoring of simple performance indicators of the RFI / operator, based on its own strategy, offers the following advantages. It simplifies performance monitoring, gives a snapshot of the overall RFI operation and makes it possible to detect warning signals at an early-stage, if the situation is deteriorating. Also, it strengthens the RFI’s accountability in relation to achievements.
B. Implementation

178. Project monitoring during the implementation phase is an important responsibility as well as a challenge for IFAD, for several reasons:

- The quality of the implementation determines the success of the programme: the greatest success stories in microfinance were due, primarily, to the quality of work during project implementation, rather than the sophistication of project design. Poor implementation will not save a well-designed RF project, whereas the contrary may be true.

- IFAD staff time and resources available for monitoring project implementation are scarce. Cooperating Institutions (CI) and Project Management Units (PMUs) have a critical role to play during this phase. In this context, it seems that one key challenge is to explore ways and means of helping the above participants increase the effectiveness of project monitoring, while not adding to the workload of IFAD CPMs during this phase.

179. Monitoring impact has been an important priority for IFAD. Recent evolutions and available tools in that area are described in Part I, Section H above. This section analyses the challenge of strengthened monitoring of rural finance projects through two perspectives, namely:

- which data should receive priority monitoring in RF projects, with the objective of increasing monitoring impact and effectiveness;
- the operational implications for IFAD. What practical steps may be considered for strengthening the Fund’s capacity to monitor the implementation of its RF projects.

1. What Should Receive Priority Monitoring During the Implementation of RF Projects

180. The initiatives and activities that require monitoring obviously depend on the type of RF project: whether they reflect IFAD support to a national microfinance strategy, a combination of policy and operational work, or a targeted intervention in support of one or several RFIs. Ensuring the quality of policy work results from a combination of factors: (i) the profile and competence of PMU and CI staff; and (ii) the ability to identify and recruit high level expertise at certain stages to support critical project interventions (i.e. on MFI regulation and supervision); (iii) Maintaining active channels of communication with other donors in the field, to ensure the coherence of donor support etc…

181. For the purpose of the DTs, the present section will focus primarily on the monitoring of RFI operations, for the following reasons: (i). it is more technical by nature (less related to the monitoring of project activities and more related to issues such as the growth, performance, outreach, sustainability and institutionalization); (ii). it is linked to the challenge of improving the quality and reliability of some basic quantitative information provided by RFIs; (iii) it is the area where some of the monitoring tools presented below could be “internalized” within IFAD and its government partners (through setting up a simple data base, for example).

a) Preparing for a successful transition from the project mode to the institutionalization of RF interventions

182. The transition from the project mode to the process of institutionalization is an issue that should not be left until the last phase of the project. When IFAD supports RF initiatives that are not yet institutionalized (development of new networks), careful attention should be given during the entire implementation phase to the conditions that will enable a successful project exit strategy and institutionalization of the RF partner. Although the specific monitoring elements will vary according to the model envisioned (board composition for a financial NGO, the relationship between elected managers and professional staff in credit union networks etc…), it is possible to identify two fundamental components that require careful monitoring throughout project implementation:
• The first, and most frequently emphasized, is financial viability: to ensure that the RFI will be able to cover its costs through its income. This may be assessed through the two ratios of operational and financial self-sufficiency (see infra):

• The second, institutional viability, relates to the quality and effectiveness of the RFIs internal operating structure and the quality of its governance.

183. The efficiency of the internal operating structure revolves around the management’s ability to coordinate the various components that function within the institution itself. These components include personnel, business planning, technical capabilities, and operating systems.

184. The quality of governance relates to the quality and intensity of oversight and guidance that the Board of Directors brings to the RFI. The factors that are important here are the composition of the board members, their levels of professional competence and their depth of interest in the RFI itself. Their ability to define the mission of the institution, monitor and control the performance of the management, represent fairly the interests of the all stakeholders and be able to act decisively in times of crisis will have a direct impact on the viability of the RFI.

185. Supervising an RF project through the above perspective makes it possible to go beyond a monitoring based on activities and expenses alone (the latter may be necessary for fiduciary reasons but often provides little information about the project’s likelihood of succeeding or failing). It facilitates monitoring based on outreach, performance, and institutional capacity, and would therefore help capture, on an on-going basis, the evolving dynamics of the RFIs funded by the project.

b) Monitoring the Effectiveness and Impact of RFI Operations

186. This monitoring should be based on the RFI’s own projections and targets. It may also compare achievements with the minimum performance targets jointly agreed between the RFI and the donor, at project inception. Several types of issues could be monitored in that respect, related to the three dimensions of outreach, impact and sustainability.

i) The Institutions’ Penetration Rate and Depth of Poverty Outreach

187. Several indicators could be monitored here:

• The client dropout/retention rate\(^{22}\) makes it possible to estimate the probability that a borrower will request a new loan once the previous one has been fully repaid (see CGAP’s Format for Appraisal). It also makes it possible to assess the cost of borrower dropouts, and the impact on the RFI’s income due to high renewal rates. Moreover, it should encourage the RFI to identify the reasons for this development (which may well be due to services that are no longer suitable to client needs\(^{23}\)).

• The outreach or penetration rate makes it possible to compare, for each branch, the institution’s clientele with the active population in the area, representing its maximum potential. This rate permits comparisons with neighboring organizations and changes over time, revealing measurements for progress. It may also highlight saturation risks (over-indebtedness, market saturation, etc.) when the penetration rate is very high. The depth of poverty outreach - i.e. the relative poverty level of an MFI’s client-base compared to the local and national environments - is also an important indicator to be monitored. The recent CGAP / IFPRI Poverty Assessment Tool\(^{24}\) offers a practical instrument that can be used by donors to help RFIs assess the depth of their poverty outreach.

\(^{22}\) see CGAP, 1998: *Format for Appraisal of Microfinance Institutions.*

\(^{23}\) This has been noticed with some compulsory savings schemes of certain MFIs, which have induced clients to leave the institution after a certain number of loan renewals and move to other MFIs.

\(^{24}\) CGAP Poverty Assessment Tool: accessible at www.cgap.org
- **Client needs assessment** may help RFIs better ensure the adequacy of the financial services they are offering, in relation to client demand. In this respect, they may use the tools from AIMS\(^{25}\) or MicroSave.

\[\text{ii) Portfolio Volume and Quality}\]

188. The volume and quality of loan portfolios should be compared to the pre-established objectives set forth in the RFI business plan, and to the mutually agreed minimum performance standards (when negotiated with the project at project inception stage).

- The four following ratios may be monitored systematically from RFI partners.

<table>
<thead>
<tr>
<th>Portfolio Quality Indicators(^{26})</th>
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<tbody>
<tr>
<td>Portfolio at risk</td>
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<tr>
<td>Loan loss ratio</td>
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<tr>
<td></td>
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<tr>
<td>Loan reserve ratio</td>
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<td></td>
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<tr>
<td>Loan Arrears Recovery Ratio</td>
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189. In order to be efficient, an RFI should maintain arrears (30 days) below 5% and PAR below 10%. Any deviation from those thresholds may compromise the institution’s long-term viability and should be addressed immediately.

**Operational Efficiency Indicators**

190. The most frequent indicators to measure an RFI’s operational efficiency are the following:

- the cost per monetary unit lent or administrative efficiency
- the number of active loans per loan agent
- the portfolio per loan agent

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<tr>
<th>Operational Efficiency Indicators(^{27})</th>
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<tbody>
<tr>
<td>Administrative efficiency</td>
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<tr>
<td>Number of active loans per loan agent</td>
</tr>
<tr>
<td>Portfolio per loan agent</td>
</tr>
<tr>
<td>Relative cost per loan to per capita income</td>
</tr>
</tbody>
</table>


\(^{26}\) Ratios proposed by the SEEP Network. See also CGAP, 1998, for equivalent ratios and the methods of calculation.

\(^{27}\) SEEP Network, see also CGAP, 1998.
Financial Self Sufficiency indicators

191. Financial viability can be monitored using the following ratios to evaluate the financial profitability of the RFI activity and the institution’s aptitude to cover its expenses (cost of funds, operating expenses, cost of loan loss reserve).

### Financial Viability Indicators

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<thead>
<tr>
<th>Indicator</th>
<th>Formula</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return on assets</td>
<td>Gross Financial Revenue / Average Total Assets</td>
<td>indicates the financial productivity of the credit rural finance programme</td>
</tr>
<tr>
<td>Operational self-sufficiency</td>
<td>Gross Financial Income - financial costs and operating expenses + provision for loan losses</td>
<td>shows the institution’s capacity to cover the costs of its operations from internally generated income.</td>
</tr>
<tr>
<td>Financial self-sufficiency</td>
<td>Gross Financial Income - financial costs and operating expenditures + provision for loan losses + imputed cost of capital</td>
<td>shows the institution’s capacity to be fully self-sufficient in the long term by covering all its expenses and maintaining the value of its capital</td>
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192. Based on experience, the main variables that impact the financial performance of MFIs, and which MFIs can influence through policies and practices are:

- The effect of the volume of activity on per unit costs (economies of scale);
- The net income spread between the overall income yield on loans, and the cost of funding (which can be increasing by raising the interest rates charged on loans and/or lowering the costs of borrowing);
- Controlling operating expenditures (sustainability has shown high sensitivity to salary structures);
- Maintaining high portfolio quality and containing loan defaults.

Institutional Viability

193. This aspect of viability pertains first and foremost to the quality of the structure’s internal organization and governance. This term is often used to evaluate the quality of the relationships between the Board of Directors (for MFIs with a Board) and managers but it can also be understood in the broader sense of ‘the art of governing’.

194. This notably concerns the Board of Directors’ ability to guide and:

- define the general orientations, and the overall direction taken by the RFI
- adapt rapidly to changes in the environment; and
- prevent and overcome crises.

195. The choice and composition of the board of directors, therefore, is crucial to the harmonious development of an institution.

196. It also relates to the manager’s ability to lead the institution on a day-to-day basis by:

- coordinating the people, resources and activities to attain the target objectives. This relates to both organizational quality (distribution of roles, accounting and information systems, degree of decentralization, incentive schemes, human resources management, etc.) and to the attainment of a certain degree of social viability.

197. Finally, it concerns the MFI’s ability to eventually become licensed and regulated, which would enable it to start deposit mobilization and thereby diversify its funding base.

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2. Operational Implications for IFAD

198. In order to reflect the above analysis and put the recommendations into practice, the following propositions may be considered:

a) Training

199. Assuming the leadership for quality rural finance programmes requires solid sectoral skills, both for country portfolio managers (CPMs) and for project managers in the field (whose profiles should match the technical requirements of RF projects).

200. This training agenda may be developed in several ways: Two possibilities, among others, are presented below:

- **Facilitate attendance at existing specialized training courses in micro and rural finance.** These range, typically, from 1 to 3 weeks (Boulder, Harvard, New Hampshire in the US / SYDEC-CEFEB in France / CGAP and SUM donor courses. The courses provided from CGAP and donor funded regional hubs may be also very relevant for IFAD project staff in the field (they usually last one week).

- **Develop training modules tailored to the specific needs and challenges faced by IFAD in RF.** These could be articulated around the structure of the RF Decision Tools, and focus on the major cross-cutting and region-specific issues. A 1 to 2 day course could be organized at the time of the IFAD programmes’ mid-term regional evaluation (benefiting from the presence of many project staff). It could be structured on (i) discussing the RF Decision Tools and the manner in which they apply to the specific regional context, and (ii) organize a more in-depth exchange and training around 2 or 3 themes particularly relevant to the issues faced by IFAD RF projects in that region.

b) Review Partnerships with IFAD Cooperating Institutions (CIs)

201. The type of monitoring currently performed by IFAD Cooperating Institution may be further strengthened in terms of monitoring RFI development and performance.

202. The challenge here would be to ensure that the CIs are able to assign staff who have the required technical expertise to carry out monitoring missions. Several possibilities could be explored in this respect:

- CIs may build up internal technical capacity in the area of RF, by training the staff assigned to IFAD monitoring missions (compulsory attendance at the regional training hubs initiated by CGAP and donors could be one practical possibility).

- CIs may retain institutions with specialized expertise during project monitoring missions, at least once a year. For example, IFAD may request that the CI sign an agreement with a recognized regional training center (or a specialized sub-contractor) on the following principle. One consultant from the region, who has been certified by this center (or sub-contractor) would join the monitoring mission, at least once a year. Such agreement may be negotiated, for example, with AFCAP in West Africa, CAPAF or MicroSave in East Africa, the Microfinance Center for Eastern Europe (based in Warsaw), and similar centers in Asia and Latin America. The additional cost of this specialized input could be reflected in the agreement signed between IFAD and the CI. It would remain a minimal investment, compared to the potential impact this could have on project monitoring.

203. Ideally, multi-year contracts would be signed between the CI and the selected training center or subcontractor. The contract would stipulate the requirement for the technical monitoring of IFAD RF programmes (from policy issues to RFI supervision). This would enable IFAD to get concise information on its RF programmes, as well as the performance and development of its RF partners. IFAD would also be able
to get early warning signals on potential crises (portfolio or financial crisis, weakness in systems that may encourage fraud, governance issues etc…), and to take measures to remedy this situation.

204. The interaction between these RF specialists and the PMU staff would also contribute to on-the-ground training for these staff, improving their ability to monitor IFAD projects on a technical basis. Finally, The CI would be responsible for commissioning financial audits for the RFIs, analyzing their financial statements and checking the performance indicators that those RFIs would be regularly collecting during the year (see below).

c) Collecting simple performance indicators from RF partners

205. IFAD could request its RF partners to provide to PMUs in the field 7 to 8 key performance indicators, on a regular basis. These should include: outstanding portfolio / number of clients (including % of women) including number of new clients / volume of voluntary savings and number of savers (when relevant) / average initial loan size / portfolio at risk (> 30 days) / active portfolio and number of clients per credit officer and operational self-sufficiency. Those indicators may also need to be adapted to the different types of institutions / models funded by IFAD, when necessary.

206. The above indicators would normally be calculated by a RFI every quarter. Two of them may however be collected once per semester, due to their mode of calculation: operational and financial self-sufficiency.

207. With the PMU monitoring these on a quarterly basis IFAD could only receive them on a yearly basis, with a detailed analysis from the cooperating agency. This approach would help to increase the scope and quality of reporting on RF project activities, while not giving CPMs additional workload.

d) Clarify the Position of RF Operations vis-à-vis the State

208. Rural Finance programmes should, for the most part, be anchored in the non-governmental sphere and in civil society initiatives. It is this ‘orientation’ that is responsible for their dynamism and strength to date.

209. In many countries, governments have clarified their role in the field of microfinance, taking a supervisory role (providing licensing and supervising the sector), while providing an environment that is conducive to its development. This implies that the State has renounced any managerial role (operator) in order to avoid being both judge and jury.

210. The dynamics of the relationship between Project Management Units within Ministries (with government staff) vis a vis local RFIs deserves careful analysis in this context. Hierarchy-based power from PMUs and their staff vis-a-vis local RFIs would be inappropriate, especially in countries where the government is both centralized and dominant. This may be a blocking factor in the development of grassroots initiatives. The risk would be that governments start influencing strategic orientations and decisions on the part of RFIs, which might replicate the causes for the failure of former state-controlled credit programmes. This is where a distinction between project’s fiduciary control and the technical monitoring of RFIs may need to be further discussed, in the context of PMUs’ role and status, with the objective of preserving the autonomy and independence of RFIs.
III. REGIONAL SPECIFICITIES
One striking characteristic of IFAD rural finance programs has been the great variety of approaches and models promoted across regions. These models include, among others, financial NGOs, Rural Savings and Credit Associations, Financial Cooperatives, Financial Services Associations, Grameen Bank replications, and self-help groups models. Despite this great diversity, all these approaches often face similar issues and challenges, such as (i) how to combine effectively their objectives of outreach and sustainability, (ii) how to improve their internal reporting systems and administrative efficiency, (iii) how to better document the depth of their poverty outreach and their impact on the lives of the rural poor. In that context, the cross-cutting issues (Part I) and the challenge of improving project cycle effectiveness (Part II) are largely shared in their principle by most of these models. However, they are reflected operationally in different ways across regions.

These differences have been highlighted in the Regional Strategies that were finalized in the wake of IFAD Strategic Framework for 2002 – 2006. These regional differences are analyzed in Part III, which includes for each region, a brief summary of the current status of rural finance in the region, a review of IFAD interventions, as well as the methods and tools that are particularly relevant to this region (along with IFAD’s comparative advantage in RF).

A.  West and Central Africa

1.  Current State of Rural Finance in West and Central Africa

211.  At the end of 1999, the Central Bank of West African States (BCEAO) reported 272 decentralized financial systems (227 savings and credit institutions, 21 direct lending institutions, and 24 projects with credit components) covering 2,351,800 clients. The penetration rate in the WAMU zone is 7.5% of the active population. Twenty percent of households have access to the financial services of decentralized financial systems.

212.  In 2000, the Central African Banking Commission (COBAC) had 1,034 microfinance structures in Central African Economic and Monetary Community (CEMAC) countries (12 umbrella organizations with 762 connected entities and 260 independent bodies), servicing 414,000 clients or members. The penetration rate in the CEMAC zone is 3% of the active population. Eight percent of households have access to the financial services of microfinance structures.

213.  As a result of the increase in the number of decentralized financial systems and volumes of deposits and loans handled (on average 4% of national financial systems), the monetary authorities took an interest in this sector and decided that it should be regulated and supervised.

214.  In West Africa, a framework law defining the legal framework governing the activities of decentralized financial systems in the sub-region was passed by WAMU’s Council of Ministers in December 1993, in Dakar. This law applies to mutualist savings and credit institutions or savings and credit cooperatives, and their unions, federations or confederations, who must apply for a license from the Ministry of Finance. Non-mutualist decentralized financial systems can apply for framework agreements with the relevant Ministry of Finance.

215.  In Central Africa, the Bank of Central African States (BEAC) and COBAC began a census of decentralized financial systems in 2000. Preliminary CEMAC draft regulations covering conditions for exercising and controlling microfinance activities are being studied in all member countries. These regulations are expected to become effective early in 2002.

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29 West Africa Monetary Union
30 The microfinance structures counted by COBAC are not identical to the BCEAO’s decentralized financial systems as the latter are more institutionalized and organized in networks.
216. Decentralized financial systems in West Africa have a strong rural tradition and they generally started in rural areas. Of the sub-region’s fifteen largest decentralized financial systems, at least ten still operate mainly in rural areas. However, they are concentrated in ‘wealthy’ rural areas with cash crops or secure production (irrigated perimeters), to the detriment of areas that are more disadvantaged than the Sahel zones, either in terms of rainfall or because of distance and inaccessibility. Furthermore, in an attempt to reach financial self-sufficiency more rapidly, numerous mutualist systems are leaving villages for secondary cities or large towns and markets.

217. The same trend is underway in Central Africa, with an even sharper rural/urban split. The majority of microfinance structures are concentrated in large cities, secondary cities, and built-up areas, and are not very numerous in rural areas and village contexts. Thus, villagers and small farmers in Central Africa have little access to formal financial services.

218. In most countries in West Africa, more than 60% of the population and 70 to 80% of the rural population lives below the poverty line. Decentralized financial systems generally reach clients in the ‘average’ and ‘slightly above average’ categories. Such systems practicing solidarity group lending and the mutualist system’s credit and education programmes reach poor or medium-poor women. while CVECAs reach villagers in disadvantageous rural regions. The very poor population is probably not reached at all.

219. The average loan amount in West Africa has increased from 181,000 CFAF in 1997 to 251,000 CFAF in 1999, or approximately 100% of the GDP per capita (245,000 CFAF) for the WAMU zone. The microfinance sector uses average loan size to give an indication of the economic level of the clients reached: 100% of the GDP per capita indicates an ‘above average’ clientele. This trend also applies in Central Africa. In Cameroon where the average loan amount is 380,000 CFAF, 50% of loans are for more than 200,000 CFAF and 20% more than 500,000 CFAF.

220. Overall, demand is relatively well met in cities and in ‘wealthy’ rural areas in West Africa. Outside of these areas, demand is only partially met, since active decentralized financial systems are more difficult to find. In countries where the sector is relatively dynamic, a large amount of these ‘borderline’ zones are reached all the same, although it would be both possible and desirable to increase the volume of supply.

221. In Central Africa, the sector is still very young and there is considerable, unmet demand everywhere - particularly in the countryside, where microfinance does not yet seem to have made an entry-point. Extension potential is immense.

222. An analysis of decentralized financial systems funds in West Africa reveals that out of a total of 157 billion CFAF, 64% come from deposits and 20% from equity. In Central Africa, out of a total of 77 billion CFAF, deposits represent close to 69%, whereas equity represents only 11%. Therefore, the main hindrance to their growing and extending outreach does not seem to be access to external capital.

223. Relatively few decentralized financial systems in the two sub-regions have attained financial self-sufficiency, according to CGAP’s method of calculation. Numerous decentralized financial systems still receive subsidies for operations and investment. It would seem, however, that approximately 40% of the decentralized financial systems identified in West Africa have attained operational self-sufficiency. The survey conducted in the CEMAC zone does not, however, allow for meaningful comparisons. The situation in Central Africa would seem to be more fragile.

224. In both sub-regions, mutualist financial organizations or savings and credit cooperatives make up the dominant legal model. However, both models adopt very different approaches.

225. In West Africa, mutualist financial organizations have a widespread and relatively homogenous membership - farmers, craftsmen, small salespeople. In this case, the main governance problems relate to:

- conflicts of interest typical of cooperative savings and credit structures in which the decision-makers are also the users,

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• elected members’ lack of qualification to manage financial structures that are becoming increasingly large,
• lack of motivation among elected members who have very little personal financial stakes in the structure (dilution of ownership) in addition to their regulatory volunteer status, and
• power struggles between elected members and salaried staff, in a framework in which roles and responsibilities are not clearly defined.

226. This governance problem has reached such proportions in West Africa that it is at the origin of the freeze or failure of several of the largest networks. A legal and regulatory solution would need to be found to resolve the situation.

227. In Central Africa - Cameroon in particular - because of the more urban nature of the savings and credit cooperatives and their promoters’ profiles (business men, public and private sector executives, former bank executives), their social base is both smaller and of a higher educational level. These structures operate rather like small banks, with branch offices that drain popular savings towards lucrative private investments. The risk here is that rural or working-class small savers might well be left out.

228. Decentralized financial systems in the two sub-regions have serious failings in accounting, financial management, MISs, internal control and operational organization. Tools exist on the international scale but need to be adapted to local realities. Service providers specialized in the microfinance sector—i.e. auditors, training organizations, computer services, and consultancy firms—are still relatively rare and need to perfect their knowledge and practices.

229. Thus, the sector’s main need is for technical assistance and capacity-building, much more than for capital, whether in the form of equity or loan capital.

2. IFAD’s Rural Finance Interventions in West and Central Africa

230. Traditionally, in West and Central Africa, IFAD’s portfolio contained mainly integrated rural development projects with agricultural credit components. Since the internal revision of its rural finance portfolio in 1996, most of these projects have been redefined or reoriented: IFAD has entrusted the loan components to operators or specialized decentralized financial systems, supported professionalization for generic NGO operators, and backed the institutional transformation of credit components into formal, decentralized financial systems.

231. The new generation of IFAD projects in West Africa can be classified in two categories:

a) Projects to Support the Emergence or Development of Decentralized Financial Systems on a Regional or National Scale

• 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

232. Those programmes have reflected 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
233. While there is room for further improvements, IFAD has already integrated the major lessons learned from past programmes (and failures) in its more recent interventions.

234. A recent external assessment for the West Africa rural finance projects’ portfolio has revealed that the new projects are generally well-designed. Greater attention has been paid to analyzing the projects’ sectoral contexts; the decentralized financial systems supported or promoted are also studied more attentively, and efforts have been made to choose operators based on their professionalism and experience in the rural finance sector. Similarly, on a more general level, better consultation among donors has been sought and sometimes obtained, thus contributing to the credibility of the approach and the success of the undertaking, especially in the face of national sectoral policies.

235. The challenge for the coming years lies in the proper implementation of these new projects, anchoring IFAD more decisively in microfinance ‘best practices’. This means that the institution will need to train its monitoring staff, review its partnerships with cooperating institutions or find specialized technical partners, allocate more resources to technical assistance in projects, and review its operational position vis-à-vis States.

3. Operational Considerations for IFAD Rural Finance Interventions

236. IFAD’s current comparative advantages in microfinance in relation to other donors can already be clearly identified and relate both to its mandate and its experience:

- **Focused interventions** in rural areas, including disadvantaged rural zones, while most donors are withdrawing from those areas,
- **grassroots interventions** closest to communities, and consequently able to encourage them to participate in designing products and systems to better match local needs, constraints and strategies,
- **launch of new decentralized rural finance institutions**, encouragement for action research and innovation, and
- **long-term partnerships** (10 years and beyond): in order to successfully accompany the growth and outreach of its RF partners in challenging rural areas.

Methods and Tools to Improve Implementation of IFAD’s New Rural Microfinance Projects in West and Central Africa

a) **For Supporting Rural Finance Institutions**

237. A set of participatory microfinance assessment tools proposed by MicroSave can be found in the *Participatory Rapid Appraisal for Microfinance: (see MicroSave website)*, and can be attached to operators’ terms of reference, to assist them with participatory feasibility studies.

238. Similarly, the “Implementation” section contains practical recommendations on how to select RFIs (see CGAP’s Format for Appraisal of Microfinance Institutions), use calls for bids to select a good technical operator, and establish lists of performance indicators for MFI outreach and sustainability allowing appropriate monitoring and assessment. Impact monitoring tools are covered in part I of this document (cross-cutting issues for rural microfinance).

b) **For National Microfinance Sector Support Projects**

239. These types of projects are being envisaged more and more frequently in the region. This is why they are receiving particular attention in this regional section, in spite of the fact that these tools are valid everywhere.

240. National microfinance sector development support projects are only recommended in countries where decentralized financial systems are dynamic and have a clear vision of their development strategies, and where they are sufficiently organized to become strong interlocutors vis-à-vis the State and donors. Without
these prerequisites, a national strategy may entail the risk of the State taking control of the sector or donors having too-strong an influence on its development.

241. Where these pre-conditions are met, and the added-value of such national microfinance strategies clearly demonstrated, IFAD may support their development, in coordination with other donors.

c) Elaborating National Strategies and Plans of Action for Microfinance Development

242. The approach should, first of all, be participatory, transparent, and open. One should ensure that no single party can impose its views on or dominate the others.

243. Undertake a diagnostic study on the state of the sector: analyze the supply of and demand for financial services by people excluded from classic banking systems. This analysis should be broken down by geographic zone, market segment (women, small farmers, small shopkeepers, artisans, urban VSEs, etc.), and type of products and services (savings and credit).

- Assess the performance of the most significant decentralized financial systems in the country: institutional analysis (organization, management, governance, vision, procedures, human resources management, business plan) and financial analysis (reliability of accounting and information systems, examination of financial statements for the past three years, calculation of profitability and efficiency indicators). Take a census of decentralized financial systems’ business plans and evaluate quantitative and qualitative evolutions in the sector, from its own perspective.
- Promote a benchmarking mechanism among the country’s decentralized financial systems and between the country’s decentralized financial systems and similar decentralized financial systems in other contexts.
- Seek to build a consensus around a few principles of good management for decentralized financial systems and performance indicators accepted by all, as the basis for financing and support provided in the framework of the Plan of Action.
- Observe the consequences of MFI development on need for financing, refinancing, and supervision. Ask each category of stakeholder to establish its own plan of action.
- Assess banking sector interest / ability to play a role in meeting refinancing needs from RFI s.
- Ask regulatory authorities to assess control needs, devise a method, and estimate their needs (staff and material and financial means) to implement it.
- Discuss with donors pledging of financial commitments.

244. National strategies define a vision, objectives to be attained, and principles of action to which all adhere: clear distribution of roles among all the various categories of stakeholders is crucial for success. Good national strategies must be elaborated jointly by all parties involved; they must not be written by any one stakeholder alone—whether it be the State, donors, or even a decentralized financial system with a dominant position in the country.

245. The resulting Plan of Action must be specific, scheduled over time, and quantified. The stakeholders in charge of each section must be clearly identified and must accept their roles. Good national plans of action can be measured by the degree to which the concerned stakeholders internalize such plans; this improved the effectiveness of their implementation.

d) Key Elements of National Microfinance Plans of Action

246. A national microfinance plan of action can include the following elements:

- Sector structuring, via the emergence and strengthening of a professional association likely to (i) represent the interests of decentralized financial systems, (ii) formulate proposals to the State, supervisory authorities and donors, (iii) be able to institute self-regulation within the profession, and (iv) be organized in such a way as to offer pertinent services to its members.
- Support for the adoption of appropriate regulations and effective supervision to foster an enabling environment for the pluralist development of microfinance. The plan of action can help clarify
choices by conducting complementary studies, providing specific expertise, and/or by training supervisory staff.

- Securing the sector by analyzing the main risks encountered and establishing collective mechanisms to limit such risks: regional or local credit information bureaus, deposit insurance funds, measures to clean up the sector involving the liquidation or turnaround of some failing RFI's etc.

- Sector development through individualized technical and financial support for the establishment of business plans for healthy decentralized financial systems: MIS, internal control, new product design, staff training, and/or increasing equity and investment capabilities, as well as general capacity-building for decentralized financial systems through management training for salaried technicians, local elected members, and umbrella structures.

- Coordination with the banking sector to increase loan funds: training banks in microfinance, training decentralized financial systems in elaborating refinancing or guarantee applications.

247. The implementation of plans of action such as the above requires the availability of specialized expertise specific to each type of intervention. It is best to ensure that such expertise is available before making specific commitments in this area.
B. East Africa

1. The Current State of Rural Finance in East Africa

\textit{a) General Characteristics}

248. The main characteristics of the countries in the sub-region are:

- considerable economic poverty that can be seen in the per capita GNPs, ranging from $110 to $350 per inhabitant for more than half the countries in the sub-region. Eighty-three percent of the rural population lives in extreme poverty,\(^{32}\)
- strong demographics: the 21 countries comprise 350 million inhabitants (63 million in Ethiopia, 30 million in Kenya, 24 million in Tanzania, and 23 million in Uganda),
- the preponderance the rural world, in which 3 out of 4 inhabitants of the sub-region live and depend on agricultural for survival,\(^ {33}\)
- centralized government very present in economic regulation until recently and slow to adopt the necessary reforms.

249. Poverty reduction - the main challenge in this region - clearly depends on rural development.\(^ {34}\)

\textit{b) The Characteristics of Microfinance in East Africa}\(^ {35}\)

250. The microfinance sector is usually made up of two sub-groups:

- Member-based microfinance institutions (MFIs) such as Savings and Credit Cooperatives (SACCOs), and financial services associations (FSAs in Kenya).
- Non-member based microfinance institutions such as solidarity group lending systems and small enterprise loan systems.

251. Until recently, in East Africa, the member-based MFI sector was not seen as belonging to microfinance because of the strong influence of the promoters of the second category. Today, this gulf tends to narrow and countries are starting to define sectoral policies that cover both categories and place them under the supervision of the monetary authorities, clearly showing them to be part of the financial sector.

252. MFI penetration rates in the sub-region are relatively weak—approximately 1 to 2\% of total population, with some concentration in urban areas and very little coverage of rural populations. SACCOs are present in rural cash crop (coffee and tea) production zones. There are practically no microfinance interventions in areas of rural staple food crop production.

\textit{1) Savings and Credit Cooperatives (SACCOs)}

253. Depending on the political history of the country in question, the savings and credit cooperative sector is more or less developed. Thus, in Kenya, SACCOs are very present in large cities and rural towns, have close to 2 million members, mobilize millions of US dollars in savings, and play a very large role alongside commercial banks. However, in countries such as Tanzania and above all Ethiopia, successive governments’ policies were not favorable to the cooperative movement and those structures were forbidden to operate during certain periods. SACCOs there are either very few (especially in rural areas of Ethiopia) or very weak (in Tanzania), playing hardly any meaningful role in financial intermediation. However, this movement is currently gathering momentum.

\(^{35}\) Comparative study of member-based MFIs in East and West Africa – MicroSave / UNCDF – 2000.
254. SACCOs share certain characteristics:

- Presence in cities close to populations made up of enterprises’ salaried staff,
- Presence in rural areas limited to large towns in cash crop production zones where they form the financial counterpart to cash crop (coffee, tea) production cooperatives from the time when a State monopoly relied on cooperatives to commercialize these products,
- Absence in staple food crop production zones, remote areas, and villages.

255. Their operating methods also show some similarities:

- Strong capacity to mobilize savings despite somewhat unattractive product and interest rate policies (commercial banks create increasingly strong barriers to accessing their services, pushing small savers more and more towards SACCOs),
- Weaker capacity in loan disbursement and management (outside of loans secured by payments for cash crops), which gives them excessive liquidity: SACCOs place most of the savings they collect in banks or in the Cooperative Bank. SACCOs therefore do not meet the credit needs of their members who continue to make use of rotational savings and credit associations (ROSCAs, very numerous in these countries) to finance their needs.

256. With the liberalization of the economy, SACCOs must undergo considerable change and redefine their roles in the economies of their countries. They will need to review their policies pertaining to member services and acquire new skills.

2) Client-Based Microfinance Institutions (MFIs)

257. With the exception of Ethiopia, client-based MFIs were set up by NGOs supported by donors in the 1990s. They share the following characteristics:

- Concentration in cities,
- Focus on the medium-income small entrepreneur clientele,
- Use of the solidarity group lending approach, which is quite restrictive and may possibly explain their relatively low outreach (the largest have approximately 25,000 clients, in Tanzania and Kenya),
- Professional management that is relatively centralized and standardized, leaving little room for clients in the definition of products and participation in management,
- Considerable use of loan fund capital from outside donors (either grants or loans at concessional interest rates),
- Little mobilization of local savings and little coordination with their countries’ banking systems.

258. In Ethiopia, the main microfinance institutions were promoted by the government - who continues to play a central role both as shareholder and member of boards of administration, and as provider of loan capital. These MFIs tend to be present in rural zones and reach a population made up of small and medium agricultural producers, providing agricultural and rural loans and mobilizing the savings of their clients and of local institutions. They have good repayment rates and are relatively efficient. Their fragility is often found in strong dependence on subsidies and government funds, which can influence their governance and sustainability. These MFIs are concentrated in two regions (Tigray and Amhara), leaving the rest of the country relatively uncovered.

3) The Legal and Regulatory Framework

259. Ethiopia is the only country to have created a regulatory framework specifically for microfinance by establishing a license for microfinance institutions in the form of public limited companies. This framework is more open, which has allowed approximately twenty local structures to obtain licenses in four years. The Central Bank is the supervisory body although it does not really have the tools it needs to ensure control.
260. In Tanzania, there is a national microfinance policy that includes SACCOs, banks working in this field, and NGOs although no specific regulatory framework has yet been defined.

261. In Kenya, SACCOs still depend on the Ministry of Agriculture, which removes them from the financial sector. NGOs that promote microfinance projects have clearly separated this component from their other activities and given the activity a specific legal identity although not that of a financial institution, as such. Only K-REP has made the full transition from NGO to commercial bank. licensed by the Central Bank.

262. In general, governments are aware of the stakes for microfinance and favorable to developing this sector.

2. IFAD’s Microfinance Interventions in East Africa

263. Previous projects focused on granting agricultural loans, either for inputs or medium-term loans to finance animal-drawn cultivation, irrigation equipment, and soil preparation.

264. During the 1990s, the development banks in the sub-region were closed or privatized, largely depriving IFAD of its traditional formal sector financial partners. In addition, IFAD sought to offset the generalized culture of not repaying loans that was widespread above all in countries where the government showed little determination to implement reforms.

265. In 1993, a turning point was reached, both with the introduction of savings mobilization 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.

266. This new orientation is coherent with IFAD’s regional strategy which aims to “enable the rural poor to overcome their poverty”. This poverty reduction strategy is resolutely focused on growth and concentrates on the regions with medium to high production potential. There, it is a matter of providing a response to the demand of the rural poor for a range of financial services including savings, loans to smooth consumption and face shocks, financial transfers, and secure household subsistence. 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.

267. At this stage, the majority of non-bank financial institutions and savings and credit cooperatives or other member-based organizations are only getting started and the institutional environment requires mainly capacity-building initiatives. It appears that sustainable development support for rural financial systems will be necessary for the next 10 to 12 years.

268. The present RF programmes funded by IFAD are characterized by three aims:

- developing grassroots organizations,
- improving the legal and regulatory framework, and
- coordination with commercial institutions.

269. This is the case for recently approved programmes in Tanzania (2000), Ethiopia (2001), and Uganda. In order to best support these interventions, decision tools may be used in the following fields:

- identification and selection of the RFIs, based on their potential to meet IFAD RF objectives;
- conditions and modalities for accessing bank refinancing;
- conditions to be met for institutions mobilizing deposits, and support through appropriate TA;
- policy dialogue with governments to create an enabling environment for grassroots initiatives;
- policy dialogue in support of appropriate legal and regulatory framework for microfinance; and

• the role of PMOs, specialized technical assistance, and cooperating institutions in implementing and monitoring RF projects.

3. Operational Considerations for IFAD Rural Finance Interventions

270. The tools the division may need more specifically, given the new direction taken by rural finance programmes in the region, will be discussed here. Mobilization of savings in particular is a new element in the reorientation of IFAD’s programmes, along with policy dialogue and improving the regulatory framework in the region.

271. As underlined in Part I, Section E, understanding when and how to promote savings mobilization, and ensuring that the necessary safeguards are in place when doing so, are crucial issues for IFAD to reflect upon in its interventions.

272. The issue of legislative and regulatory framework is also of key importance in Eastern – Southern Africa. Paragraph c) highlights what may be considered as an optimal development process for such policy, that would protect savers while not imposing a premature framework (which could have the adverse consequence of slowing the microfinance industry’s growth and stifling innovation). IFAD however should carefully assess its comparative advantage before getting directly involved in this technical area, which may best be let with more specialized partners with strong field presence. IFAD may however engage, when appropriate, its government partners in understanding the process and ideal sequencing they should consider when planning to introduce such legislative /regulatory frameworks.

a) Requirements and Responsibility for Institutions Mobilizing Micro-Savings

273. As part of the new direction taken by IFAD for rural finance in the sub-region, mobilization of savings appears to be a crucial element today.

274. However, savings mobilization implies a number of risks and responsibilities, and therefore the meeting of preconditions, before it is encouraged. The preconditions for RFIs to mobilize savings, the considerations as to an appropriate design of savings services, and the operational implications for IFAD’s support to savings mobilization (especially with respect to areas of possible interventions) are developed in detail in Part I, Section E. They apply particularly to the opportunities and challenges that IFAD faces in East Africa.

b) Elements of Policy Dialogue with Governments to Create an Enabling Environment for Grassroots Initiatives

275. Since IFAD wishes to support the autonomy of rural populations and their organizations, it is indispensable to engage in policy dialogue with States so that they facilitate grassroots economic initiatives and free association, and encourage the emergence of motors for popular proposals.

276. In order to do so, IFAD should help States clarify their roles as creators of favorable environments and as supervisory and control authorities and relinquish direct involvement in promoting and managing economic and financial systems so as to not be both judge and jury.

277. The State should create the conditions for micro-enterprise development, initiative-taking in the framework of local and community development, and the emergence of local economic operators. It should be committed to non-interference in the orientation and decision-making of grassroots organizations, and in the implantation, loan and interest rate policies of microfinance institutions.

c) Elements to Consider when Analyzing the Legal and Regulatory Framework for Microfinance

278. When nothing exists as far as a legal and regulatory framework for microfinance is concerned, it is appropriate to analyze the sector’s state of development, its size, its level of structuring, and the maturity of existing entities, in order to determine the timeliness of regulation. When regulations are already in place, it
is appropriate to assess their pertinence in relation to the sector’s development prospects; if necessary, proposals for modifications may be submitted.

279. Several stages are recommended in the setting up of a legal and regulatory framework that takes into account stakeholders’ processes. These are:

- **An initial stage of inventory-taking** and becoming aware of what exists in the field so as to classify entities according to their real situations. This may be done by the regulatory authorities’ offices.

- **A second stage merely recording** these entities with the monetary authority in charge of supervision with a mandatory statement of existence and some basic information such as implantation sites, services offered and means mobilized. Annual activity reports must be requested, accompanied by financial statements. The reports should be treated by the regulatory authorities to establish a database and produce annual sector evolution reports. The authorities can, at this stage, conduct field visits to gain familiarity with these types of entities and better understand how they operate.

- **A third stage, regulating** savings and credit activities by classifying the entities in general categories (with or without savings, with or without bank loans, etc.), planning their licensing accordingly, and defining the management rules to be followed for each category. Moreover, the entities are categorized by segment, according to transaction volumes with corresponding increasing reporting and external audit requirements. The regulatory authorities license and control structures (through documents submitted and on site), and ensure the proper application of regulations by the ensemble of licensed structures.

- **A fourth stage** can be the **legalization of microfinance institutions** strictly speaking - that is to say, the creation of a specific legal status if needed and once the sector has reached a level of maturity at which such status can be defined in a relatively stable manner.

  - Regulations can be established without passing laws, which is always preferable in new sectors of activity.
  - Overly-hasty legislation is often prejudicial for the development of the sector because it tends to create a rigid mould in which all institutes must fit—which inhibits all innovation and reduces the flexibility necessary for the proper operation of these enterprises.
  - Good legislation acknowledges the validity of plurality in approaches and allows all institutions to adopt the type of status and organization that suit them and are appropriate for the market segments they address. All single status must be excluded (only cooperative or joint stock company).
  - When the State or monetary authorities formulate regulations and pass laws, it is crucial to ensure that they have the means necessary for implementation, monitoring and control. Laws that are not applied, regulations without supervision and control (or with inadequate control) increases the sector’s fragility rather than making it safer or stronger.
  - Staff working for the authority in charge of supervision should be trained to know and control this type of institution: staff must become aware of microfinance specificities and the need to adapt their skills and attitudes to these stakeholders.
  - It is advisable that all microfinance institution categories be regulated and supervised by the same monetary authorities: Central Bank or Banking Commission. Countries where SACCOS are supervised by the Ministry of Agriculture or the department of Cooperatives and MFIs by the Central Bank create distortions in terms of requirements and norms of good management among institutions that conduct financial activities.
C. Asia

1. Current Status of Rural Finance in Asia

280. The Asia and Pacific region has been host of a great variety of micro and rural finance approaches, some of which have become landmark successes. They include the pioneer model of the Grameen Bank, the subsequent development of some of the fastest growing MFIs in the World (ASA in Bangladesh), innovative models with very strong outreach (self-help groups / bank linkage models in South and South East Asia), reformed state-owned institutions such as the BRI Unit Desai in Indonesia (with its great success in promoting saving mobilization), as well as financial NGOs that successfully transformed into licenced commercial institutions, with impressive outreach (such as ACLEDA in Cambodia or CARD in the Philippines).

281. It is important to highlight the essential characteristics of the Asian context, in view of their impact on rural finance:

- IFAD’s Regional Strategy Paper emphasizes the persisting high incidence of poverty in Asia; the growth and profound economic changes in the region over recent decades seem to have been accompanied by an increase in economic inequalities. More than two-thirds of the world’s poor live in Asia, and South Asia represents approximately half of this figure. Furthermore, the accent is on rural poverty: Eighty to 90% of Asia’s poor live in rural areas; the rural population still represents more than 50% of the active population in most of the countries of the region.

- Poverty affects areas of low agricultural productivity in particular - notably, upland and mountain areas frequently inhabited by minority ethnic groups. In Vietnam, for example, the IFAD regional strategy paper notes that the incidence of poverty among ethnic minorities ranges from 66 to 100%, whereas the national average is 51%.

- One must emphasize the extremely high variations between and within the different zones in Asia, in terms of both general environment (density, climate) and culture / social context that encourage or hinder the formation of groups and people’s participation, justifying equally diversified intervention methodologies. Within a given country and especially in rural/mountainous zones, one can note the presence of ethnic groups with very diverse cultures, religions, languages, and social structures; this can be very marked even within provinces (for example, Shan State in Myanmar comprises a dozen different ethnic groups).

- The level of State intervention in most of these countries is generally high. Nevertheless, Asia forms a set of very heterogeneous countries and in certain cases one can note movement towards liberalization. The fact that some countries stand out as exceptions, and have significantly more liberal environments (Cambodia, Mongolia), must also be emphasized. This has resulted in microfinance success stories regarding State intervention in the sector, such as Bank Rakyat Indonesia (BRI) and the Bank for Agriculture and Agricultural Cooperatives (BAAC) in Thailand. However, strong State involvement in some cases has also resulted in constraints to microfinance development (rate caps, subsidized State interventions, etc.).

38 see Regional Strategy Paper, IFAD: “Recent studies show that income inequality is increasing in several Asian countries that had achieved both high economic growth rates and significant poverty reduction in the last three decades. This will have a major adverse impact on poverty-reduction efforts […]”

39 The RSP emphasizes the causes of this poverty among ethnic groups: non-access to resources, of course, but also political oppression and population displacement.
• The microfinance sector’s maturity level varies greatly. For example, in Mongolia and Bhutan, this sector is just emerging whereas in Bangladesh and India the sector is very structured and includes many stakeholders. In countries where microfinance is just emerging (Mongolia, China), there are few quality partners, and they are not very present in rural areas. On the contrary, in countries where microfinance is already well developed (Bangladesh, Indonesia, etc.), the supply is diversified. In some countries, one can also note the co-existence of different models (CBO linkage and solidarity group lending in Bangladesh).

282. In Asia, IFAD often faces the following dilemmas: should it support and help reform existing partners, even if they are weak? Should it help set up new institutions? How can IFAD become involved in piloting innovative RF approaches within State-controlled institutions (Post Banks in Mongolia, Rural Credit Cooperatives in China)? Which model should be privileged and in which environment?

2. IFAD’s Interventions in Asia

a) Current Interventions

283. Since 1978, IFAD has funded 153 projects in Asia and the Pacific for a total commitment of approximately USD 2.4 billion (see IFAD Regional Strategy). Out of the Fund’s USD 602 million in outstanding loans in 1999, microfinance represented 253 million (42%), spread over 15 different countries. The main microfinance commitments are in China (45%), India (15%), and Indonesia (10% for only one project.

284. Projects that include ‘microfinance components’ are being progressively abandoned. IFAD interventions in Asia concern mainly the rural finance sector, through support to systems using a variety of approaches that can be classified in three general categories:

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

285. One of IFAD programme characteristics is that its interventions have often targeted remote rural areas (mountainous areas where ethnic minorities are predominant).

b) Lessons Learned from these Interventions

286. As mentioned in Section II.1 (choice of models), the underlying question in Asia, as in the other regions, is not so much that of identifying which model is best, but rather assessing the strong points and unanswered issues of the models tested in different contexts, in order to identify practical operational recommendations for IFAD programmes. With regard to each of the three categories indicated above, a certain number of lessons have been learned.

287. A brief summary of the advantages and risks identified for each of the types of models tested in Asia is presented below.
Self-Help Groups – Bank Linkage Model

**Strong points**

- The outreach of these systems is very impressive (at the end of 2000, the self-help group programme supported by Nabard in India covered 5.8 million members through 364,000 self-help groups, 194,500 of which had links to banks).
- Strong community participation in launching and managing systems can have positive impacts beyond financial services alone (collective organization of other services such as mutual assistance, literacy, collective infrastructures, etc.).
- This model can have a very strong demonstration effect (e.g. spontaneous creation of groups in India, for example).
- Self-help groups are strongly oriented towards client demand and can be innovative in terms of financial products and services (as was shown by the analysis of 6 cases of SFCLs in Nepal).
- When they are effective (India), links with bank refinancing may help anchor the self-help group system in the national financial sector.

**Limitations and questions**

- Uncertainty remains as to the capacity of self-help groups to survive after the departure of the supporting NGO that has played a crucial role in launching the system. Surely, long-term subsidies would be required for these systems?
- Links with the banking sector are possible in countries where the State shows strong determination to provide support and has an objective interest in making under-utilized bank structures in rural areas profitable (BRI in Indonesia, CBs in India). Are such links possible elsewhere?
- It seems necessary to reflect on an umbrella structure or common services and financing for the creation of such structures or services: reflections on sustainability must include the whole system rather than just the groups alone. These reflections have only just begun and need to mature.
- Analysis of the cost of the system and its financial equilibrium should include (if necessary) the need for long-term support from NGOs or umbrella structures. In most cases, the overall reflections on the system’s sustainability still need to be undertaken.
- Frequently, there is insufficient information available to judge financial performance – mainly because these systems rarely have complete management information systems, especially when it comes to arrears.
- The question has been raised as to whether or not the very poor are excluded from these groups.

288. In short, several key issues would need to be further assessed:

**Social Mobilization**

- Analysis of prior social cohesion and informal activities (informal financial systems) is particularly crucial for two reasons. First, this level of participation by the population in managing the financial system may not be appropriate in certain social environments (groups of 15-20 people are not always possible in some contexts). Second, caution should be exercised to avoid imposing a self-help group structure that would replace other traditional solidarity mechanisms instead of complementing or strengthening them.
- To what extent are supporting NGOs indispensable for coordinating and/or running self-help groups after the launch phase, or can the groups’ mobilization be maintained without support from NGOs/GOs? Is this support recurrent? If so, who will finance it in the long term and what role will these groups have in the governance of the structure? If not, how can one prevent possible drift by these groups after the departure of the NGO?

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• Generally speaking, it seems important to validate the extent to which the creation of groups and the nomination of representatives for these groups truly reflect organization by the clients themselves—which, in any case, takes time.

**Ties with Banks**

• When supporting this model, prior analysis of the banks’ interest and services, and of State involvement, is crucial in order to measure the self-help groups’ refinancing possibilities.
• Beyond the political determination displayed, it is important to measure the banks’ real interest in ties with self-help groups: What is their financial interest and what risks will they take? How viable are these banks?

**Governance**

• The need to plan a legal status for self-help groups or self-help group federations is becoming increasingly obvious. In India, for example, banks objectively take risks in refinancing these groups without a clear legal framework.
• The question of amalgamating self-help groups or setting up common services for these groups also needs to be addressed. No matter how well the groups function, group leaders have limited capacity to manage financial products and recurrent training needs. Technical support (financial control, management information systems) is needed. In addition, groups often have difficulty in negotiating refinancing conditions directly with banks.
• Several questions arise when planning the setting up of umbrella structures or common services: How will they be financed? Are the self-help groups ready to request and pay for common services or political representation (negotiation of refinancing conditions)? Is the whole structure (groups + umbrella structure) viable? How should its governance be organized?
• In the case of bankruptcy, who will be accountable? What will be the share of responsibility between banks or a federation of these groups?

**Sustainability**

289. It seems necessary to reflect further on how sustainability can be achieved for this model by:

• strengthening information systems, notably to ensure more precise long-term monitoring of arrears;
• undertaking detailed analysis of costs for the whole structure (including, for example, second-tier representation when deemed pertinent), and assessing whether or not the interest rates charged on loans would enable the system to be sustainable.
• monitoring these systems’ clientele (are they part of the poor or the very poor - or is the system used more by a well-off minority of villages?) and verifying that the products match needs. An important indicator would be client dropouts; it would be interesting to understand the reasons behind a high proportion of dormant groups, in some cases (a 1994 evaluation report indicated 23% of dormant groups in Indonesia (48% in West Java)\(^{42}\)).

290. In conclusion, at this stage there is a very promising scope for IFAD to further analyze and document this model in order to gain a better understanding of its success and vulnerability factors, and the conditions for successful expansion / replication.

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\(^{42}\) Indonesia: Income-Generating Projects for Marginal Farmers and Landless, Mid-Term Evaluation Report, October 1994
Pilot reform programmes within State-Owned Banks

<table>
<thead>
<tr>
<th>Strong points</th>
<th>Limitations and questions</th>
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<tbody>
<tr>
<td>• If the pilot reforms are successful, they may have a strong demonstration effect for the SOB and the State’s RF policy.</td>
<td>• Even with successful RF pilot programmes, reforms risk being cumbersome and costly, with a real risk of failure. Among the difficulties to be addressed are:</td>
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<td>• The structures concerned (RCC in China, for example) have massive networks in rural areas and some comparative advantages for a rapid up-scaling of successful pilot programmes.</td>
<td>- Governance issues, which are generally complex;</td>
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<td>- internal resistance, which may often be considerable (attitudes of staff and regulatory bodies, sometimes limited knowledge of the target clientele);</td>
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<td>- products not suited to the poor clientele (e.g. collateral required for loans); lack of flexibility in procedures and products;</td>
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<td></td>
<td>- lack of competent staff and executives when it comes to techniques and management; and</td>
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<td>- a considerable volume of doubtful debts, which is a specific problem to address.</td>
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291. More specifically, the following considerations may be considered when dealing with pilot reform programmes within SOBs (these are in part reflected in the interesting thematic study done on IFAD recent RF programmes in China)43:

- Working on a pilot scale initially makes it possible to verify the feasibility of the reform and the system’s sustainability prospects. The “experimental” notion is also a political argument: governments may accept as ‘experiments’ situations that they would probably not accept on a larger scale.
- Which zones/structures should be chosen for pilot reform projects? This question was raised for the RCCs in China, as their contexts and levels of development were very heterogeneous. The reforms would perhaps have a greater chance of success with the best performing RCCs (motivated staff, dynamism), but these cooperatives are not necessarily interested in the prospect of attracting a new clientele and they are not necessarily in the often isolated, rural zones concerned.
- Prior in-depth analysis of the strengths and weaknesses of the structure to be reformed is required, to enable the carrying out of a real diagnostic study, as the starting point for project design.
- Government confirmation of its strong political support for the project is indispensable.
- It is important to verify the structure’s interest in the reform and in lending to the target population (and not only to the best-off segment), and also to analyze in detail how well the products and procedures match these people’s requirements, so as to help these services to progress.
- It is key to increase, to the extent possible, the accountability and responsibility of the structures concerned by reforms. This means verifying the structures’ financial interest in the reforms beyond political support. This also means that these structures, which are made responsible for borrower selection and recovery, should be able to take charge of the risk.
- Providing technical support is key because this type of institution suffers from a lack of technical skills on the part of staff; capacity-building may also be necessary for regulatory bodies.

43 see “Thematic Study on Rural Financial Services in China”, December 2001, IFAD.
292. In conclusion, the success of State structure reforms requires prior strong political will on the part of the country concerned. In this case, it is particularly pertinent for IFAD to get involved in policy dialogue with the State, making it possible to implement the reforms successfully, define an appropriate legal framework, and remove existing constraints to microfinance in the country. When in-depth prior diagnostics confirm the interest in attempting this type of reform, it is nevertheless preferable to pilot test it so as to verify the experiment’s accomplishments before expanding on a larger scale.

1) NGOs/Financial Institutions

293. In reality, this is not a true model, as such, because very different realities co-exist under the form of NGOs and financial institutions: more or less decentralized systems, different capital structures, varied levels of client participation in management, different approaches regarding savings mobilization etc. The more heterogeneous nature of this category makes it difficult to list specific strengths and weaknesses. Nevertheless, IFAD’s experience in Asia reveals the following elements:

- It is not a standard model but multiple options that can be relatively flexible and adaptable. The clients’ level of participation in the methodology can take on diverse forms: participating in equity financing, management, and/or loan distribution in function of the context.
- In Asia (Philippines, Cambodia), these NGOs/financial institutions’ methodologies are often based on small, progressive loans with or without compulsory or voluntary savings components. A central or regional technical division supports the local branches/units.
- Institutional considerations (financial viability, organizational self-sufficiency, legalization) are generally taken into account relatively far upstream. However, no matter what methodology is chosen, establishing a sustainable institution is a long-term task (notably in less favorable, sparsely populated, or mountainous rural areas).
- It is particularly important to incite this type of institution to be demand-driven; it is sometimes tempting for them to develop very rapidly, based on only one relatively standardized product - to the detriment of flexibility in services and adaptation to changes in client needs. The risk is client dropouts; it is crucial, therefore, to set up adequate tools to adapt and diversify products.
- For the Grameen Bank-type approach to solidarity group lending, as for any model, attention must be paid to the model’s replication limits and the requirements for its adaptation to local contexts need to be taken into account.

3. Operational Considerations for IFAD Rural Finance Interventions

294. Four priority niches for IFAD interventions may be identified, that correspond to its comparative advantages:

- **Work with poor populations in remote, mountainous rural areas**: intervening in such conditions presents additional difficulties but IFAD’s experience in Asia gives it a comparative advantage in relation to other donors.
- **Analyze and document self-help group and CBO linkage experiences**: above all, it is a matter of learning lessons from the major examples of this model, notably in India, to analyze replicability in other environments. This implies conducting in-depth studies, perhaps on the oldest and most ‘mature’ examples of this model (Maharashtra in India, certain SFCLs in Nepal).
- **Pilot test State structure reforms**: here, too, it is a matter of testing an original model on a limited scale and capitalizing on these experiences.
- **Policy interventions** with governments and in dialogue with all stakeholders - notably in countries where the sector faces strong constraints (capped interest rates or other obstacles to the viability of MFIs) or in countries were microfinance is only just emerging (Laos, Myanmar).
In the above context, and in line with its present interventions, IFAD faces a few key operational questions, highlighted below:

**a) How Can the Poor Populations Be Reached?**

Given IFAD’s frequent interventions in remote rural areas, one of its constant concerns in this region is knowing how to reach poor populations, how to verify that they are really part of the RFI client-base and whether access to financial services actually contributes to their social and financial empowerment.

On this aspect, three key points mentioned in the previous sections of this document are of importance:

- The surest way to offer the poor long-term financial services is to set up sustainable microfinance institutions. The prospect of financial equilibrium for these institutions should be envisaged right from start; when designing projects, attention must be paid to avoid defining an overly narrow target that would work against this objective (for example, targeting the poorest 10% of farmers in each village is most likely not viable for an MFI in a mountainous areas with sparse population densities).
- It is not so much a matter of targeting the poorest in remote areas but rather one of proposing products that are appropriate for this target population and planning an equally suitable mode of management for the institution (notably, the amount of decentralization).
- Tools to monitor the clientele, understand its needs, and adapt products to better meet these needs do exist (client satisfaction or dropout surveys, for example). These tools (by AIMS and MicroSave, notably) were described in part I of this document.

**b) What Should the Population’s Participation Be?**

In Asia, the question of people’s participation in rural financial systems is central, notably for models such as self-help groups.

As indicated in part I, client participation can take on different forms in microfinance institutions: participation in borrower selection, the decision to grant loans, management, ownership, etc. Rather than starting from pre-conceived ideas on this subject, it is appropriate to start from the awareness that the desirable level of participation depends heavily on the specific context. Above all, it is indispensable to take into account existing social models that should be analyzed in feasibility studies.

In some countries, such as Vietnam or China, society is organized at all levels (local/village level to national level), both politically (e.g. elected representatives in villages) and through the implantation of mass organizations (Women’s Union, Farmers’ Union, etc.). In terms of ‘participation’, in such contexts, one should consider that groups or associations cannot be formed independently of this pre-existing structure. While these mass organizations can play an active role in social mobilization, intermediation in selecting borrowers and in organizing credit, they are not, however, qualified or able to replace MFIs.

When working in a decentralized manner with local elected officials, the risk is that the credit tool (which carries strong social and financial stakes) may be taken over by a few influential persons, to the detriment of IFAD’s project target (the very poor households). To prevent this, particular attention should be paid to understanding the RFIs’ real clientele, in particular by using the tools developed by AIMS or MicroSave (clientele surveys, client dropouts, etc.).

**c) Must One Chose a Model?**

As indicated in part II, it is important to remember that the approach taken in designing an intervention methodology should not be exclusive. Rather, it should take into account several options and chose among them, according to what the potential partners may propose, based on its experience and know-how. Ideally, one should retain realistic options - outside of any ideological debate - that correspond to the potential partners and the particular context.
303. This is all the more valid in Asia, as the main models supported by IFAD have not provided full answers and validation regarding several key aspects pertaining to governance and sustainability prospects. A promising task for IFAD could in that context be to capitalize on the experiences that seem the most advanced, using field studies before proposing the elaboration of similar experiments in other contexts.

d) **What Monitoring Should IFAD Implement?**

- Whatever the model, it is necessary to take into account legislation and governance issues as early as possible. (In the case of self-help groups, for example, reflect on the need for federations, support services, and the possibility of the cost being borne by the groups).
- Planning for long-term support is all the more necessary when IFAD intervenes in relatively disadvantaged zones or in ambitious public structure reform programmes. This implies reflecting as much as possible on a realistic time-frame required for the institutionalization of financial structures (at least 10 years in sparsely populated zones). It is also a matter of using technical assistance to support MFI capacity-building, more than providing lines of credit.
- Whatever the model, better development and optimization of the monitoring tools used (financial indicators and portfolio analysis as well as clientele monitoring) would help to have a clearer assessment of project performance.

e) **Enter into Policy Dialogue**

304. In some countries in Asia, several hindering factors are linked to State intervention. Positioning itself as a policy interlocutor for the government, in consultation with other donors, is a real stake for IFAD in this region. Long-term dialogue with Governments can make it possible to:

- **Lift constraints on the microfinance sector.** Capping rates is often a key question in several countries. It is necessary to prove to the government, both in practice and based on impact assessments and/or an analysis of informal sector rates, that sustainable access to financial services is often considered more vital by poor populations than the cost of these services.
- Create a **favorable context for a pilot reform of public structures** and accompany the demonstration effect in the case of successful pilot tests.
- Lead the State to acknowledge the **validity of diversity in microfinance approaches**, in order to provide access to basic financial services for the largest clientele possible.
D. Central and Eastern Europe


305. The countries of Central and Eastern Europe currently borrowing from IFAD are: Albania, Armenia, Azerbaijan, Bosnia and Herzegovina, Georgia, the Republic of Moldova, Romania, and The Former Yugoslav Republic of Macedonia. This group of countries comprises 53.3 million inhabitants, 23.2 million of whom live in rural areas and earn their livelihoods from agriculture.

306. The collapse of the former centralized economy and the closure of many state-controlled financial institutions have let a vacuum in the provision of rural finance services. Although the past ten years have witnessed the emergence of several successful microfinance banks in the region, their operations have mainly remained concentrated in urban areas.

307. The poverty situation in this region is an unusual one and represents a unique challenge for IFAD. Just like poor people elsewhere, the poor in the countries of this region lack access to basic services, have a low standard of living, and feel powerless and insecure. Unlike other parts of the world, however, this situation is relatively new. Currently, the people living in transition countries attend schools and many are well-educated. Until recently, they enjoyed secure employment and social benefits. Poverty reached its current level - one person in five in the region lives on less than USD 2.15 per day - only after the collapse of the Communist system.

308. Poverty and inequality are much higher in rural than in urban areas. Despite land reforms and other important policy changes, rural incomes have remained stagnant because of limited access to inputs, technologies, markets, and off-farm employment opportunities, and the scarcity of rural credit. The main challenge for poverty reduction is to build new institutions adapted to current realities.

2. IFAD’s Rural Finance Interventions in the Region

309. 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 lines of credit to existing banks, in order to facilitate their access to bank financing.

3. Operational Considerations for IFAD Rural Finance Interventions

310. IFAD could encourage a more in-depth assessment of the concepts of Savings and Credit Associations (SCAs). This initiative would also benefit other donors that have been supporting this model. In particular, the prospects of institutional and financial viability for this model may be further analyzed (for example, by applying the CGAP Format for Appraisal of Microfinance Institutions to on-going initiatives).

311. As for existing commercial banks, the challenge seems 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…). In this area, IFAD could develop promising partnerships with some microfinance operators that have already successfully enhanced local bank capacity to enter this market (such as IPC). IFAD may negotiate with such partners to extend their activities in rural areas, where access to basic financial services has been scarce.

312. IFAD may finally have a role to play in supporting, in coordination with other donors, a policy dialogue with governments on the setting up of an appropriate regulatory framework for rural finance institutions, based on the analysis and general policy recommendation reflected in Part I.F.3.
E. Near East and North Africa

1. Current State of Rural Finance in the Near East and Africa

313. Most countries in the region (with the remarkable exception of Lebanon) have a history of direct State intervention in the financial sector. The current level of intervention of local governments remains generally high, resulting in important constraints for the development of sustainable RFIs (such as interest rate caps and subsidized credit). In some countries, the government’s position has been recently evolving towards liberalization.

314. Existing CBs and microfinance institutions are mainly concentrated in urban and periurban areas. The delivery of financial services to rural areas has long relied on large SOABs. However, there is a large consensus on the fact that these SOABs generally failed to provide adequate financial services to the poor. The adjustment programmes launched in the 90’s reduced the resources of governments and accelerated the difficulties of these large banks.

2. IFAD’s Rural Finance Interventions in the Region

315. The countries of Near East and North Africa currently borrowing from IFAD are: Algeria, Egypt, Jordan, Tunisia, Lebanon, Morocco, Sudan and Yemen. This group of countries represented in 1999 USD 214.4 millions in outstanding loans, of which microfinance represented roughly 40%.

316. IFAD’s intervention in RF in the region has long been through the provision of credit lines to SOABs. The cooperation with SOABs has now declined and recent projects concerning SOABs tend to focus on small-scale reform initiatives: in Algeria, a recent IFAD project encourages the pilot creation of local “Caisses Mutuelles de Proximité” out of the national, large “Caisse Nationale de Mutualité Agricole”.

317. Increasingly, IFAD also tends to support the provision of short-term credit through emerging specialized NGOs, while relying on SOABs for medium- and long-term lending only.

318. Two interesting initiatives supported by IFAD in the region must be highlighted:

- In Lebanon – a country with a favorable context (no direct government intervention; free interest rates) – IFAD supports the establishment of a network of SCAs. An interesting point is that two local commercial banks have accepted to refinance the SCA network, not only through a secured credit line from IFAD but also with their own funds.

- In Syria, IFAD is taking advantage of the recent openness of the government to support the development of a network of small credit associations in rural areas - the ‘Sanduq’ network.

319. It must be noted however that both experiences are still very recent and not yet mature. In particular, the institutional model of the Sanduq network in Syria still has to be defined and its viability prospects further analyzed.

320. IFAD is finally actively involved in policy dialogue in several countries of the region.
3. Operational Considerations for IFAD Rural Finance Interventions

321. Based on the general recommendations in Part I Section C, it might be possible to test a cooperation with carefully selected SOABs, on the basis of pilot technical assistance programmes (and not through the provision of credit lines to these institutions). The recommendations and possible options highlighted in the above section may apply here.

322. Since very few SOABs may be ready or able to launch pilot programmes based on new rural finance practices, IFAD should consider, when possible, support to alternative RF models. IFAD should however ensure that:

- Such projects take into account at an early stage the issues of institution-building and sustainability; in particular, interest rates should be set at a level ensuring the institution’s full sustainability.
- Specialized technical assistance is provided to those RF programmes – one should avoid to rely on generalist, non-specialized NGOs for capacity building.
- The RF methodology should be carefully appraised before up-scaling the programme; in-depth analysis of the strength and weaknesses of the approach should be assessed to verify the sustainability prospects and set the conditions for successful expansion.

323. Taking into account its experience in policy dialogue in the region, IFAD may have a role to play in supporting the evolution towards a more conducive enabling environment for RF. However, given IFAD’s limited resources, the Fund may want to concentrate on a few countries where an evolution in the environment seems possible in the short run.
D. Latin and Central America

1. Current State of Rural Finance in Latin and Central America

324. Five hundred million people live in Latin American, three fourths in or around urban areas - half of which in Brazil and Mexico. The main characteristic of this region is the existence of a ‘dual’ society marked by very strong social inequalities inherited from the colonial era – notably, with regard to access to productive resources and land in particular.

325. While growth occurred nearly everywhere in the past ten years, the number of poor and very poor people has also grown to reach approximately 40% of the region’s total population (slightly more than 200 million people). This increase in poverty seems to have been accelerating since 1997 at an alarming rate of between 10 and 20% in Central America, Venezuela, Mexico, and Brazil in the past four years according to IFAD.\(^4\) Thus, the wealthiest 20% receive 60% of total incomes whereas the poorest 20% receive only 3%.\(^5\)

326. Ninety percent of rural poverty is concentrated in four large arid and semi-arid ecosystems that cover 9 million sq. km., including north-eastern Brazil, northern Mexico, the Pacific coasts and the central regions of Honduras and Nicaragua, as well as the Andes regions of Peru, Ecuador, Bolivia and northern Chile. Two-thirds of rural populations presently live below the poverty line - that is, approximately 80 million people, including 24 million indigenous peoples.

327. It is estimated that the microfinance sector’s outreach in Latin America; in 1999, was of 1.5 million clients, or between 4 and 8% of the poor and very poor in the region.

328. The first observation pertains to the imbalance between the microfinance’s very low penetration in the most heavily populated countries, such as Brazil, Mexico, and Argentina, and its greater penetration in countries such as Columbia and Peru. The areas in which microfinance is little developed - Mexico and the MERCOSUR countries - are relatively rich and have interventionist governments when it comes to financing the economy and agriculture. In other countries, microfinance has reached level of penetration of almost 30% of poor households (although a strong disparity remains in these cases between urban and rural zones. It is clear, therefore, that there is still a large unmet demand from poor people for financial services, in rural areas.

329. Regulated institutions now dominate the microfinance market with 53% of the clientele and three fourths of the outstanding loan portfolio. A few large institutions and networks, such as PRODEM in Bolivia, Caisses Municipales in Peru, and Genesis in Guatemala serve most of the microfinance sector’s clientele.

330. The special-licensed limited public companies (PRODEM and FIE in Bolivia), companies using the pre-existing legal status for financial companies (CONFIA and FINDE in Nicaragua), and banks (Bancosol in Bolivia), were created by influential NGOs specialized in microfinance. Historically, the majority of these institutions have been oriented towards a rather urban clientele engaged in commercial activities, services, and processing, through the development of various individual and solidarity lending methods. Some of these institutions have however started to expand their activities towards rural areas (PRODEM), as part of a new “frontier” where penetration is still low, compared to urban zones.

\(^4\) Hacia una región sin pobres rurales, Benjamín Quijandría, Aníbal Monares, Raquel Ugarte de Peña-Montenegro, Latin America and the Caribbean Division, FIDA, 2001

\(^5\) In Regional Strategy Paper: Latin America and the Caribbean, IFAD, March 2002.
331. The State-Owned Agriculture Banks’ (SOABs) overall focus on agro-export activities as well as their usual collateral requirements have largely excluded small farmers. However, some state-owned institutions have started promising pilot microfinance programmes (such as Banco del Estado in Chile and Banco do Nordeste in Brazil), opening up new ground for innovation, and potential up-scaling of those programmes, if successful.

332. Apart from a few exceptions, Commercial banks have tended not to invest in agriculture, or else they have lent to pesticide and input merchants and to enterprises that collect and process harvests (mills, silos). Those, in turn, have sometimes extended loans to small producers. “Because the amounts involved are small and the poor lack collateral, banks are usually not interested in lending to them”.

333. Projects and NGOs not specialized in microfinance abound, above all in Central America and the Andes. They see credit as a means to attain other objectives (for example adoption of ‘modern’ production technologies). These initiatives do not seek the sustainability of the services they offer, and generally combine grants and subsidies with credit, causing high arrears. Consequently, their activities have a tendency to hamper the development of more rigorous systems and spread the idea that loans do not need to be repaid, due to the lack of effective sanctions.

334. Savings and credit cooperatives do not weigh heavily in rural financing as they are above all urban. In the rural world, cooperatives often stagnate, especially when savings are weak and when the literacy level of their members is low (self-management requirements). These cooperatives are frequently dominated by important local figures who sometimes may take advantage of their position to divert funding to their benefit.

335. Community banks have sprung up almost everywhere in urban and rural areas over the past ten years, but they have limited outreach and face governance problems similar to those of cooperatives. Nevertheless, these experiments have the advantage of being more focused on clients’ needs, more frequently involving women, and reaching out to the very poor. By including their clients in management and credit financing through savings collections within the group, these organizations also play quite a tangible role in their participants’ empowerment and education.

336. Dispersed populations in marginal areas with limited economic potential, poor communications and transportation infrastructures, and the low profitability of local producers facing competition from subsidized imports, have contributed to making the RFIs’ operations more risky and costly. They have had difficulty in understanding the complexity of agricultural and livestock activities within family economic units and communities whose first objective has not been profit but risk reduction and food security. Yet, these households form a sizeable and extremely diversified market. It is also within this public that one encounters most endogenous financial systems - ROSCAs, solidarity funds - which clearly indicate the existence of long and productive experience with savings and credit.

2. IFAD’s Rural Finance Interventions in Latin / Central America

337. With close to 150 million dollars invested in the credit components of 38 projects in 22 countries in the region, IFAD is currently one of the major donors in the field of rural finance.

338. Until the mid-1990s, the credit components of IFAD’s projects were set up according to the classical concept by which they were secondary to other objectives, notably increasing production through the adoption of new technologies that often made more intensive use of industrial inputs (certified seeds, fertilizers, pesticides). This model relied on privileged links with public banks who played the role of resource administrator with no financial risk, while loan attribution decisions were taken by the project. The model turned out not to be viable, because of high levels of loan arrears. It had also little impact on the rural poor.

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46 In Enabling the Rural Poor to Overcome their Poverty: Strategic Framework for IFAD 2002-2006
In recent years, IFAD has attempted to improve the effectiveness of its interventions in financial markets by learning the lessons from its wealth of past experience and taking into account the emergence of microfinance organizations, now seen as potential partners. The main changes concern:

- Contractual operations between local credit operators and various local institutions (SACCOs, NGOs, microfinance companies) refinanced through formal banking institutions which administer projects’ credit funds;
- loans geared more towards producers’ demand;
- acknowledgement of the demand for services other than credit - transfers, savings mobilization;
- increased attention to institutional issues.

Today, projects are centered around the issue of partnerships with a diverse group of national institutions (Ministries, commercial banks, microfinance companies, NGOs, SACCOs, etc.). This new approach has started to give an increasing role to microfinance institutions, their professionalization and specialization. It emphasizes the identification of market opportunities and the need to adapt financial services to the needs of the rural poor.

The principle modes of IFAD interventions are:

- New regional support programmes such as SERFIRURAL and TAG/FINCA International in the institutional area of rural microfinance development.
- Certain projects that intervene, in partnership with commercial banks, in the refinancing of financial NGOs, and savings and credit cooperatives.
- Projects working through specialized public institutions, such as Banco de Fomento in Mexico, INDAP in Chili, and Banco de la Republica in Uruguay. However, some are evolving as in Mexico where IFAD today supports the semi-public “Cajas Rurales” network refinanced by Banco de Fomento.

These programmes and projects are facing difficulty with technology transfers and the ties between extension, credit, and subsidies. Often, in the field, one can observe research methods and themes that are not suited to poor farmers, mainly because they did not participate in an appropriate manner in project diagnostic and implementation. Credit is sometimes tied to more or less ‘closed’ sectors (dairy and poultry in Uruguay, coffee in Guatemala) within which small producers may be left out on the larger commercialization circuits, due to a lack of organizations to defend their interests. Experience has shown that instead of strengthening the economic stability of rural MFIs, the above practices may make them more fragile. Three main lessons can be learned from IFAD’s reflections in recent years:

- Efficiency and access are not antagonistic as long as one develops appropriate methods to work with the poor. The key questions pertain to borrower selection, market opportunities, and methods to encourage good repayment.
- It is necessary to respond to farmers’ demands with a suitable supply, and the interested parties need to participate in the definition of this supply. Innovations are therefore necessary in response to the heterogeneous needs of the rural poor and diversified solutions must be found.
- Savings mobilization is important, but should be encouraged under certain criteria and conditions linked to the RFI status and capacity.

47 Purpose: (1) Examine the main obstacles, at the micro, meso and macro level, that limit the access of rural finance institutions to the rural poor and analyze the best way of dealing with them; (2) Assess the experience and interactions between FINCA and IFAD in order to explore the possibility of future joint activities, taking advantage of their individual complementary strengths and unused opportunities; (3) Prepare themselves for the Micro Credit Summit + 5. It is expected that the outcome of these interactions would enhance the contribution of IFAD and FINCA to the Summit.

48 PROSESUR and TROPISEC in Nicaragua and PLANDERO in Honduras, for example.
3. Operational Considerations for IFAD Rural Finance Interventions

343. In which rural finance niche(s) should IFAD intervene? In line with its comparative advantages, the Fund has both the means and tools compatible with medium- and long-term rural finance sector development in the 4 main arid zones where the marginal rural population is concentrated (notably indigenous peoples, most of whom have little or no access to land).

344. In line with IFAD’s general and regional strategic framework, it may therefore be appropriate for IFAD to consider the following areas of intervention:

- Contribute to extending the ‘frontier’ of microfinance more decisively to the rural world. This may be done 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.

- When appropriate, encourage diversification of services towards savings mobilization (for licenced institutions), reflecting IFAD’s overall policy in that respect. “Assistance needs to focus on developing professional and responsive rural finance institutions, with a strong emphasis not just on providing credit but also on encouraging savings”.

- When appropriate, contribute to structuring the rural finance sector by promoting appropriate national policies and more efficient cooperation among donors and within the sector itself.

- Set up effective and useful monitoring and assessment tools based on a limited number of key indicators that would enable IFAD to better assess its present and future RF partners, regarding their outreach capacity (including depth of poverty outreach), institutional strengths and financial performance.

- Support the structuring of RF national sectors, notably through the development of national and regional networks, when feasible and appropriate. This should be done while carefully assessing the added value of those networks to their member institutions and the type of support, services and representation functions they provide them. (one important factor to be assessed in that context would be the members’ readiness to contribute financially to maintaining and expanding those networks).

- Support farmers’ organizations’ development and acquisition of real influence on the economic and policy choices that concern poor producers.

345. IFAD faces a number of important operational questions in Latin America, which are briefly highlighted below.

a) Choosing an Appropriate Model

346. There is no single model that should be encouraged as opposed to other options. Different contexts call for different solutions and innovation. Latin America offers a very large scope and variety of successful microfinance interventions (commercial banks, financial NGOs, community banks, pilot programmes within large SOBs). However, only a few of those partners have started to venture successfully into rural areas. IFAD should support them and, when feasible, help them further “extend the frontier” of their intervention, in line with their own strategies and capacity.

347. In order to strengthen the impact of IFAD interventions, avoid scattering project resources over an excessive number of RFIs but rather choose a more limited number of RF partners who could benefit from more intensive support. In that context, it would be advisable to specify the size of the market each project would attempt to reach. Within project zones, a few institutions could then be selected, according to their capacity and potential to provide financial services to the rural poor on a sustainable basis.

49 Some MFIs that developed very successful operations in urban contexts have been moving into rural areas, with their experience, technical capacity and financial resources. They may prove promising partners in that context for IFAD programs.

50 In Enabling the Rural Poor to Overcome their Poverty: Strategic Framework for IFAD 2002-2006
b) **Project Planning and Preparation**

348. Project identification and design may be improved in terms of better understanding local and national socio-economic dynamics - investment opportunities - and the needs of target populations. Based on local studies, including agrarian diagnostics that provide a better understanding of the strategies and needs of producers, and women in particular, it may be possible to commence dialogue with them and seek financial products that closely suit their needs. These studies should adopt a multi-disciplinary, socio-anthropological and socio-economic approach and include the active participation of producers’ organizations, universities, and specialized consultancy firms.

c) **Strengthening the Sectoral Development of Rural Finance**

349. In addition to interventions focused specifically on selected RFIs, IFAD could envisage - as it has started to do in West Africa - taking an active role in structuring and strengthening the rural finance sector. This could be accomplished by supporting these networks’ representation and exchange bodies at national and regional levels, such as, for example, the Rural Microfinance Forum initiative in Latin America.

350. Supporting dialogue between governments and RFIs would also facilitate the emergence of appropriate national rural finance policies. Specific areas of interventions may include a) helping to set up local and national credit bureaux; b) helping to disseminate and publish information on RFIs for the public - including the clientele; c) undertaking studies and applied training on market behavior, production, and the impact of economic policies in RF.

d) **Promoting a Suitable Legal Framework**

351. IFAD’s projects and programmes would be more efficient, if adjustments and improvements were made to the legal framework for rural finance, with the aim of favoring the implementation of innovative institutional and technical solutions. Whether the need is for grouping local initiatives in emerging networks, external regulation and control of existing networks, or access to savings collection, legislation should be adapted to facilitate the sustainability and expansion of RFIs and their outreach to the rural poor. While reflecting the general considerations on regulation and supervision mentioned in Part I Section G, IFAD interventions may focus on the following:

- seek acknowledgement of an appropriate status for new RFIs;
- prevent discrimination against rural microfinance institutions in relation to banks (interest rates, conditions of operations, prudential norms etc…)
DECISION TOOLS IN RURAL FINANCE

List of Appendices

1. Diversity of Agricultural Financing Needs by Agro-ecological Zone in West Africa
2. Estimated Volume of Agricultural Financing by the MFI's in the WAEMU Zone in 1997
3. Financing Medium-Term Investment: Lessons Learned from CECAM (Madagascar) and ANED (Bolivia) Leasing
4. Farmers Representation in the Evolving Agricultural MFI’s: the Executive Boards in the Madagascar CECAMs
### Appendix 1: Diversity of agricultural financing needs by agro-ecological zone in West Africa

**Attempt to synthesize financing problems by type of stakeholders x agro-ecological zone and activity system**

<table>
<thead>
<tr>
<th>Agro-ecological zones</th>
<th>Dry Sahelian Zones</th>
<th>Forest</th>
<th>Irrigated zones</th>
<th>Cotton zones</th>
<th>Periurban zones</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Activity system</strong></td>
<td>Dry crops without build-up</td>
<td>Extensive, more or less settled, animal farming; major trade zones</td>
<td>Diversified system supported by plantings</td>
<td>Irrigated crops (rice growing, market gardening)</td>
<td>Integrated systems</td>
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<tr>
<td></td>
<td>Weak diversification (remoteness of markets)</td>
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<tr>
<td><strong>Risk level</strong></td>
<td>Greatly subject to climatic risks</td>
<td>High (climate, health)</td>
<td>Unfavourable evolution of productions on global markets</td>
<td>Protected from risks of drought, frequent single-crop farming</td>
<td>Protected from risks of market (before liberalization of systems)</td>
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<tr>
<td><strong>Constraints</strong></td>
<td>Priority to food and to food self-sufficiency</td>
<td>Management of herds</td>
<td>Major level of investment</td>
<td>Investments in irrigation system</td>
<td>Seasonal fluctuations in revenue</td>
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<tr>
<td></td>
<td>Seasonal fluctuations of revenue</td>
<td>Significant mobility of animal farmers</td>
<td>Deferred profitability</td>
<td>Frequent single-crop farming</td>
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<td></td>
<td>Low market integration</td>
<td></td>
<td></td>
<td>Seasonal fluctuations of revenue</td>
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<tr>
<td><strong>Financing potential</strong></td>
<td>Limited by low level of credit-worthy demand</td>
<td>Risky</td>
<td>Financing by planting segment</td>
<td>Large and relatively secured</td>
<td>Large volumes; securing mechanisms need to be rebuilt</td>
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<td></td>
<td>Possible w/diversified activity system, esp. trade</td>
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<tr>
<td><strong>Need to finance operations</strong></td>
<td>Short-term credit</td>
<td>Weak</td>
<td>Animal food, Health, Pre-harvest</td>
<td>Inputs, labour for main crop and associated crops</td>
<td>Large volumes seasonal credit</td>
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<td>Lean-season credit</td>
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<tr>
<td></td>
<td>Animal food, Health, Pre-harvest</td>
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<tr>
<td></td>
<td>Medium-term credit</td>
<td>Marginal</td>
<td>Equipment</td>
<td>Power pump</td>
<td>Animal traction or small-scale mechanization</td>
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<td>Long-term</td>
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<tr>
<td></td>
<td>Savings</td>
<td>Low capacity for savings</td>
<td>Strong competition from traditional savings</td>
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<td></td>
<td>Insurance</td>
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</table>

Source: CERISE (Committee for the Study and Sharing of Information on Savings and Credit) – CIRAD (International Cooperation Centre on Agrarian Research for Development): Dakar seminar materials: Additional information
Appendix 2: Estimated Volume of Agricultural Financing by the MFIs in the WAEMU (West African Economic and Monetary Union) Zone in 1997

<table>
<thead>
<tr>
<th>1997</th>
<th>MFI CREDIT VOLUME (Billions of CFAF)</th>
<th>ESTIMATED AGRICULTURAL CREDIT VOLUME (Billions of CFAF)</th>
<th>IN % OF GLOBAL MFI CREDIT VOLUME</th>
<th>CONTRIBUTION / type MFIs (%)*</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>SM</td>
<td>CV</td>
<td>PVC</td>
<td>CD</td>
</tr>
<tr>
<td>BENIN</td>
<td>14.5</td>
<td>5.5 - 5.7</td>
<td>36</td>
<td>99</td>
</tr>
<tr>
<td>TOGO</td>
<td>7.8</td>
<td>0.780</td>
<td>10</td>
<td>75</td>
</tr>
<tr>
<td>COTE D'IVOIRE</td>
<td>6.1</td>
<td>1.2</td>
<td>20</td>
<td>&gt;90</td>
</tr>
<tr>
<td>SENEGAL</td>
<td>16</td>
<td>2.5 - 2.8</td>
<td>19</td>
<td>75</td>
</tr>
<tr>
<td>MALI</td>
<td>9.5</td>
<td>4.7 - 5</td>
<td>49</td>
<td>&lt;75</td>
</tr>
<tr>
<td>NIGER</td>
<td>4.5</td>
<td>1.3</td>
<td>29</td>
<td>26</td>
</tr>
<tr>
<td>BURKINA FASO</td>
<td>9.7</td>
<td>3</td>
<td>27</td>
<td>60</td>
</tr>
<tr>
<td>TOTAL</td>
<td>66.3</td>
<td>19 – 20</td>
<td>27</td>
<td>-</td>
</tr>
</tbody>
</table>

Source: Combination of the PASMEC (a support programme for credit cooperatives and societies) database with direct information gathered from MFIs in the CIRAD mission and research programme on agricultural financing (Wampfler 2000).

* PASMEC Classification:
  - SM = financial cooperatives
  - CV = community funds
  - PVC = projects with a credit component
  - CD = direct credit

Exchange rate: 1 USD = 714,0 FCFA
Appendix 3: Financing Medium-Term Investment: Lessons Learned from CECAM (Madagascar) and ANED (Bolivia) Leasing

Source: Work by CIRAD-Cerise TAP [Thematic Action Programme] and Dakar seminar

Hire-purchase (or leasing), is an alternative to standard medium-term loans for equipment, removing the collateral constraint. Experienced with relative success in animal traction promotion projects, hire-purchase was picked up and perfected by microfinance institutions (MFIs). The example of the CECAMs (Caisse d’Epargne et de Crédit Agricole Mutuels – Mutual Agricultural Savings and Credit Funds) in Madagascar and that of ANED (National Ecumenical Development Association) in Bolivia provide interesting perspective on this alternative approach.

**The basic principles of hire-purchase as practised by the MFIs**

- The financing organization continues to own the asset until it has been paid in full by the beneficiary. The latter is considered as lessee until the full acquisition cost of the asset is paid (original value + interest + charges).
- The lessee is selected by the financing organization, which also monitors the asset throughout the duration of the lease.
- The lessee self-finances part of the asset (usually about 25%); this contribution is paid at the beginning of the lease in order to increase lessee accountability.
- In the event of default in paying the rent, the financing organization may take its asset back without any specific litigation.

**The experience of the mutual hire-purchase plan of the CECAMs in Madagascar**

The Madagascar CECAMs are an agricultural credit mutual organization. Begun in 1991, by the end of 2001 the CECAM network included 41000 members in 164 local funds. The network is organized in 6 Regional Unions (URCECAM), federated into an Interregional Union (UNICECAM). The CECAM capital is FMG 6 billion, savings are 8 billion, and the average annual outstanding credit totals 23 billion.

The CECAMs offer seasonal credit for agricultural production, inventory credit, short-term credit for para-agricultural and commercial activities, social credit and loans to acquire production equipment, mutual plan leasing (LVM).

Mutual plan leasing was introduced in 1991 and in 2001 it represented outstanding balances of FMG 4.7 billion, or 20% of the portfolio of the CECAMs for 1780 beneficiaries. The average amount of a mutual plan leasing agreement (FMG 2.5 million) is relatively high compared to other loans granted by the CECAMs. Although the volumes are high, mutual plan leasing still affects only 11.5% of the loan beneficiary members and 4.3% of all members.

Most of the assets financed are related to agricultural activity (harrows, ploughs, carts, seeders, dairy cattle, draught oxen, brood hens) and to the first transformation of the agricultural products (hullers, grinders, oil presses, etc.); are also financed with equipment for crafts and trade, as well as for family life (sewing machines, refrigerators, freezers, etc.).

The modalities for granting the mutual plan leasing are strongly supported by the mutual nature of the network:

- The credit application is presented by an individual, but must be validated either by the mutual group to which the individual belongs or by the members of the local CECAM; the application is then sent to the local level of the CECAM or to the regional level, depending on the amount of the loan.
- The CECAM borrower selection criteria emphasizes borrower reliability (trust of peers in the borrower’s ability to honour the contract, prior history of meeting commitments as member of the CECAM, etc.), and the feasibility and profitability of the project. Project analysis will be more significant if the amount of the loan is high.
Depending on the circumstances, collateral in an amount varying from 50 to 150% of the loan amount will be requested; identification and evaluation of the value of the asset proposed as collateral will be done by the members of the local CECAM; the endorsement of two or three members of the CECAM can also be used as collateral.

To limit the risks of litigation, only the lessee shall be responsible for selecting and purchasing the asset (especially when animals are involved).

The modalities for payment of the rent are studied according to the value of the asset and the projected cash flow of the borrower and are formalized by contract. The borrower pays a down payment of 25% of the original value of the asset. The interest rate used varies from 24 to 30% per year, for a maximum duration of 36 months. Interest is calculated on the remaining balance due.

The procedure is monitored regularly by the members of the local CECAM. In ten years, the CECAMs signed 20 000 mutual plan leasing agreements benefiting 10 000 members. In 93% of the cases, the contract was honoured without default.

The hire-purchase experience as practised by ANED in Bolivia  
Source: Statement from FAO/AGSM [Agricultural Management, Marketing and Finance Service] in the Dakar seminar

The Asociacion Nacional Ecumenica de Desarrollo (ANED) is a microfinance institution established in 1978 by 11 NGOs (non-governmental organizations) working on rural development in Bolivia. Its objective is to provide the poor rural populations supported by these NGOs with access to credit. Today it has 24 branches in eight of the nine regions of the country. In 2000 it had a credit portfolio of USD 7.4 million, 75% of which was granted to agriculture.

The ANED credit system is based on small-scale integrated loans. Faced with demands to finance agricultural equipment, ANED first tried to respond in this way, but encountered major problems (arrears, household indebtedness, etc.). Leasing has been done since 1997 under a pilot phase, in two forms:

- single leasing: ANED buys the equipment and delivers it to the borrower, who pays for it in rental charges.
- lease back: the borrower sells ANED an asset belonging to him and uses the amount received for productive investments; ANED then reassigns the asset to the borrower using a leasing formula.

In 2000, the ANED leasing portfolio was USD 505 671, or 7% of its total portfolio, benefiting 481 borrowers from 6 regions. 95% of the contracts concerned agricultural equipment, predominantly tractors and power pumps. The standard profile of the borrower is the dairy producer wishing to modernize production of fodder by purchasing a tractor. Servicing the equipment leased is also encouraged.

The beneficiaries are selected by the ANED technical personnel. The selection criteria involve:

- the borrower’s respect for commitments in prior relationships with ANED
- economic project analysis: project revenue must allow the equipment rental to be paid; the other household economic activities are considered only secondarily in order to offer flexibility to the evaluation; rentals are not to exceed 30% of total revenue to the borrower
- the level of the borrower’s technical mastery: ultimately, “experienced farmers” in an organized production chain are given priority (especially dairy producers having a marketing contract with a dairy).

Several types of measures seek to limit the ANED risk:

- the borrower must self-finance 25% of the original value of the asset.
- the duration of the lease varies depending on the equipment (2 years for a power pump, 5 years for a tractor), but in any event must be lower than the depreciation period for the equipment.
- The ANED technical personnel frequently check the condition of the equipment.

To improve the leasing environment, ANED develops contractual relationships with institutions providing the farmers with technical training and with agricultural equipment suppliers, ensuring service after the sale and maintenance for the equipment.
The pilot programme had two good years, then experienced reimbursement problems related to an erosion of agricultural prices, particularly in market garden production, which is less organized than dairy production. Many questions remain unanswered regarding the viability and extension of the programme:
- to limit the default risks, ANED gives priority to the purchase of new equipment, leading to high costs, rentals that are incompatible with the revenue of most farmers and a stagnating demand for the products of the leasing
- the cost for the checking done by the salaried personnel in the structure is high
- the interest rate applied is 16%; this rate does not cover the ANED management costs; the leasing formula is not viable at the moment because ANED has access to concessionary resources

Risks of hire-purchase

Although the hire-purchase allows the constraint of collateral to be removed, it still involves risks the MFIs should avoid:
- insufficient control of the purchase price: poor condition or overvaluation of the assets acquired by the MFI and leased, even a fraudulent transaction that could involve MFI stakeholders; this risk arises particularly with the CECAMs for transactions involving used equipment or livestock; it is more limited with ANED, only affecting new equipment and transactions with approved equipment suppliers, but paid at full price
- litigation over ownership: the vendor from which the MFI buys the asset does not have legal title (inheritance, joint ownership, etc.), which could lead to litigation, misuse, disputes
- default by equipment supplier on warranty and maintenance
- poor maintenance or use of the asset being leased leading to its deterioration
- trouble applying the hire-purchase status: in Madagascar in particular, the hire-purchase status contained in banking law is poorly understood in the legal environment, causing problems with removal of the asset in the event of lessee default.

Lessons learned to replicate these experiences

Hire-purchase is a credible alternative to finance agricultural investments over the medium term. The collateral on the asset offered by the hire-purchase should not obscure the risk for an MFI: the amounts at stake are often significant, the brand name image and the soundness of the institution could be affected by defaults on this product.

Borrower selection is a fundamental step. Three types of criteria are given priority: borrower’s seniority at the MFI and record of prior commitments with it, the financial viability and profitability of the project and the borrower’s level of technical mastery. Evaluation of these criteria requires knowledge of the borrower, the ability to assess his level of technical mastery and the ability to assess the quality of a financial project in its environment. The mutual plan formula allows for the association of the borrower’s capital (by the borrower’s peers and by local elected members) with a technical and financial evaluation of the project. As the financial project becomes more complex and innovative, the competencies to be evaluated by the MFI may be exceeded and alliances with more specialized institutions could be required (management centres, agricultural council, etc.).

The borrower’s accountability is a deciding factor. Incentives for accountability could be self-financing of part of the asset, borrower selection of the asset acquired, a guarantee based on another of the borrower’s assets or an endorsement by multiple other members of the MFI.

Monitoring and evaluation of the transaction remain fundamental and should be done regularly throughout the term of the hire-purchase. The cost for this action is a deciding element of the final intermediation cost of the transaction. The mutual plan structure allows for minimization of this cost by having it partially taken over on a pro bono basis by the members of the MFI. Proximity management of the records is another factor leading to cost reduction.
Development of hire-purchase requires a favourable environment in the following areas:

- technical: mastery of techniques by the farmers to use the equipment, existence of nearby services for maintenance and repair of the equipment or for animal care, availability of spare parts, etc. …
- economic: remunerative agricultural prices, organized chains, etc. …
- legal: the hire-purchase status should be addressed in the banking law and known to the stakeholders in the legal sector

Despite the removal of the collateral constraint, in current experience it seems that hire-purchase is still a relatively elitist product that is accessible, at least at first, to only the most favoured segment of farmers who already have a productive capital and technical mastery allowing for a profitable financial project. To expand this original target, an alliance of the MFI with institutions supporting agricultural development (training, improvement of competencies, organization of the agricultural environment, etc.) and with structures of services to agriculture (agricultural equipment suppliers, repair people, veterinarians, etc.) is recommended.

Hire-purchase can be developed only progressively at an MFI. It requires a reliable technical structure, a confirmed social baseline and a solid financial structure (equity, long-term resources). Stable concessionary resources could be a bargaining chip to initiate this kind of innovation.
Appendix 4: Farmers Representation in the Evolving Agricultural MFIs: the Executive Boards in the Madagascar CECAMs

When a microfinance institution created by the agricultural world develops and institutionalises, it is quickly faced with the question of diversification of its portfolio towards non-agricultural activities. This portfolio diversification is needed to meet the various financing needs in the rural zones, as well as to limit the risk taken by the MFI. But it also involves risks: diversification of financial activities lead to diversification in the membership, opening up to non-agricultural socio-professional categories; financing non-agricultural activities often proves more profitable, with faster capital turnover; the capacity to influence merchants, public servants and entrepreneurs is often greater than with farmers; the balances between the activities and the social groups participating in managing the MFI could be profoundly changed and the agricultural potential could be weakened or even threatened.

The Madagascar CECAMs, created in 1991 by a farmer organization, FIFATA, to finance agriculture, are facing this problem. The need to make the financing functions autonomous in order to allow for growth of the institution was acknowledged very early on by FIFATA: in 1994, the CECAMs were formed on financial institutions independent of the parent farmer organization. The institutionalisation process engaged in by the CECAMs seeks to reconcile the agricultural potential and the financial development approach. However, the network is highly dependent on outside resources at a high cost; to reduce this dependency, an effort has been undertaken to mobilize savings. As rural savings are difficult to mobilize, the network turned to the towns, where the savings capacities are higher. This step (about a dozen urban funds for now) is a risk to the agricultural potential of the network (power taken over by non-agricultural socio-professional categories, economic and financial interest in non-agricultural activities, etc.). The elected and salaried managers of the network are aware of this risk and are testing procedures seeking to limit it: the farmer organization FIFATA remains the guarantor of the network’s policy orientation and network governance is provided by socio-professional councils of administrators.

The CECAMs are organized into Regional Unions. In each Union, the FIFATA directors are entitled to hold 3 seats out of 15 on the Executive Boards of the Unions.

The CECAM members are organized into three socio-professional councils:

- Council A is for farmers, with at least 50% of the revenue coming from agricultural activities (including livestock and fisheries)
- Council B is for individuals other than farmers (merchants, craftspeople, public servants, small-scale business owners)
- Council C is for legal entities: groups of farmers in marketing cooperatives, or purchasing cooperatives for agricultural inputs.

Each council elects its representatives to the directing bodies of the CECAMs. Council A has a majority share of representatives in the Executive Boards.

The chairmen of the local CECAM management committees, and the executive boards, must be farmers by profession belonging to council A.