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DECISION TOOLS IN RURAL FINANCE

SUMMARY

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ACRONYMS

CGAP	Consultative Group to Assist the Poorest
CI	Cooperating Institution
MFI	Microfinance Institution
MIS	Management Information System
NGO	Non-Governmental Organization
PMU	Project Management Unit
RFI	Rural Finance Institution
SCA	Savings and Credit Association

DECISION TOOLS IN RURAL FINANCE
SUMMARY

INTRODUCTION

Background

1. Since its inception, IFAD has developed an extensive body of knowledge in rural finance, with practices at the field level analysed in numerous thematic reports, programme evaluations and mid-term reviews. More recently, broad policy directions were set out in a document entitled IFAD Rural Finance Policy.

2. At the Sixty-Ninth Session of IFAD Executive Board in May 2000, it was decided that a set of guidelines would be defined in order to 'operationalize' IFAD Rural Finance policy within the context of IFAD rural finance programmes. The ensuing paper, Decision Tools in Rural Finance, also reflects the thrust of the Strategic Framework for IFAD 2002-2006 and its translation into regional strategies. In that context, the present summary version of Decision Tools has been prepared for the information of the Executive Board. Interested Board members may also refer to the full version of the document, available on request.

3. The goal of Decision Tools is to provide operational guidance to country portfolio managers (CPMs), project staff and consultants on the key rural finance issues reflected in IFAD Rural Finance Policy and on their significance for IFAD interventions at all stages of the project cycle.

4. The present guidelines are the result of an intensive participatory process within IFAD. The content of Decision Tools was finalized in close consultation with the rural finance thematic group. A questionnaire was sent to all CPMs, and in-depth discussions were organized with CPMs and management on their experiences with rural finance programmes. The draft of the paper was discussed further during a two-day workshop at IFAD in May 2002, after which the paper and the present summary version were finalized.

5. Decision Tools is organized in a 'reader-friendly' format, facilitating readers' access to the conceptual analysis and practical operational guidance they require. Moreover, since the paper cannot provide in-depth responses to all the questions raised, each section includes links to the most relevant websites for accessing more detailed references, papers and case studies. The document may also be placed on IFAD's website.

6. Finally, Decision Tools is a *living document that will be updated and 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 learned from IFAD-specific rural finance models*, reflecting IFAD's focus on knowledge management and the promotion of sound rural finance practices.

Structure of the Document

7. IFAD Rural Finance Policy highlights IFAD's four main policy directions:

- building sustainable rural finance institutions (RFIs) that provide outreach to the rural poor;
- encouraging active stakeholder participation in the development of rural financial services;

- creating diversified financial infrastructures that are appropriate to their operating environments; and
- helping to create a regulatory and policy environment that is conducive to rural finance activities.

8. Decision Tools reflects these themes, and the IFAD Strategic Framework for 2002-2006 and its associated development into regional strategies. Consequently, the topics of Decision Tools are categorized into three main sections:

- Section I highlights the various cross-cutting issues that are common to all IFAD rural finance programmes and form the basis of understanding rural finance.

- Section II examines the identification, formulation and implementation stages in the project cycle, and proposes ways and means of addressing the various challenges that arise from them.

- Section III focuses on issues and types of interventions that are specific to each of the regions in which IFAD operates. Additionally, it underscores IFAD's comparative advantage in implementing programmes in the particular regions.

I. CROSS-CUTTING ISSUES RELATING TO ALL RURAL FINANCE PROGRAMMES

9. Eight cross-cutting issues have been identified that impact nearly all IFAD rural finance programmes:

- the unique characteristics of agriculture finance;
- the impact of financial sector reform, and potential roles for state-owned banks;
- the role of client participation in rural finance programmes;
- the importance of savings and remittance services;
- identifying and overcoming factors that limit expansion of rural finance programmes into remote rural areas;
- how to balance the provision of loan capital versus funding capacity-building and technical assistance;
- policy issues; and
- conduct of impact analysis.

A. Unique Characteristics of Agricultural Finance

10. All lending activities imply risk. Agriculture finance is, however, characterized by a high level of risk, both climatic and economic (price fluctuations, difficulty in selling harvests, etc.). These risks are often covariant: they affect all borrowers in a given zone at the same time (e.g. drought, floods, epizootic diseases). Covariant risks are therefore harder to manage and make it difficult for RFIs to secure their loan portfolios. All these constraints are also intensified in the areas in which IFAD is present; namely disadvantaged areas with fewer cash crops and food crops, and where infrastructure and markets are often underdeveloped.

11. While microfinance already contributes to the financing of agricultural activities (seeds, small livestock, certain short-term needs such as post-harvest loans, etc.), this contribution remains largely

insufficient compared with the volume and diversity of agriculture financing needs in the current context of liberalization of farm economies in developing countries (including longer-term loans and repayment schedules adapted to production cycles).

12. Nonetheless, certain innovations in securing agricultural loans seem promising, particularly agricultural warrants, loan delegation, jointly managed guarantee funds and mutual guarantee associations. These security mechanisms make use of new types of contracts between the various partners in agricultural activities: producers, farmer organizations, processors, traders, etc.

13. In general, RFIs may only develop agriculture financing on a larger scale if farming itself becomes a more profitable and safer economic activity. This is why strong caution should be exercised in extending credit for the funding of staple productions in rainfed areas, for example. It is also important to assess the safeguards that exist on the economic activities themselves (such as price policy and the organization of markets and producers). This implies not only coordinating policies and donor actions but also forging new alliances between the various rural stakeholders, such as farmers' organizations and support services.

14. From the experience gained so far, various recommendations have emerged regarding the funding of agriculture needs, such as: (i) ascertain that there is a solvent demand; (ii) improve the RFI's knowledge of agriculture practices; (iii) diversify loan portfolios to minimize covariant risks; (iv) support service innovations as a way to secure loan portfolios; (v) strengthen cooperation between RFIs and farmers' organizations, while clearly separating lending and technical support functions; and (vi) develop ties with the formal financial system to access the funding sources needed for agriculture financing.

B. Impact of Financial Sector Reform and Potential Roles for State-Owned Banks

15. IFAD's experience of working with state-owned banks has not been successful in general. State-owned banks have often failed to service IFAD's targeted clientele, providing instead subsidized credit to favoured clients. Moreover, they have incurred a poor repayment history and have been prone to political interference. State-owned banks do, however, have certain potential comparative advantages that cannot be ignored, including large retail networks, trained staff, facilities for the transfer of funds, and the capacity to mobilize savings. Consequently, circumstances may provide incentives for IFAD to form partnerships with certain state-owned banks on a pilot basis, but only after an analysis of the state-owned bank itself is undertaken to assess its capacity to carry out such pilot programmes.

16. Beyond the analysis of the state-owned bank's underlying financial position, a strong political commitment from its senior management to support such pilot programmes should be considered as a prerequisite. A number of key criteria should also be met when considering a pilot operation with a state-owned bank. One should ensure that: (i) the pilot operation has programmatic autonomy and aims at sustainability; (ii) it is ready to offer financial services that meet the needs of the rural poor and to price these services at a rate that permits operational and financial cost recovery; (iii) it can develop adequate systems to manage and track loan portfolios; and (iv) it is willing to ensure accountability of staff through performance-based incentives. However, experience shows that only a very small minority of state-owned banks may be ready to experiment with microfinance and rural finance on the above basis. Before considering any such programme, IFAD should give priority to establishing very clear and strict criteria upfront, based on the above considerations. Otherwise, it runs the risk of replicating the flaws of its past programmes with state-owned banks.

17. A state-owned bank may also operate as a wholesaler of funds to smaller RFIs. This may often be a more viable option, considering the challenge a state-owned bank faces in managing retail lending

operations based on the sound practices mentioned above. The decision to set up such wholesale funding capacity should, however, be based on a careful analysis of the funding constraints faced by the recipient RFIs. This option should only be considered when the lack of loan capital is confirmed to be an important constraint in the expansion of those RFIs' operations. In addition, funds should be extended at a price that does not reduce the incentive for RFIs to mobilize savings.

C. Role of Client Participation in Rural Finance Programmes

18. Client/member participation in the design and operation of a rural finance programme can have different dimensions and meanings. It may reflect participation in the *design* of products and services, in which case it refers to the concept of *market research* and the need to adapt services to people's needs. It may also refer to participation in some *operational aspects* of service delivery as a means to diminish transaction costs for the RFI and help to achieve sustainability. It can relate to participation in the *decision-making process*, in the case of self-managed models where clients' representatives cover most of the institution's managerial tasks (as, for instance, in village banks). Finally, participation may be achieved through RFI *ownership*, with staff and client representation to the executive board of the institution.

19. The key benefit of participation, as suggested by the above examples, is that it creates a sense of ownership vis-à-vis the RFI operations. The RFI is no longer perceived as an external institution; rather, it is seen as the community's institution servicing the community.

20. Care needs to be taken when promoting participation that special interests do not hijack the programme for their own ends. This includes borrowers insisting on being subsidized by savers through low borrowing costs, or powerful local individuals having access to most of the assets. To prevent such undesirable outcomes, those promoting participation should address this issue within the larger context of good governance in order to ensure appropriate supervision of RFI management and operations.

D. Importance of Savings and Remittance Products

21. Contrary to popular belief, extensive research has proved that the rural poor can and do save. Saving services can be a critical factor in helping poor people to smooth consumption patterns, diminish vulnerability, overcome crises and eventually build assets on an incremental basis. From the viewpoint of an RFI, savings are also important because they help to diversify its funding base, sometimes at a lower cost than borrowed funds.

22. For savings programmes to be successful, however, there must be a minimum level of physical security, inflation must be steady and at low levels, and the local population must have confidence in currency as a store of value. From an institutional viewpoint, RFIs need to understand clearly the risks of intermediating savings. They must also have the necessary liquidity, management skills, and a strong and reliable management information system (MIS). Finally, RFIs that mobilize savings need to comply with legal and regulatory requirements.

23. The design of demand-driven savings services is an important and difficult challenge. The issue has been raised that compulsory savings may not, in the long run, serve either the client or the RFI, and that mobilization of voluntary savings may have the strongest impact on poor people's lives. Typically, a savings product should offer safety, be sufficiently flexible to meet the cash flow demands of the clients and be easily accessible.

24. While savings are an important tool, very few donors are equipped to support savings initiatives per se, particularly in the light of the perceived moral responsibility governments and donors have to depositors to ensure that their savings are safe. Compared with promoting credit alone, mobilizing savings requires closer and more intensive monitoring. Given the above, possible entry points for IFAD in supporting savings mobilization may include the following: (i) participate in donors' discussions with governments on policy and regulatory issues, helping to ensure that the needs of RFIs are considered; (ii) support capacity-building of regulatory and supervisory bodies; (iii) develop research and disseminate best practices; (iv) help RFIs to price both savings products and loan products correctly; and (v) support pilot experiments to increase the outreach of savings services.

25. In areas where there has been a high level of emigration, the provision of fund-transfer services (remittances) can be an extremely useful financial product. Possible mechanisms through which this service can be provided include a partnership with a larger commercial bank located in the capital, the use of post office services, and a linkage with a commercial provider. Before this area is embarked on, however, the risks relating to the security and transportation of funds, legal liability, staff capacity and internal control need to be considered.

E. Identifying and Overcoming Factors that Limit Expansion of Rural Finance Programmes into Remote Rural Areas

26. While it is difficult to provide a fixed list of conditions that are essential to the success of a rural finance programme, certain minimum conditions should be considered as prerequisites before launching such a programme. These conditions include basic political and macroeconomic stability, absence of very high inflation, basic security (enabling 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 RFI. The feasibility of any rural finance intervention should be carefully assessed in the light of the above criteria.

27. Different types of innovations can help to make rural finance interventions sustainable in remote rural areas. They include: (i) different outreach mechanisms that help to reduce transaction costs; (ii) management rules that set up highly decentralized and very low-cost systems; (iii) and innovative governance structures that fully draw on local social cohesion, checks and balances, and incentive systems.

28. In remote rural areas, it is important that the local social and cultural conditions reflect a certain level of collaboration, or social cohesion, which can be built on to establish local rural finance services. This can be a key factor in enabling most management functions to be decentralized at the local level, thereby dramatically diminishing operating costs. After these conditions have been identified and assessed, the appropriate methodology (group lending, village banking or individual loans) for this operating environment will need to be selected, and a specific range of services designed.

29. An operator who has a track record of success should be hired, and sufficient funding provided. These two factors are critical since experience has shown that providing financial services in remote rural areas requires strong technical expertise and is substantially more expensive than operating in urban environments.

F. How to Balance the Provision of Loan Capital versus Funding Capacity-Building and Technical Assistance

30. IFAD has for a long time provided lines of credit to the rural poor through agricultural development banks or integrated rural development projects. The performance and social impact of these projects have been very mixed, causing the Fund to revise its approach over the past few years. Today IFAD is putting more emphasis on strengthening the capacities of autonomous RFIs to provide diversified financial services (including savings) through a combination of technical assistance and loan capital. The appropriate balance between the two is very dependent on the stage of development of the individual RFI and will evolve progressively as the RFI moves along its growth curve. This balance should also be defined in the context of building strong *partnerships* with RFIs, whereby IFAD's support would be provided based on the RFI's own development plans and would reflect its commitment to meet mutually agreed minimum performance benchmarks. IFAD's support should also reflect, whenever possible, close partnerships with donors, where each party would seek to maximize the impact of its respective intervention (for example, bilateral donors' ability to provide grant funding to support RFI institution strengthening).

31. During the start-*up phase*, the provision of technical assistance is critical to enable the RFI to develop its systems, perfect products and services, and establish operational policies and procedures. These services should be provided on a grant basis. At the same time, soft capital is also needed, in the form of either grants or soft loans to strengthen the RFI's loan resources. During the *growth phase,* grant funding is still required to help to build an outreach infrastructure, while additional funding is needed to finance loan portfolio growth. The latter assistance, however, must be carefully coordinated with the development of the RFI's other loan capital resources (such as interbank lines) or savings mobilization to ensure that the RFI does not become donor-dependent. During the *maturity and institutionalization phase,* the RFI's dependence on donor finance should be reduced and replaced by mobilization of savings, commercial lines of credit or equity investors.

32. Technical assistance itself can take the form of strengthening management and human resources (staff training), improving operational structures (organization of headquarters and branch offices, procedural manuals, MIS, etc.), carrying out market research and developing financial products.

33. A key factor to the success of any technical assistance component, however, is the selection of the appropriate partner to deliver it. The provision of technical assistance services should be organized on a contractual basis, with potential suppliers submitting detailed proposals. These proposals should be rated, possibly using the methodology outlined in the main text ("Request for Proposals"), and both the quality of the assistance and the cost/benefit ratio should be considered. Prior experience in the designated technical field is a prerequisite. Care should also be taken that any assistance provided to the RFI blends into its long-term development strategy towards sustainability.

G. Policy Issues

34. Policy issues related to rural finance are of major importance to IFAD for many reasons: (i) they reflect the upstream dialogue and impact sought from on-the-ground rural finance projects; (ii) they may impact the growth, institutionalization and sustainability prospects of RFIs (e.g. interest rate 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.

35. Four policy areas appear to be of major importance to the Fund's operations: (i) the definition of national strategies; (ii) interest rates, fiscal policy, and any relevant aspect of monetary policy affecting RFIs; (iii) regulation and supervision; and (iv) other structural policies that affect rural development (and the status and operations of RFIs). When assessing its potential involvement in policy issues, IFAD should, however, first carefully consider whether it has a comparative advantage in this area (in relation to other partners with a strong field presence and more specialized technical expertise).

36. Regarding national microfinance strategies, and while taking the above into account, IFAD may help to bring about stronger coherence among national stakeholders and provide support to consolidate the sector in partnership with other donors. IFAD should also focus on the need for a liberalized interest rate regime for rural finance programmes. It may support an active policy dialogue regarding when and how to set up a legal and regulatory system, while ensuring that the requirements are practical and appropriate to RFIs. Furthermore, IFAD may consider providing assistance to the regulatory authorities to help make their supervisory function to RFIs effective.

H. Conduct of Impact Analysis

37. As emphasized in the Strategic Framework, IFAD has put great emphasis on monitoring the catalytic impact of its interventions, both at the field level and in relation to its policy dialogue and advocacy role. This also applies to the area of rural finance, where the prime objective of IFAD programmes is to improve the lives of the rural poor by providing them with sustainable access to a variety of financial services, including savings. From the early stages of microfinance development, donors have stressed the need to understand what the impact of microfinance is on the designated client base. Over time, several approaches to impact analysis have been tried. Based on lessons learned from earlier experiences, impact assessments today increasingly seek to identify how RFIs can serve their clients better. In addition to providing knowledge, impact assessments – in their various forms – are becoming tools to steer the policies and innovations (on new products and outreach mechanisms, for example) of microfinance institutions (MFIs)

38. Recently, several new impact methodologies have emerged. These models include the Consultative Group to Assist the Poorest (CGAP) client poverty assessment tool, the Microcredit Summit's poverty measurement tool kit, Microsave's participatory rapid appraisal, the United States Agency for International Development's assessment tool, and the Institute for Research and Implementation of Development Methodes/Centre for International Studies and Research impact analysis model. All of these methodologies and models are discussed in more detail in the body of Decision Tools.

II. FORMULATION AND IMPLEMENTATION OF RURAL FINANCE PROGRAMMES: THE CHALLENGES AND HOW THEY CAN BE ADDRESSED

39. In this section, the various stages of inception, formulation, implementation and monitoring of a rural finance programme are discussed. Additionally, certain key ratios and performance guidelines are highlighted that can help track the performance of ongoing programmes.

A. Project Inception Stage

40. Once it is ascertained that the minimum conditions for a viable rural finance intervention are met (discussed in section I/E), the project identification process may begin. Clear project principles and objectives need to be established. The issues that need to be decided at this stage are the possible scale of intervention, the appropriate strategy to achieve success in the local environment, and how sustainability and institutionalization can be achieved. Thereafter, the methodology to be adopted can be selected.

B. Project Formulation

41. Different project options are available to IFAD at the formulation stage: will the programme be a national-level intervention, or will it be more focused on a specific rural finance intervention? Before undertaking a national-level intervention (for example, defining a national strategy in support of microfinance or rural finance), IFAD should assess whether it has a comparative advantage to do so in relation to other donors (who may have a stronger field presence) and the likely impact of such a programme. In many instances, innovative field interventions may 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 brought about by governments to encourage their growth.

42. When IFAD focuses on setting up (or strengthening) a rural finance operation, the following principles should be reflected at formulation: (i) maintain the required flexibility in project design to enable the RFI partner to meet the twin objectives of outreach and sustainability in a way that is adapted to its own constraints, comparative advantages and strategy; (ii) provide for the principle of flexibility in budget allocation (as much as feasible) to meet more effectively the evolving needs of the RFI partner during implementation; and (iii) if the RFI partner cannot be selected at the formulation stage, at least clearly highlight the selection process, conditions and criteria that will be used to choose this RFI partner at project inception (possibly using the format of the "Request for Proposal" mentioned in the main text of Decision Tools).

43. Where an existing RFI is being considered as a potential partner, an institutional assessment should be undertaken, which could follow the guidelines of CGAP's format for MFI appraisal. This assessment will include a review not only of the RFI's vision (including its goals on poverty outreach), its operating systems, the types of services it provides and its projection on operational sustainability, but also of its institutional structure and governance.

44. When a potential partner appears weak, providing technical assistance to strengthen it needs to be considered with caution, since this approach may be time-consuming, expensive and ultimately self-defeating. Donors tend to be over-optimistic about the possibility of turning weak institutions into well-performing ones. If the weakness is with the management team itself, rather than with the RFI systems, selecting another partner would often be a better alternative.

45. After an RFI partner is selected, a performance-based contract should be signed between the partner and the Government/IFAD. Setting appropriate minimum performance targets is in itself difficult: they would typically be lower than the targets reflected in the RFI's own business plan. Reaching performance targets should also be a condition for IFAD's continued funding to this RFI. Targets should be set on a limited number of critical performance indicators, which may include a measure of outreach (number of clients), operational self-sufficiency and portfolio quality (delinquency

and portfolio-at-risk). This approach has the advantage of providing early warning signals of a deteriorating situation, thus allowing issues to be addressed before a major crisis occurs.

C. Project Implementation and Monitoring

46. Project monitoring is both a key responsibility and challenge for two reasons. First, the quality of implementation determines success: poor implementation will jeopardize a well-designed rural finance project. Second, IFAD staff time and resources for monitoring projects are scarce. Cooperating institutions (CIs) and project management units (PMUs) have a critical role to play during this phase. In this context, the key information to be reported by RFIs and the recipients of that information need to be clearly established.

47. Monitoring functions would obviously depend on the type of rural finance project, for instance, whether it reflects IFAD support to a national rural finance strategy, a combination of policy and operational work, or a targeted intervention in support of one RFI or several. Ensuring the quality of policy work would result from a combination of factors: (i) the profile and competence of PMU and CI staff; (ii) the ability to identify and recruit high-level expertise at some critical stages (e.g. on MFI regulation and supervision); and (iii) maintainance of active channels of communication with other donors in the field, for instance to ensure the coherence of donor support.

48. Monitoring *of rural finance operations* should focus on a few selected issues such as growth, performance, outreach, sustainability, institutionalization and impact. Such monitoring reflects the challenge of improving the *quality and reliability* of selected information provided by RFIs, which would need to be collected by project PMUs and shared with IFAD. Tools available to conduct *impact analysis* are described in section I/H. They are analysed in detail in terms of scope, advantages, limitations and cost in the full version of Decision Tools. Monitoring and evaluation of rural finance projects will also build on the framework recently finalized by IFAD's Office of Evaluation.[1]

49. The progression towards outreach, financial viability and institutional sustainability deserves a particular focus during project implementation. In that context, the ratios mentioned below should be analysed carefully during implementation from a trend perspective. Ideally, those ratios should be provided by the RFI to the PMU on a quarterly basis, and shared with IFAD headquarters once a year, with a concise technical analysis of the RFI's recent developments (highlighting outreach and impact, financial performance and institutional status).

50. Financial *viability* can be monitored using the following ratios:

- Outreach and market penetration can be tracked by the use of the client drop-out/retention rate and the percentage of the RFI's clientele to the overall target population, and by using one of the aforementioned client assessment/impact models (e.g. the client poverty assessment tool).

- Portfolio volume and quality are vital to the financial health of the RFI. The portfolio can be monitored by the loan-recovery-rate ratio, portfolio-at-risk ratio, loan-loss ratio and loan-reserve ratio. Of these, the portfolio-at-risk ratio is considered the most important indicator since it is predictive rather than historical in nature.

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[1] *A Guide for Project Monitoring and Evaluation,* IFAD Office of Evaluation, 2002.

- Reaching a certain level of operational efficiency is critical to achieving, and maintaining, long-term financial viability. The efficiency of the RFI can be tracked by following the trends of the administrative-efficiency ratio, the number of active loans per loan officer, and the average portfolio outstanding per loan agent. Of these, the average portfolio per loan agent may be considered the most useful.

- The long-term financial viability of the RFI can be monitored by comparing the return-on-equity ratio, the operational self-sufficiency ratio, and the financial self-sufficiency ratio against both their historical trends and the performance of the RFI's peers. On balance, the operational self-sufficiency ratio is the most important and the most widely understood.

51. In the monitoring and tracking of these ratios and statistics, it is important to note that the main variables that affect the performance of an RFI are the: (i) achievement of economies of scale; (ii) net interest spread between the cost of funds and the income yield on the portfolio; (iii) effectiveness of controlling operating costs; and (iv) ability to minimize loan losses. Variations in these statistics will reflect volatility in the earnings performance of the RFI.

52. Institutional *viability* relates to the effectiveness of the RFI's internal operating structure and the quality of its governance.

- The efficiency of the internal operating structure revolves around the management's ability to coordinate the various components within the institution itself. These components include personnel, business planning, technical capabilities, operating systems and social/professional cohesiveness.

- The quality of governance relates to the quality and intensity of oversight and guidance that the supervisory structure (often the board of directors) brings to the RFI itself. The important factors here are the supervisory structure's members, their levels of professional competence and their depth of interest in the RFI's operations. Their ability to define the mission of the institution, to monitor and control the performance of management, to represent fairly the interests of all stakeholders (including clients and staff) and to act decisively in times of crisis will have a direct impact on the viability of the RFI.

53. To improve the monitoring of its rural finance programmes, IFAD should consider the following recommendations: (i) facilitate staff attendance at specialized training courses; (ii) develop specific rural finance training modules with existing regional training hubs (such as those set up with CGAP support) for project staff in the field; (iii) review its partnerships with CIs and identify appropriate mechanisms to secure the presence of specialized rural finance expertise in the CIs' technical review missions. This could be done through agreements with the above regional training hubs, which would ensure the presence of certified rural finance experts in those missions; (iv) require RFIs to prepare the previously mentioned ratios and statistics and forward them to PMUs on a quarterly basis; and finally (v) conduct annual audits of rural finance projects with qualified firms.

III. RURAL FINANCE STRATEGIES IN THE GEOGRAPHIC DIVISIONS

54. One striking characteristic of IFAD rural finance programmes has been the great variety of approaches and models promoted across regions. These models include, among others, financial non-governmental organizations (NGOs), rural savings and credit associations (SCAs), financial cooperatives, financial services associations, Grameen Bank replications, and self-help groups. Despite this great diversity, all these approaches often face similar issues and challenges, such as how to: (i) combine effectively their objectives of outreach and sustainability; (ii) improve their internal

reporting systems and administrative efficiency; and (iii) document better the breadth of their poverty outreach and their impact on the lives of the rural poor. In that context, the cross-cutting issues (section I) and the challenge of improving project cycle effectiveness (section II) are largely shared in principle by most of these models. However, they are reflected operationally in different ways across regions.

55. These differences have been highlighted in the regional strategies finalized in the wake of IFAD's Strategic Framework for 2002-2006. They are discussed in section III of Decision Tools, which includes, for each region, a brief summary of the current status of rural finance in the region, and a review of IFAD interventions and of the methods and tools that are particularly relevant to this region (along with IFAD's comparative advantages in rural finance).

A. Western and Central Africa

No. of Ongoing Projects with Microfinance Component	IFAD Loans USD million	Microfinance Component USD million	Microfinance Component %	% of Microfinance Operations Region/ Total IFAD
33	364.3	82.3	23%	12.1%

56. Decentralized financial systems have a strong rural tradition in both Western and Central Africa, but the majority of these are concentrated in the relatively wealthy rural areas, where cash crops are harvested or irrigated farming is in use. This suggests that there is considerable scope for IFAD to expand access to financial services to its target population.

57. The mutualist system is the dominant legal model in use in Western Africa. It has generally been very successful at savings mobilization and outreach. However, many of the large networks have recently encountered serious governance problems related to conflicts of interest between elected and salaried staff, and to members' weakness in assuming managerial tasks. This has in some instances been reflected in a decline in loan portfolio quality, which could jeopardize the recovery and future development of some of those networks. In both regions, the institutions have suffered from weaknesses in MIS, internal control and operational organization. Thus, the basic need for support in the region is technical assistance and capacity-building, rather than loan capital.

58. Given the above, relatively few RFIs have reached full financial self-sufficiency. In Western Africa, however, about 40% seem to have achieved some level of operational self-sufficiency, while in Central Africa the proportion may be lower.

59. Following its rural finance portfolio review in 1996, IFAD has been supporting two types of interventions. First, it has funded the emergence of decentralized RFIs (new structures such as financial services associations or highly decentralized village bank structures) or the extension of existing systems into new rural areas. Second, in some countries such as in Niger, it has embarked on national microfinance sector support programmes.

60. IFAD's current comparative advantages in microfinance in relation to other donors are associated with both its mandate and its experience. These advantages are as follows: (i) *interventions in rural areas*, including disadvantaged and remote zones, while most donors are withdrawing from those areas; (ii) *grass-roots interventions*, working closely with communities and encouraging them to participate in

designing products and systems that match local needs, constraints and strategies more effectively; and (iii) *piloting of new decentralized financial systems*, while encouraging action research and innovation.

B. Eastern and Southern Africa

No. of Ongoing Projects with Microfinance Component	IFAD Loans USD million	Microfinance Component USD million	Microfinance Component %	% of Microfinance Operations Region/ Total IFAD
27	356.8	97.4	27%	14.4%

61. The majority of MFIs currently operating in Eastern and Southern Africa are member-based MFIs, such as savings and credit cooperatives, or locally based solidarity systems. The member-based institutions have had a chequered history over the past 20 years, suffering heavily from government interference. While their penetration levels in certain countries used to be quite high, it currently totals only 1-2% of the total population and with little coverage of rural populations. Although these institutions have the capacity to mobilize savings, their overall management is usually weak, especially their loan portfolio management, which severely curtails their effectiveness.

62. Solidarity systems are concentrated mainly in urban areas and focus on the middle-income entrepreneurial class. Their level of outreach varies on a country-by-country basis, with the highest outreach being achieved in Ethiopia.

63. Until the early 1990s, IFAD worked mainly with formal finance sector partners (usually agriculture development banks). After the closure of most of these institutions, IFAD reviewed and dramatically changed its strategy. It has since promoted a rural finance strategy based on diversified partners (especially member-based RFIs) and a broader selection of rural finance services (including savings). Stronger emphasis has consequently been placed on capacity-building and institution strengthening, as opposed to the provision of large credit lines. IFAD has also been involved in policy work, supporting the improvement of rural finance legal and regulatory frameworks.

64. Areas where Decision Tools may particularly support IFAD’s work in this region include: (i) requirements and responsibilities for the mobilization of savings by institutions; and (ii) policy dialogue with governments to help to create an enabling environment for grass-roots and member-based rural finance initiatives.

C. Asia and the Pacific

No. of Ongoing Projects with Microfinance Component	IFAD Loans USD million	Microfinance Component USD million	Microfinance Component %	% of Microfinance Operations Region/ Total IFAD
36	654.4	231.8	35%	34.2%

65. The Asia and Pacific region has been host to a great variety of microfinance 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 world’s fastest-growing MFIs (such as the

Association for Social Advancement in Bangladesh), innovative models with strong outreach (self-help groups/bank linkage models in south and south-east Asia), reformed state-owned institutions (such as the Bank Rakyat Indonesia Unit Desai in Indonesia, with its great success in mobilizing savings), and financial NGOs that have successfully transformed themselves into licensed commercial institutions with impressive outreach (such as the Association of Cambodian Local Economic Development Agencies in Cambodia or the Centre for Agriculture and Rural Development in The Philippines).

66. Representing almost 35% of its total funding in rural finance, IFAD activities in Asia have been both important and diversified. Among others, IFAD has supported self-help group/bank linkage models (in India and Nepal), has worked with very large state-owned institutions (rural credit cooperatives in China) and has provided support to RFIs using solidarity group lending methodologies (Grameen Bank replications in The Philippines, for example).

67. Each of the above models has both strengths and weaknesses. This provides IFAD with the opportunity to document their achievements and shortcomings more fully, leading the way to new interventions and assessments that will help fulfil the potential of those approaches.

68. The self-help groups generally have been found to have very good outreach and strong community focus; and in certain circumstances, they have facilitated linkages to the commercial banking sector. Some questions, remain, however, related to the survival rate of the self-help groups after the closure of support programmes, the reluctance of some private banks to work with these groups (when the state does not have a proactive policy promoting such linkages), the accounting of the full cost of the system and its sustainability, as well as whether this model actually serves the very poor. IFAD is very well placed to undertake, with other donor partners, in-depth analysis to document more fully not only the critical success factors and challenges of this model, but also the appropriate circumstances for its successful replication.

69. The benefits of innovative pilot programmes in state-owned banks (e.g. in China) are reflected in their strong demonstration effect on government policy, and their massive impact through replication via the state-owned banks' large networks in rural areas. However, the conditions for launching and implementing successful pilot reform projects are very demanding and often difficult to secure. Clear government support remains a prerequisite for securing the key conditions that will largely determine the success (or failure) of such interventions (see section I/B). The issue of reaching IFAD's target population (the very poor) is also a challenge that needs to be addressed by defining appropriate outreach mechanisms and products (e.g. non-collateral lending).

70. IFAD's comparative advantages in the region are perceived to be its ability to access poor populations in remote areas (often mountain zones), its inclination to work with grass-roots organizations (including self-help groups), its experience in using pilot projects for testing ideas, and its capacity to dialogue with governments on policy issues.

D. Near East and North Africa/Central and Eastern Europe

No. of Ongoing Projects with Microfinance Component	IFAD Loans USD million	Microfinance Component USD million	Microfinance Component %	% of Microfinance Operations Region/ Total IFAD
36	336.9	145.6	43%	21.5%

Near East and North Africa

71. Most countries in the region have had a history of direct state intervention in the rural finance sector, and some policy issues have hindered 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, with the emergence of new actors on the rural finance scene. New MFIs have, however, mainly been concentrated in urban and peri-urban areas, and the delivery of financial services to rural areas has continued to rely on large state-owned agriculture banks.

72. IFAD's rural finance interventions in the region have long been through the provision of credit lines to state-owned agriculture banks. Lately, however, cooperation with these banks has declined, and recent projects with those partners have tended to focus on pilot reform initiatives (e.g. in Algeria). Increasingly, IFAD has also tended to support the provision of short-term credit through emerging specialized NGOs, as highlighted in two recent projects in the Middle East. In Lebanon, IFAD is supporting the establishment of an SCA network, with two local commercial banks refinancing the network, partly with their own funds. In Syria, IFAD is supporting the development of a network of small credit associations in rural areas – the *sanduq* network.

73. IFAD is well positioned in the region to continue to support, on a very selective basis, pilot programmes with existing formal institutions that are ready to implement reforms to facilitate access to rural finance services by the rural poor. Such programmes should, however, be pursued only when the conditions highlighted in section I/B are met and should focus on the provision of technical assistance/capacity-building (as opposed to the provision of credit lines). Whenever the conditions permit, IFAD should also support the emergence of alternative rural finance models. Key conditions to be assessed in that context are the following: (i) such models should take into account at an early stage the issue of institution building and sustainability (and its relation to operating principles such as sufficient interest-rate level); (ii) appropriate specialized technical expertise should be identified and mobilized in support to those interventions; and (iii) the rural finance methodology should be carefully appraised before scaling up the pilot programme. Taking into account its experience in policy dialogue in the region, IFAD could also play an active role in promoting a more conducive environment for rural finance.

Central and Eastern Europe - the Commonwealth of Independent States

74. The collapse of the former centralized economies and the closure of many state-controlled financial institutions have created 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 remained largely concentrated in urban areas.

75. Moreover, unlike IFAD's target populations elsewhere, those in this region usually have a strong level of formal education and are relatively new to the effects of poverty. As in other regions, however, rural poverty is more severe than urban poverty, despite post-communist land reforms and other policy changes.

76. IFAD's rural finance policy in the region is twofold. For rural populations that are excluded from the banking system, SCAs have been encouraged at the village level to provide basic banking services. For small to medium-sized farms needing access to medium-term credit, IFAD is providing lines of credit to existing banks, which then on-lend to borrowers.

77. Looking ahead, IFAD could undertake an in-depth assessment of the SCAs to examine the prospects for their institutionalization into viable RFIs and their potential replication in other areas. The partnership with the banking sector could also be expanded to upgrade their systems and

technology so as to increase their outreach to the rural areas (building on other donors' programmes in that area). In certain countries, IFAD may also have a role to play in facilitating a dialogue with the governments regarding the establishment of a more conducive environment for RFIs.

E. Latin America and the Caribbean

No. of Ongoing Projects with a Microfinance Component	IFAD Loans USD million	Microfinance Component USD million	Microfinance Component %	% of Microfinance Operations Region Total IFAD
36	454.1	121.5	27%	17.8%

78. Latin America has had a long history of very successful microfinance development, with some of its MFIs considered as pioneers in that area. However, most of those MFIs have concentrated their operations in urban and peri-urban areas (although this is changing in certain countries). Moreover, contrary to what has occurred in other regions, savings mobilization has not developed as rapidly as lending. Overall microfinance penetration into rural areas still remains an important challenge in many countries.

79. Historically, IFAD's strategy had been to consider rural finance as a component of integrated programmes, usually through the offices of a state-owned bank. This strategy has been less than successful, however, due to the reasons mentioned earlier (section I/B). Based on lessons learned from this earlier approach, a new strategy was adopted to work through local RFIs, and focus on broadening the services offered (including saving products). Increasing emphasis has also been placed on institution-building considerations.

80. Current IFAD interventions in the region support the emergence of rural grass-roots institutions, work with experienced operators and build partnerships with interested formal financial institutions when possible and appropriate. Furthermore, when legally permissible and when the RFI has the in-house capacity to manage savings, the mobilization of savings is being encouraged.

81. Areas of future involvement for IFAD may include strengthening of grass-roots and rural financial institutions, further encouragement of savings mobilization (when legally authorized and operationally feasible) and support for the creation of a more enabling environment for RFIs.