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Investing in rural people

## Proposal to accept supplementary funds from the Bill & Melinda Gates Foundation

### Note to Executive Board representatives

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For: Approval

## Recommendation for approval

The Executive Board is invited to authorize the President to negotiate and finalize a supplementary funds agreement with the Bill & Melinda Gates Foundation in support of rural finance activities in Nigeria, building on the IFAD-supported Rural Finance Institution-Building Programme.

## Proposal to accept supplementary funds from the Bill & Melinda Gates Foundation

### I. Background

1. The Executive Board is invited to note that IFAD is seeking supplementary funds from the Bill & Melinda Gates Foundation, a non-profit philanthropic organization located in Seattle, Washington, United States of America. To this end, the President is seeking the Executive Board's approval to negotiate and finalize a supplementary funds agreement, substantially in accordance with the terms outlined in this document.
2. Further to the statement of intent signed with the Bill & Melinda Gates Foundation and presented to the Executive Board for information at its 105<sup>th</sup> session, IFAD has already signed three grant agreements with the Bill & Melinda Gates Foundation. One of these is an ongoing initiative to support small ruminant value chain development in India. The Executive Board provided its approval for the President to negotiate and finalize this agreement at its 114<sup>th</sup> session held in April 2015.
3. Building on these experiences, IFAD intends to seek further supplementary funds from the Bill & Melinda Gates Foundation to fund activities to strengthen the rural finance policy support and financial inclusion activities of the ongoing IFAD-supported Rural Finance Institution-Building Programme (RUFIN) in Nigeria and contribute to the sustainability and scaling up of these activities when RUFIN reaches completion in 2017. The amount of funds will be in the range of US\$300,000 to US\$500,000, and activities will be implemented over a period of 36 months.
4. The Bill & Melinda Gates Foundation recognizes the good relationship between the Government of Nigeria and IFAD, and sees IFAD as a valuable partner in addressing issues of rural financial inclusion in Nigeria.
5. The output of the supplementary funds from the Bill & Melinda Gates Foundation will be direct policy support to the Government of Nigeria's financial inclusion initiatives, particularly regarding policy development and policy refinement in the rural space. There are multiple initiatives that can deliver services in the rural areas; however, these need substantial support to ensure outreach. The process of policy development and refinement needs continuous reinforcement and adequate resources.
6. An outline of the draft programme proposal is provided in the appendix to this document.
7. The Executive Board is the competent organ to decide on acceptance to administer supplementary funds and on the related conditions and restrictions. However, the Board resolved to delegate a part of that authority to the President, that is, to receive and administer grants from any source for the financing of ongoing IFAD programmes, and grants from Member States for the financing of studies and short-term technical assistance activities related to IFAD operations, on similar conditions as those specified in EB 1986/28/R.47 and EB 1987/30/R.28

respectively. However, as the Bill & Melinda Gates Foundation is not a Member State of IFAD, and the proposed supplementary funds contribution will not directly cofinance an ongoing IFAD programme, the Executive Board is invited to authorize the President to negotiate and finalize a supplementary funds agreement with the Foundation.

8. A full cost-recovery principle (five per cent plus interest retention) will apply, and indirect costs will be covered by these management fees. IFAD's direct costs will be included in the budget for programme activities.
9. The signed agreement will be submitted to the Board for information at a subsequent session.

## II. Recommendation

10. The Executive Board is invited to authorize the President to negotiate and finalize a supplementary funds agreement with the Bill & Melinda Gates Foundation to support rural finance activities in Nigeria, substantially in accordance with the terms outlined in this document.

## Annotated proposal

### Technical Assistance to Strengthen Rural and Development Finance

#### I. Background

1. Developments in Nigeria indicate that there is significant potential to enable rural people's access to basic financial services. The Federal Ministry of Finance is in a position to coordinate and work alongside key stakeholders in the rural and development finance space; particularly in the public sector. There is a need for policy dialogue to keep abreast of issues impacting rural, agricultural and development finance and seek for the implementation of initiatives aimed at eliminating or reducing them.

2. Despite the significant potential of microfinance, the actual financial outreach figures are quite disappointing. The 'Access to Financial Services in Nigeria' survey of 2014 indicates that 40% (37 million out of 94 million) of the adult population was totally excluded from financial services which included exclusion from deposit banking services, other formal and informal services like insurance, pension, savings clubs and money lending services. The level of exclusion was even higher, at 51% of the adult population, if those who have access to only informal services such as savings groups and moneylenders are also considered as excluded.

3. This wide gap in financial inclusion in the rural areas is a major challenge for IFAD's target group and affects the effectiveness, impact and sustainability of project interventions. Though the financial inclusion survey results do not separately report on the rural status, it is obvious that in the rural areas, which have 53% of the total population (World Bank, 2014) and much thinner density of formal financial services, the level of financial exclusion is likely to be much higher than the national aggregate. A number of constraints are responsible for this gap in rural outreach as highlighted below:

- i. The financial inclusion approach does not prioritise rural outreach: Although it is acknowledged that the extent of financial exclusion in the rural areas is much wider, CBN's financial inclusion strategy so far does not have special rural focus. Meanwhile, there is a lack of thrust on specialised products, methodologies and approaches to enable rural penetration of financial services in a scalable, profitable and sustainable manner. At present the coordination mechanisms for galvanising and harmonising the initiatives of different departments on financial inclusion is not very strong. Initiatives through the IFAD-supported Rural Finance Institution Building Programme (RUFIN) and the BMGF-sponsored Financial Inclusion Secretariat (FIS) have been supporting financial inclusion. Consequently, technical assistance through the Federal Ministry of Finance could provide a good organising platform.
- ii. Weak farmers' organisations and groups at the community level: There is a long history of failure of farmers' organisations, cooperatives and groups that were hastily mobilised for delivering credit, inputs and other handouts without proper screening, training and institutional development inputs. They often disintegrated or became dormant after receiving the benefits leaving behind a negative reputation of fraudulence, repayment problems and weak credit culture. The financial operators are highly influenced by this negative image of poor business culture and the perception

of excessive credit risk in rural areas and are ready to consider only strong rural groups where members can effectively cross guarantee the loans. However, the financial operators lack adequate experience and knowledge about group mobilisation, their business orientation and mechanisms for developing group solidarity and effective cross guarantee orientation. In addition, the initial cost of these activities discourages microfinance operators from starting rural operations.

- iii. High costs of the rural lending: The high cost of rural lending arises due to the need for frequent visits to manage a portfolio of relatively small loans distributed amongst a large group of clients scattered across vast large geographical area with poor transportation infrastructure. In addition, road security risks add to the costs and, in the absence of digital banking solutions in the rural space, mechanisms for lowering costs are limited. When these costs are further loaded with the credit risk factors and cost of funds (10-15% from commercial banks) the interest rates to the final borrowers become very high. With the backdrop of targets to keep interest rates to single digits and availability of subsidised public funds at capped interest rates of 9%, the microfinance operators choose to stay away from the rural markets fearing that reducing interest rates will make rural operations unviable and increasing interest rates may be controversial.
- iv. Challenges facing agricultural production loans and agricultural value chain financing: Financial operators generally avoid agricultural production loans even though it is the mainstay of the rural economy. Financing agricultural production loans is considered risky due to factors such as improper cultivation practices, underdeveloped extension services, and gaps in inputs supply, lack of insurance against crop production and crop damage risks and weak marketing mechanisms. Microfinance institutions usually do not have special agricultural financing products and specially, value chain lending practices are totally absent. Even commercial banks, which otherwise have a large private sector client list comprising potential and existing agricultural off takers, usually do not venture into the agricultural production space in partnership with the private sector clients, except for a handful of banks such as the Union Bank.

The first reason for this is the general production, market and price risks for the farmers and consequently for the finance providers. Secondly, lack of presence of commercial banks in the rural areas has resulted in their limited exposure to agricultural production and marketing systems. Third, the volume of low-cost credit lines available to the commercial banks for structuring single digit production loans is very limited. Lending from their own resources can cost the final borrower between 20 to 25%, which against the backdrop of a single digit interest rates agenda for the rural sector, can generate controversies and repayment risks. Although there is private sector involvement in agricultural value chains, their growth in outreach is very limited due to the lack of agricultural production financing for the final borrower, third-party selling risks and lack of safeguards against production and price risks. Moreover internal financing of the value chains through off takers and input suppliers is very limited.

- v. Underdeveloped micro-insurance and agricultural insurance mechanisms: The underdeveloped agricultural insurance market is another major gap. This market is dominated by the Nigerian Agricultural Insurance

Company (NAIC), a public sector entity delivering its products through banks and financial institutions, with very little product innovations over time. Consequently, the agricultural insurance market remains supply driven with little awareness and demand by farmers themselves. Similarly, the target group households do not have access to life, health, and asset insurance facilities. This lack of agile insurance mechanisms in the rural sector is also a major deterrent against increase in the outreach of rural financial services.

## II. Rationale

4. The Rural Finance Institution Building Support Programme (RUFIN) implemented by the Federal Ministry of Agriculture and Rural Development (FMARD) has been working with the Central Bank of Nigeria to strengthen the financial inclusion through existing financial service operators in the rural space. RUFIN has promoted several ground level interventions that have policy implications. RUFIN started a system of adequately trained volunteers to replicate group formation and group mentoring across the RUFIN communities even after RUFIN closure. The experience has shown that the engagement of the volunteers is a viable mechanism for replicating strong groups and potentially reducing costs of rural financial operators. Also, RUFIN has clearly demonstrated that strong women's involvement and savings led approach generate solidarity and business culture within farmers' organisations/rural groups and make them capable of strong linkages with financial operators. RUFIN has developed and mentored around 12,000 groups, a substantial number of which are based on criteria such as only women. RUFIN has demonstrated that a guided and well-structured rural business planning exercise is often very revealing for microfinance operators to clearly perceive the cost benefit aspects of rural operations. The RBP approach has helped microfinance operators, including the Bank of Agriculture, to understand the approach, institutional structure, human and infrastructure investment required for rural operations from their current resources.

5. As RUFIN is reaching its last year of implementation, policy support in the Federal Ministry of Finance would be critical to ensure that the operation lessons that have been learnt can be mainstreamed for the sector. There are several areas of policy gap which has affected rural penetration by financial operators. The entire community of NGO-MFIs, which have strong social motives and much better rural presence, are still not regulated either directly by the CBN, or through self-regulatory mechanisms through the Association of Microfinance Institutions (ANMFIN). Being unregulated in nature, they are considered relatively risky which has curtailed the full utilisation of their potential. Similarly, the areas of micro-insurance and agricultural insurance remain underdeveloped due to limited policy efforts to revitalise and make this space attractive for investment by other insurance companies beyond the monopoly of NAIC. The microfinance policy and regulatory framework too has several areas which act as barriers rural outreach. For example, unit banks which already had their main office/branch in an urban center are not allowed to start full rural branches making it efficient rural expansion very hard. Similarly, CBN lowering the capital adequacy ratio requirements for MFBs which develop rural outreach can release substantial equity funds for expanding their rural portfolio. Another major area of policy intervention is the capping of interest rates at 9% for MSMEDF instead of encouraging mechanisms for reducing the cost of delivery, competition and market led reduction of the interest rates. This cap has so far been counterproductive as the larger microfinance operators have not accessed the MSMEDF and the overall draw-down is only moderate. While the Bank of Agriculture has initiated the BoA Rural Business Initiative, which promotes savings, Know Your Client (KYC) techniques, group lending, tailored conditions and follow up on loans, this new way of

working has not been mainstreamed through the BOA and it continues to incur losses through poor repayment. Although RUFIN has initiated a regular policy review mechanism, changes occur through sustained dialogue over time and there are still several policy issues which need attention in order to promote rural sector outreach.

### III. Proposed Outputs

6. Policy support would be of great value to directly key into Ministry of Finance and CBN's financial inclusion initiatives. The proposed outputs of this policy support would include policy development and policy refinement in the rural space. There are multiple initiatives that can deliver services in the rural areas, however need substantial support to ensure outreach. The process of policy development and refinements needs continuous reinforcement of messages and adequate resources.

### IV. Proposed Activities

7. Identify lessons learned and promote visibility, adoption, sustainability and wider replication of successful interventions: This will be carried out through the following activities:

- i. Mapping of rural, agriculture and development finance stakeholders
- ii. Identification and documentation of rural, agriculture and development finance initiatives conducted in Nigeria (provide timeframe)
- iii. Collation of key learnings from initiatives (including online publication of learnings)
- iv. Stakeholder workshop to promote/discuss key learnings

8. Work on an enabling policy framework: Through the Federal Ministry of Finance, promote policy dialogue with stakeholders like the CBN in areas such as de-capping of interest rates, lowering of guarantee requirements by microfinance operators for accessing wholesale financing, de-risking agricultural production loans through shared guarantee mechanisms and developing the agricultural micro-insurance sector. Enabling rural, agriculture and development finance policies will be promoted through discussions, joint publications and policy forums. Policy dialogue will be practiced in strong partnership with other development partners.

9. Promote success stories over wider geographical areas: Promote innovative ideas by financial service providers to provide savings, loans, payment and insurance products to farmers. Insurance services will be promoted to ensure formal protection of farm revenue, reduction in distressed sales of farm assets and increase in the sense of security.