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FLEXIBLE LENDING MECHANISM



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FLEXIBLE LENDING MECHANISM

I. INTRODUCTION

1. The purpose of the present document is to seek Executive Board approval of an additional lending instrument, the Flexible Lending Mechanism (FLM). The overall objective of the proposed FLM is to introduce a greater degree of flexibility into IFAD's project design and implementation in order to: match project timeframe with the pursuit of long-term development objectives when it is judged that a longer implementation period will be required to meet such objectives; maximize demand-driven beneficiary participation; reinforce the development of a grass-roots capacity; and ensure that critical financial and programming control mechanisms are in place so that the funds are managed judiciously and the development objectives achieved. In addition, the FLM will enable IFAD to be more responsive to the calls of Member States for a longer-term commitment on its part; and, finally, it will demonstrate the Fund's interest in developing a greater variety of lending instruments to enable it to cater more effectively to the diverse financing needs of the beneficiary countries.

2. The main elements of the FLM include longer loan periods (10-12 years as opposed to the typical five-to-six-year loans); a clear articulation of long-term development objectives; an iterative, phased design process over the extended period of the loan to allow for greater flexibility in resource allocation and planning; a detailed design process for the initial cycle of project activities, with a set of clearly-defined pre-conditions, or "triggers", for proceeding on to subsequent cycles; and an enhanced role for monitoring and evaluation (M&E) to ensure that the projects remain on-track in pursuit of their immediate and long-term objectives. Approval of the initial loan envelope, project objectives and technical approach will rest with the Executive Board, while the decision whether or not to proceed to subsequent cycles will be taken by IFAD management. The key operational elements of the FLM are spelled out in greater detail below.

II. BACKGROUND AND RATIONALE

3. The Fund believes that, for any investment in the development of rural institutions and in capacity-building to be effective, projects should be viewed as a continuously evolving and iterative process of design, implementation and evaluation. As a certain degree of overlapping between the various phases of the project cycle is inevitable, specific provision should be made to this effect.

4. The need for such an approach and for developing appropriate facilitating instruments was recognized during the project cycle re-engineering exercise; and, more recently, this need figured prominently among the recommendations of the evaluation of the Special Programme for the Sub-Saharan African Countries Affected by Drought and Desertification (SPA). It was also recognized that increased emphasis on implementation, greater use of in-country knowledge, and more budgetary flexibility called for new operational approaches. The FLM will enable IFAD both to address these concerns and to overcome a number of constraints to adapting loans to specific country circumstances and changing priorities, thereby enhancing project effectiveness and impact. It is sometimes found that the five-to-six year life of a typical project is too short to reinforce institutional capacity sufficiently for project-initiated activities to be sustained past project closing. As a result, project activities may be accelerated artificially and/or second phases required.

5. A number of positive developments have increased the opportuneness of following a more flexible, participatory programming approach. For instance, the 1990s have witnessed the rapid development of civil society in numerous countries where IFAD operates, thus requiring that many different actors now need to be brought into the process of designing and implementing projects; and decentralizing decision-making to the grass-roots level is advocated increasingly as the only means of



pursuing meaningful long-term development. While all this may lead to complications over the short term, it will ultimately increase the sustainability of project interventions. Moreover, with the increasing importance placed on good governance and decentralization in many countries, organizations such as IFAD will be required to assist in the development of local governance through strengthening capacities for planning and implementation.

6. There is now a greater availability of appropriate methodologies for flexible programming. Some donors have adopted participatory planning approaches for project development. Participatory processes for constructing and updating logical frameworks have been developed; and a battery of other anthropological and sociological tools have been adapted for this purpose. While differing in the details, one common aspect of all these participatory approaches is that they emphasize the paramount importance of appropriate **processes** as necessary pre-conditions for achieving development impact. This implies continuous dialogue and consensus-building among a large and varied group of stakeholders.

7. Other international financial institution (IFIs), such as the World Bank, are experimenting with similar mechanisms. Several bilateral agencies are also trying out new approaches, albeit mainly with regard to grants. With its long history of promoting beneficiary participation, by introducing the FLM, IFAD has the opportunity to be at the cutting edge of the movement towards developing more flexible lending instruments. Now, rather than later, is the time for IFAD to consider introducing an additional financial instrument to fit this changing environment.

III. OBJECTIVES

8. IFAD seeks to pursue the following objectives by means of the FLM:

- (a) **Reinforced participatory process for design and implementation.** IFAD has a long tradition of pioneering participatory approaches to project development so as to ensure that the needs and views of the poor are duly taken into account, as witnessed by innovations introduced through the SPA and the re-engineered project cycle. With the FLM, the Fund will continue this tradition by offering an alternative loan mechanism that is consistent with the need for continuous design processes and that will enable it to “learn by doing”.
- (b) **Loan periods more congruent with the attainment of development objectives.** At times, the length of the typical IFAD loan makes it difficult to secure full beneficiary participation and reinforce institutional capacity at the grass-roots level with a view to enhancing project sustainability. Adoption of the FLM will allow IFAD, within a more realistic timeframe, to accommodate the capacity-building issue in countries where it is felt that more time is required. The new lending instrument will therefore require initial commitments for longer periods to allow two-to-three cycles to complete themselves. Therefore, Executive Board approval will be requested for loan periods in the range of 10-12 years.
- (c) **Increased flexibility.** The need for greater flexibility in design and implementation is another major concern. Experience has shown that not even the best designed projects can anticipate the future evolution of beneficiary priorities. Therefore, strategies will need to be introduced at the design stage so as to capitalize on “learning-by-doing” as projects go forward.
- (d) **Greater IFAD involvement in implementation.** One of the major thrusts of the Fund’s corporate strategy is that it is required to devote more attention to implementation. The FLM will enable IFAD to pursue this objective because staff will be called upon to take a major role in orienting project development at key moments during the course of



implementation - mainly in terms of organizing and participating in missions to prepare second and/or subsequent cycles (see discussion below on joint assessments).

- (e) **Increased client responsiveness through the development of additional financial products.** As an IFI, the Fund can improve its services to Member States in a number of ways, for example, by diversifying its financial products. At the present time, IFAD provides several different types of grants, including technical assistance grants for agricultural research and training, Special Operations Facility grants for facilitating smooth project start-up, and grants under the IFAD/Non-Governmental Organization Extended Cooperation Programme for fostering grass-roots innovations. However, to date, it has only been able to deliver one type of loan - the standard five-to-six year loan - in sharp contrast to other IFIs that have a variety of lending instruments available.¹

IV. KEY OPERATIONAL ELEMENTS OF THE FLEXIBLE LENDING MECHANISM

- 9. The most important operational elements of the proposed FLM include:
 - (a) **Clear specification at the initial design stage of long-term goals, objectives, project management structure, and M&E strategy.** Annex I compares the major design characteristics of the standard project design approach with those of the FLM. With the latter, the long-term project goals, objectives, and anticipated development impact will be clearly stipulated at the initial design stage, and the degree of specificity in these areas will not differ from that of a typical project. In addition, planning and decision-making procedures to be followed during implementation, management system structure and governance, and design of M&E systems that stress active beneficiary input and feedback, will be clearly spelled out from the outset.
 - (b) **Identification of activities in cycles.** Under the conventional project mechanism, most - if not all - activities, physical targets and costs are usually defined at the design stage. In contrast, the FLM will follow a cyclical design process over an extended 10-12 year period, thus allowing for flexible resource allocation and planning. For example, at design, a set of well-defined activities for the first three-to-four years will be identified, including specific field investments and the training and sensitization of beneficiaries, project staff and selected service providers. Concurrently, background studies and consultations will be carried forward in order to prepare the next three-to-four-year cycle. During the second cycle and beyond, and based on M&E input, diagnostic studies undertaken during the first cycle, and the findings and recommendations of the joint assessment exercises, project staff will build on the previous cycles' successes and failures and knowledge of beneficiary priorities with a view to continuing the implementation of ongoing activities, initiating new activities in first-cycle villages, and expanding to other villages in the project zone.²
 - (c) **Pre-conditions for initiating new project cycles.** During the initial design stage, a set of pre-conditions (or "triggers") for proceeding to second and subsequent cycles will be

¹ For example, the World Bank currently has seven different lending instruments available for public sector borrowers.

² The "generic" discussion here relates to what a FLM might look like for an area development project. However, this mechanism could be used also for other types of investments where long-term commitment and flexibility are considered appropriate or crucial. Possible examples include the development of rural financial service delivery institutions or agricultural sector investment programmes (ASIPs).



developed. These will include the attainment of critical physical targets, a set of indicators for determining whether or not the project is likely to attain its longer-term development objectives, and effective functioning of the M&E system. No release of second and/or subsequent tranches of project funds will be authorized until the pre-conditions have been met. As mentioned earlier, the decision whether or not to proceed to subsequent project cycles will rest with IFAD management.

- (d) **Periodic joint assessments.** A joint IFAD/cooperating institution/government assessment will be carried out prior to initiation of each new loan cycle. The purpose of such joint assessments will be to verify whether the pre-conditions for proceeding to the next cycle have been met and to ensure that M&E inputs and lessons of experience can be fully incorporated into programming exercises. IFAD will participate in these exercises on an inter-departmental basis to ensure that all major managerial, technical, financial and M&E-related issues receive adequate attention. The joint assessment team will submit recommendations to IFAD management regarding the wisdom or otherwise of initiating activities under a subsequent cycle.
- (e) **An enhanced role for monitoring and evaluation.** Due to lack of proper incentives for M&E officers and project managers, M&E units are often ineffective. With the new lending mechanism, the design of each new cycle will be based on (and approved according to) the achievements of the previous cycle. The role of M&E in providing timely information will be critically important to project managers, who will be given a clear incentive to use such information because effective functioning and use of the M&E system by management will be a pre-condition for proceeding to second and subsequent cycles. Borrowers will be alerted to the fact that continued project funding is contingent upon successful project performance, for which effective M&E performance is essential.
- (f) **A set of safeguards.** If a mechanism such as the FLM is to work effectively, a number of safeguards will be required to ensure that the project activities are having the desired impact and the funds are well-managed. Several safeguards are foreseen, the most important of which are the pre-conditions and joint assessments described earlier. In addition, the financial and technical feasibility of a range of probable activities will be analysed at the design stage. As mentioned above, the role of M&E will be enhanced, and effective performance will be a pre-condition for triggering off the initiation of second and subsequent project cycles. Finally, traditional programming and control procedures (annual work plan and budget exercises and annual financial audits) will continue to be followed.

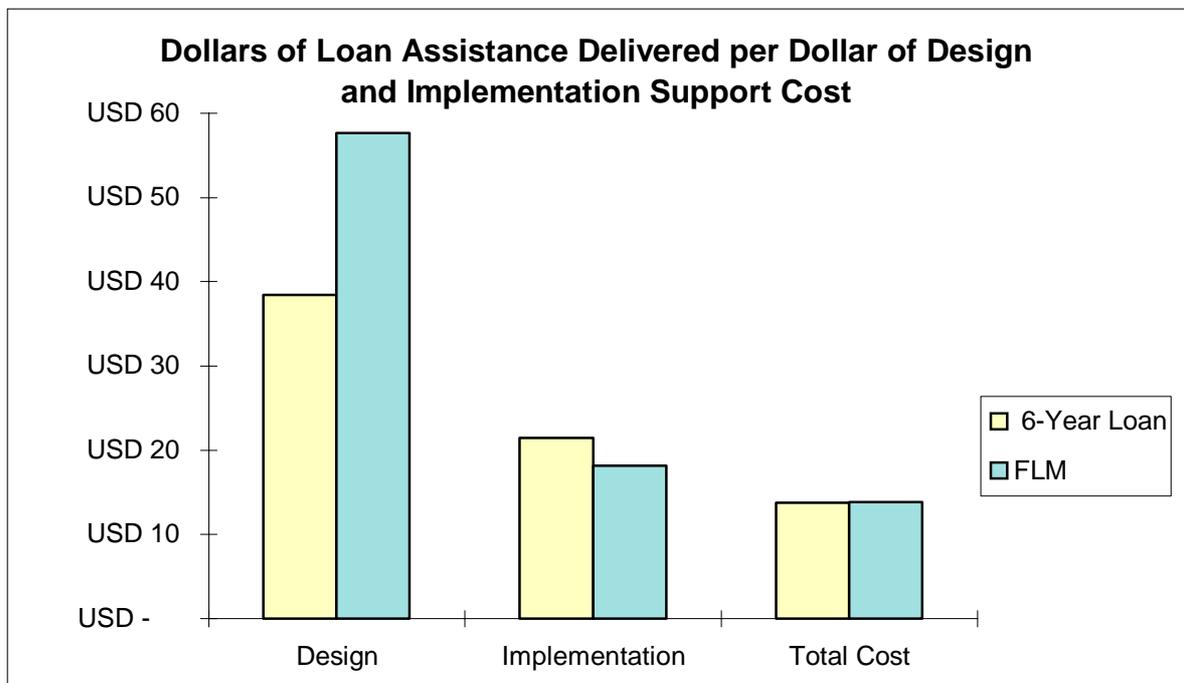
V. IMPLICATIONS FOR IFAD'S LOAN PORTFOLIO AND FOR PROGRAMME MANAGEMENT

10. Based on current costs, the average size of current ongoing loans, and hypothesized average loan amounts for FLMs roughly 50% larger than ongoing loans, it is anticipated that the overall costs of the FLM (including initial project design and development costs, implementation support, joint assessments, and evaluation) should be no higher than for a five-to-six-year loan per unit of loan resources delivered (see the following chart). With the FLM, the loan resources delivered per United States dollar of project development costs could be significantly higher than in the case of a typical loan, and the loan resources delivered per unit of implementation support cost would be slightly lower in these cases due to the importance for FLMs of periodic assessments and continuous design during implementation. Thus, in overall terms, the loan resources delivered per unit of the total costs borne by IFAD would be slightly higher for the FLM than for the standard loan. This implies a slight shift in resource allocation away from initial design towards implementation and iterative design, which is fully consistent with IFAD's corporate thrust to increasingly focus on implementation performance.



11. Introduction of FLMs into the Fund’s pipeline could also have a positive impact on overall project development costs and implementation support costs, to the degree that they will facilitate a reduction in the number of loans in the portfolio. Economies of scale would facilitate the transition to a smaller number of operations while still achieving overall lending targets. These benefits are expected to be most pronounced in regions with large numbers of small countries that have a limited absorptive capacity and where it would be difficult to increase loan sizes without extending loan periods - primarily, the Africa I and II regions. However, this would not imply any change in regional lending programme allocations.

12. The introduction of the FLM will not necessitate any amendment of the Fund’s basic documents. The General Conditions would apply and require no modification. The pre-conditions or “triggers” for proceeding to subsequent loan cycles, as well as the components of, and the resources for, first-cycle activities would need to be spelled out clearly in the initial loan agreement. Second and subsequent cycles would require an addendum to the loan agreement, specifying the resource requirements and physical targets involved, together with the pre-conditions for proceeding to the next cycle. These resource requirements, physical targets, and pre-conditions would be developed during the joint assessment exercises.



VI. EXECUTIVE BOARD NOTIFICATION

13. It will be for the Executive Board to decide whether or not to approve the initial loan envelopes, project objectives and technical approach; while the decision to proceed to subsequent cycles will rest with IFAD management. During implementation, the Board will be informed through three different reporting avenues about FLM progress and performance. First, as is the case for all projects, FLMs will be reported on in the annual Progress Report on Project Implementation. Second, for each FLM loan and prior to the end of each cycle, IFAD management will decide whether to proceed to, cancel, or delay subsequent cycles. Management will inform the Board accordingly. The document presented to the Board will set out the lessons learned from initial cycles and their incorporation into subsequent cycles, the attainment of physical targets, progress towards meeting long-term development objectives, and achievement of the pre-conditions stipulated in the



loan agreements. Finally, after several years of FLM implementation, an overall assessment of experience to date and lessons learned will be prepared and shared with the Board.

VII. POTENTIAL ADVANTAGES AND RISKS

14. The potential advantages and risks of pursuing the FLM approach are summarized in Annex II. One major advantage would be that adoption of the FLM would reinforce IFAD's pioneering approach to beneficiary participation in project development to ensure that, to the extent possible, the needs and views of the poor are taken into account both at initial design and through periodic reassessments during implementation. The proposed long-term commitment conveys a message that, as and when necessary, IFAD is willing to support achievement of development objectives over a longer timeframe. It also mitigates the disruption of activities and the uncertainty that often accompanies the transition from the first to the second phase of a typical project.

15. The proposed introduction of the FLM also conveys to Member States the message that IFAD is willing and able to innovate in tailoring its financial instruments to their needs. IFAD would also position itself strategically in developing new lending mechanisms at a moment when other donors are at the early stages of dealing with such issues. Moreover, the cofinancing of other donors' (i.e., the World Bank) projects financed under similar mechanisms would be facilitated.

16. It is proposed to use the FLM in countries whose governments have demonstrated a strong commitment to the approach and long-term objectives of specific projects being designed, and have given clear evidence of their capacity to carry out projects over the long-term.

17. The adoption of this mechanism will also help to shift attention to implementation or, in a sense, to remove the false dichotomy between design (which, under the classic project approach, stops once a loan is approved) and implementation. The reality is that effective projects continue to be "designed" during implementation as donors, project staff and beneficiaries gain knowledge about what does and does not work, and as priorities change. The FLM approach acknowledges this fact, and provides an explicit strategy for capitalizing on implementation experience.

18. Since it will be a pre-condition for proceeding to second and subsequent cycles, project managers will be given a clearer than usual incentive under the FLM to make effective use of M&E information for the purpose of improving implementation performance. As mentioned in paragraph 9(e), cooperating institutions and borrowers will be informed that continued project funding is contingent upon successful project performance, for which effective M&E performance is essential.

19. Cooperating institutions will be requested to follow M&E performance as closely as possible during supervision, and to assess the degree to which M&E outputs are being used as tools for keeping project managers informed on key implementation issues. While evaluating the achievement of physical targets will remain important, highest priority will be placed on monitoring participatory processes and assessing beneficiary satisfaction with the services they receive. M&E units will play a central role in organizing and monitoring the consultation process, in implementing field studies to facilitate rolling design, and in communicating timely feedback to management.

20. To mitigate the risk of resource-misuse or inconsistency with IFAD's mandate, the following measures will be incorporated into the FLM approach: (a) identification of criteria for eligible/non-eligible activities at design stage (including technical and financial analysis of probable project interventions to ensure their feasibility); (b) increasing emphasis on the monitoring of project progress by means of joint assessments undertaken towards the end of each cycle; (c) joint reviews of annual programmes of work and budget by government, IFAD, and the cooperating institutions; and



(d) submission of periodic performance assessments to the Executive Board as experience is gained in the use of the mechanism.

21. A final risk is that IFAD staff requirements for greater involvement in implementation may be underestimated. To reduce this risk, it should first of all be acknowledged that the FLM is viewed as a supplement - not a replacement - of standard duration loans and that, as such, they will not come to dominate the IFAD loan portfolio. Secondly, to the degree that adoption of the FLM leads to fewer loan operations within IFAD, staff time will be shifted from initial design to more active involvement in implementation, most prominently during the periodic assessment exercises. Finally, as mentioned above, it would be desirable to shift some resources from design to implementation support in acknowledgement of the increased attention on supervision and periodic assessment.

VIII. RECOMMENDATION TO THE EXECUTIVE BOARD

22. It is recommended that the Executive Board consider and approve the proposed introduction of the Flexible Lending Mechanism as an additional lending instrument to be made available to Member States, as set forth in the present document.

COMPARISON OF INITIAL DESIGN CHARACTERISTICS OF STANDARD PROJECTS AND FLMS

Design Element	Standard Project	Flexible Lending Mechanism
Overall strategic goal and specific development objectives	Full specification	Same
Activities	High degree of specification of physical targets, often with limited flexibility	Same as for Cycle 1, flexible (within a range of possibilities thereafter)
Budget	High degree of specification	Same as for Cycle 1 and for management support through end of project, unallocated for Cycle 2 and beyond
Management and governance structures	Full specification	Full specification for management, evolutionary for grass-roots governance structure development
Mechanism for passing to second and subsequent cycles	Not applicable	Set of triggers or pre-conditions clearly specified at initial design stage (with detailed activities and budgets for second and subsequent cycles later formalized through loan addenda)
Project-level monitoring and evaluation (M&E)	Lack of clear incentives for project managers to make use of M&E inputs in decision-making Emphasis often primarily on physical target achievement	Clear incentive for project managers to make effective use of M&E inputs as this is a pre-condition for proceeding to subsequent cycles Greater emphasis on monitoring development <u>processes</u> and client satisfaction, prominent use of process indicators for determining whether project is on-track for achieving impact
Economic and financial analysis	Overall economic rate of return [calculated] based on detailed assumptions of beneficiary behaviour and investment choices	Financial analysis for individual probable programme activities, no overall economic rate of return calculated
Technical analysis	Detailed for all project activities	Detailed for major probable activities
Institutional analysis	Detailed for all probable development partners	Same



ADVANTAGES AND RISKS OF THE PROPOSED FLEXIBLE LENDING MECHANISM

Advantages and Risks	Remarks
Advantages	
Reinforcement of participatory processes in design and implementation	<ul style="list-style-type: none"> Continuation of IFAD's tradition of pioneering participatory approaches in project development with emphasis on ensuring that the needs and views of the poor are taken into account by offering an alternative loan mechanism consistent with the need for continuous design processes and learning-by-doing
Increases array of services that IFAD can offer to Member States	<ul style="list-style-type: none"> Demonstrates to Member States IFAD's willingness to innovate by tailoring financial instruments to their needs Strategic positioning of IFAD in developing new lending instruments while other donors are still trying to deal with similar issues Assuming other IFIs adopt similar approaches, facilitates IFAD cofinancing
Long-term commitment	<ul style="list-style-type: none"> Conveys message of IFAD's willingness to support achievement of development objectives over a more realistic timeframe Mitigates disruption of activities and the uncertainty that often accompanies transition between first and second phases of a typical duration project
Increased emphasis on implementation	<ul style="list-style-type: none"> Mechanisms for capitalizing on implementation experience and adapting to changing beneficiary priorities built into the cyclical programming process, including a strong role for M&E in triggering second and subsequent cycles Country portfolio managers will be required to make more strategic decisions and participate in field missions at critical junctures Probable shift in budget resources from project development to implementation support (supervision and periodic assessments)
Increased efficiency in loan delivery	<ul style="list-style-type: none"> Economies of scale in loan size and duration create potential to deliver loan resources to Member States more efficiently
Risks	Mitigating measures
Resources misused or used for activities inconsistent with the IFAD's mandate	<ul style="list-style-type: none"> Triggers specified at initial design for determining appropriateness of proceeding to second and subsequent cycles No release of funds for subsequent tranches of project funds will be authorized until the pre-conditions have been met. Criteria for eligible/non-eligible activities identified at design stage (including analysis of technical and financial feasibility of probable activities) Joint assessment of annual programmes of work and budget by government, IFAD, and the cooperating institution. Information papers on performance assessment submitted periodically to the Executive Board
IFAD staff requirements underestimated	<ul style="list-style-type: none"> FLM to supplement - not replace - standard-duration loans and, as such, will not dominate the loan portfolio Assuming that FLM adoption leads to fewer IFAD operations, staff time will shift from initial design to more active involvement during implementation, especially during periodic assessments Shift of resources from design to implementation support for supervision and periodic assessments

