Distribution:	Restricted	**EB 2004/83/R.21/Rev.1**	2 December 2004
Original:	English	**Agenda Item 11(b)(iv)**	English

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IFAD

INTERNATIONAL FUND FOR AGRICULTURAL DEVELOPMENT

Executive Board – Eighty-Third Session

Rome, 1-2 December 2004

REPORT AND RECOMMENDATION OF THE PRESIDENT

TO THE EXECUTIVE BOARD ON A PROPOSED LOAN TO THE

REPUBLIC OF ZAMBIA

FOR THE

RURAL FINANCE PROGRAMME

TABLE OF CONTENTS

APPENDICES

CURRENCY EQUIVALENTS

Currency Unit	=	Zambia Kwacha (ZMK)
USD 1.00	=	ZMK 4 700
ZMK 1 000.00	=	USD 0.2128

WEIGHTS AND MEASURES

1 kilogram (kg)	=	2.204 pounds (lb)
1 000 kg	=	1 metric tonne (t)
1 kilometre (km)	=	0.62 miles (mi)
1 metre (m)	=	1.09 yards (yd)
1 square metre (m^2)	=	10.76 square feet (ft^2)
1 acre (ac)	=	0.405 ha
1 hectare (ha)	=	2.47 acres

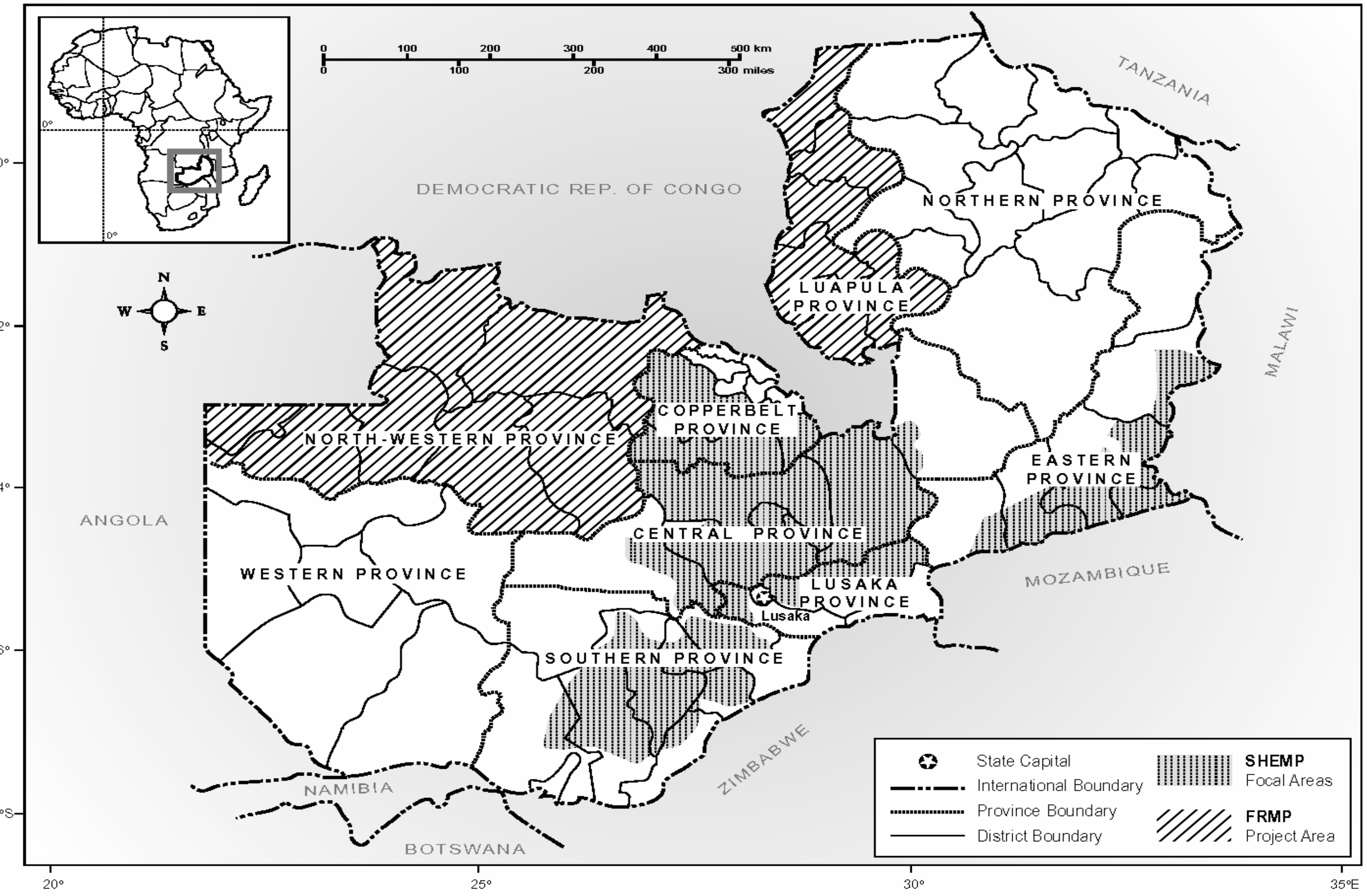
ABBREVIATIONS AND ACRONYMS

ASP	Agricultural Support Programme
BoZ	Bank of Zambia
CBFI	Community-Based Financial Institution
DBZ	Development Bank of Zambia
FRMP	Forest Resource Management Project
FSDP	Financial Sector Development Plan
GDP	Gross Domestic Product
GNI	Gross National Income
MFI	Microfinance Institution
MFNP	Ministry of Finance and National Planning
NGO	Non-Governmental Organization
NSCB	National Savings and Credit Bank
PMU	Programme Management Unit
RFU	Rural Finance Unit
SHEMP	Smallholder Enterprise and Marketing Programme
SIDA	Swedish International Development Cooperation Agency
USAID	United States Agency for International Development

GOVERNMENT OF THE REPUBLIC OF ZAMBIA
Fiscal Year

1 January – 31 December

MAP OF IFAD-SUPPORTED INTERVENTIONS



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REPUBLIC OF ZAMBIA

RURAL FINANCE PROGRAMME

LOAN SUMMARY

INITIATING INSTITUTION:	IFAD
BORROWER:	Republic of Zambia
EXECUTING AGENCY:	Ministry of Finance and National Planning
TOTAL PROGRAMME COST:	USD 17.43 million
AMOUNT OF IFAD LOAN:	SDR 9.25 million (equivalent to approximately USD 13.81 million)
TERMS OF IFAD LOAN:	40 years, including a grace period of ten years, with a service charge of three fourths of one per cent (0.75%) per annum
CONTRIBUTION OF THE BORROWER:	USD 3.04 million
CONTRIBUTION OF FINANCIAL INSTITUTIONS:	USD 431 000
CONTRIBUTION OF THE BENEFICIARIES:	USD 144 000
APPRAISING INSTITUTION:	IFAD
COOPERATING INSTITUTION:	United Nations Office for Project Services

PROGRAMME BRIEF

The Programme. The Rural Finance Programme has been designed within the framework of Zambia's poverty reduction strategy and Financial Sector Development Plan. The programme is the first intervention under an intended commitment by IFAD to support long term rural financial services development. The programme will develop community-based financial institutions, expand rural banking services, intensify and expand contracted smallholder production and promote new financial services appropriate for rural areas, paying special attention to the requirements of the poorest people. These interventions will establish a basis for improving the institutional and policy framework for rural financial services.

Who are the beneficiaries? Direct beneficiaries will include (i) 30 000 poor rural households participating in savings and credit associations; (ii) 100 000 rural households and small enterprises accessing rural banking services, including 15 000 households and small enterprises accessing credit; (iii) medium- to large-scale enterprises intensifying or expanding a contract relationship with 60 000 rural households, some of whom will also be accessing rural banking services; and (iv) an unknown number of households benefiting from the programme's matching grants for financial services projects, including those specifically targeting poor rural people such as woman-headed households and households affected by HIV/AIDS. As many as 150 000 rural households could be direct programme beneficiaries.

Why are they poor? Historical, geographic and social factors explain the severe rural poverty in Zambia. After independence, public revenue derived from mining was used to finance state-led, urban-based economic expansion, neglecting smallholder agriculture and inhibiting agribusiness development. For two decades, recurrent macroeconomic management problems have been limiting the pace of development, even during the last decade and a half, when progressive agricultural liberalization has taken place. The decline of public revenue derived from mining has been rendering previous levels of public services unaffordable. Poor public expenditure control and limited prioritization of pro-poor expenditures have added to these problems.

What will the programme do for them? Savings and credit groups are a proven source of social empowerment, especially for women, bringing benefits to communities by enabling members to generate savings and access small loans. In addition, village banks enable members to access larger loans for investment in income generating activities. The successful recapitalization and development of the National Savings and Credit Bank will improve access to rural banking services for a major part of rural society. Its will do so domestically through household savings, money transfers and to a small extent loans, institutionally through money transfer for government bodies, and commercially through working capital, investment finance, secure deposit and money transfer facilities. The programme's credit facility for contracted small scale production will enable additional smallholders to commence contracted production activities, with higher returns than would otherwise be possible. The innovation and outreach facility will help develop new rural finance products including those accessible to female-headed households and HIV/AIDS-affected households.

How will beneficiaries participate in the programme? Savings and credit groups are managed by communities. Accumulative Savings and Credit Associations can exist at various stages of development; the lowest are savings facilities which are also valuable to the poorest people, including female-headed and HIV/AIDS-affected households. The communities will decide what level is most suitable and at what pace graduation to higher levels can take place. Over time, they will likely become clients of the local branch of the National Savings and Credit Bank, either individually or as members of a community-based financial institution. Less poor smallholders along the 'line of rail' are the most likely to engage in contract farming and as such become beneficiaries of the credit facility.

REPORT AND RECOMMENDATION OF THE PRESIDENT OF IFAD TO THE EXECUTIVE BOARD ON A PROPOSED LOAN TO THE REPUBLIC OF ZAMBIA FOR THE RURAL FINANCE PROGRAMME

I submit the following Report and Recommendation on a proposed loan to the Republic of Zambia for SDR 9.25 million (equivalent to approximately USD 13.81 million) on highly concessional terms to help finance the Rural Finance Programme. The loan will have a term of 40 years, including a grace period of ten years, with a service charge of three fourths of one percent (0.75%) per annum. It will be administered by the United Nations Office for Project Services as IFAD's cooperating institution.

PART I – THE ECONOMY, SECTORAL CONTEXT AND IFAD STRATEGY[1]

A. The Economy and Agricultural Sector

1. Zambia lies landlocked on the South-Central African Plateau and covers a total area of 752 610 km^2. The population of 10.4 million is growing at 1.5% per annum compared to 2.8% growth a decade ago. Due to the historic concentration of mining and related industry, most people live along what is known as the 'line of rail' built before independence in 1964 to connect Southern Rhodesia with Livingstone and Lusaka to the Copperbelt. For this reason, only 60% of the population is rural. Upon independence, the country inherited an established mining sector and was relatively prosperous by regional standards. Since then, poor economic management, central direction of the economy and declining international copper prices have caused increasing impoverishment of the population. In the past decade, poverty has been exacerbated by the impact of HIV/AIDS, which has contributed to the decrease in life expectancy to below 33 years. The country is now classified as a least developed country and gross national income (GNI) per capita is USD 380. Three out of four Zambians are poor. In rural areas, 83% of the people are poor and 71% are extremely poor. Many of the poorest people live in female-headed households and households affected by HIV/AIDS. Since the early 1990s, economic reforms have helped limit the economic decline. Slow progress in privatisation along with poor public expenditure control and prioritization has constrained development, however. Economic growth averaged just 2% in the past eight years. The Government is currently pursuing Poverty Reduction and Growth Facility-supported programme with the International Monetary Fund and the country is expected to reach the Heavily Indebted Poor Country Initiative completion point in 2005. Macroeconomic performance has improved substantially in 2004. For example, the 91-day treasury bill rate has fallen from 30% in 2003 to 11% in August 2004.

2. Agriculture contributes about 20% of the gross domestic product (GDP) and is important both as a source of income for rural people and as a source of food for urban people. The sector grew at an annual average of 4.5% during the 1990s. Performance has varied recently because of droughts. In a single year, 1.5 to 2.0 million ha of a potential 42 million ha of agricultural land is cultivated. Crop production is generally rainfed and typified by maize, with sorghum, cassava, millet, and, particularly, cash crops including cotton, tobacco and vegetables gaining increased importance. Smallholders cultivating 1-5 ha of land constitute 90% of the farming community, accounting for 70% of

[1] See Appendix I for additional information.

agricultural production and 80% of agricultural employment. Emergent and large-scale farmers also make important contributions along with a dozen corporate operations integrated with agro-processing. Since the early 1990s, the Government has been withdrawing from agricultural markets and privatizing state-owned companies. This has caused the emergence of small-scale traders in rural areas and facilitated the establishment of contract farming operations in cotton, paprika and fresh vegetables, which provide smallholders with inputs on credit. Agricultural sector investments have remained low, constrained by high costs of, and limited access to, finance, poor infrastructure, poorly developed markets, but also by lack of clarity about the Government's future role in agricultural markets. Smaller enterprises generally have no access to financial services, and even larger enterprises lack access to long term finance.

3. Before 1990, state-controlled institutions dominated the agricultural finance market, which focused on credit for seeds and fertilizers. Over time, Government operations in the maize and fertilizer markets became unaffordable. As these operations were abolished, most of these institutions were wound up. Financial sector liberalization was initiated in 1992. The banking sector experienced instability with several bank failures in the following years. During the 1990s, the Bank of Zambia (BoZ) became responsible for supervising the financial sector, including non-bank financial institutions. Amendments to the banking laws and other financial sector regulations have been passed and a sound basis now exists for the operation and control of the sector. The informal financial sector is poorly developed, however. Although there are fifty microfinance institutions (MFIs), these mostly serve urban areas and no MFI has yet achieved financial sustainability. MFIs offer less potential and fewer options for the development of rural finance than in many other countries in the region. Some MFIs, however, can provide services to develop community-based financial institutions. At the community level, financial service arrangements do exist; the most common are rotating savings and credit associations, which are popular among poor women, and accumulative savings and credit associations, which are more flexible and responsive to member demand. The largest source of agricultural credit is from contract farming companies in cotton, horticulture and tobacco, which provide smallholders with inputs and small capital items on credit.

4. Following a financial systems stability assessment in 2002, the Government has prepared a Financial Sector Development Plan which provides overall direction to – and an organizing framework for – the development of the financial sector. The plan assigns priority to the development of a rural finance policy and strategy as a means to assist the Government to make financial services available to rural people. It also addresses a number of the issues that were raised in the assessment, including the long-standing issue of resolving state-owned non-bank financial institutions such as the National Savings and Credit Bank (NSCB) and the Development Bank of Zambia (DBZ). During 2004, International Monetary Fund-financed technical assistance has helped the Government to assess the development plans for these institutions. The development plan for the NSCB has been reviewed and refined as part of the design of the present programme. The Government and the Bank of Zambia have recently, in consultation with staff of the World Bank and the International Monetary Fund, reached decisions on action plans that will lead to the resolution of NSCB and DBZ. The action plans include strengthening the Bank of Zambia's supervisory authority.

B. Lessons Learned from Previous IFAD Experience

5. IFAD has provided ten loans to Zambia to help finance eight interventions, six of which have closed. Of the closed interventions, four were approved before liberalization took place; these sought to contribute to sustainable rural poverty reduction within the prevailing policy and institutional environment. The remaining two, both of which have closed recently, were implemented through existing Government structures under the Agricultural Sector Investment Programme implemented in the mid 1990s to reinforce household food security, reduce vulnerability and diversify incomes by improving access to support services and productive assets. Implementation of the two interventions faced administrative difficulties, including procurement and disbursement, and progress in meeting objectives was hampered by inadequate capacity to manage and deliver services and investments. The

two ongoing interventions, the Smallholder Enterprise and Marketing Programme and the Forest Resource Management Project have taken these lessons into account. Implementation responsibilities have been contracted to agencies with the capacity to deliver the required investments and services under the overall coordination and management of a Government ministry. The contract-based implementation arrangements have brought several new challenges related to management, which are gradually being overcome. Cumbersome Government procurement procedures have continued to constrain implementation. The design of the Smallholder Enterprise and Marketing Programme, which aims to improve the smallholders' linkages to markets, reflects the realization that although improved access to financial services is needed to complement improved market linkages, rural financial services development is best undertaken with an exclusive focus on rural finance.

6. IFAD's most recent experience with rural finance dates back to the second phase of the Northwestern Province Agricultural Development Project, approved in 1991. The project provided credit lines to the DBZ and to the Credit Unions and Savings Associations (CUSA); its poor performance contributed to a supply-led expansion of CUSA's activities far beyond the institution's capacities that was inconsistent with sound operating modalities for a member-based financial institution.

C. IFAD's Strategy for Collaboration with Zambia

7. **Zambia's policy for poverty eradication**. Zambia's poverty reduction strategy was finalized in 2002 and aims to achieve broad-based economic growth and reduce poverty. The main objectives are to (i) promote economic growth and diversification in production and exports; (ii) improve the delivery of social services; and (iii) address HIV/AIDS and gender as crosscutting issues. The approach is to achieve poverty reduction through a combination of growth-promoting investments in important sectors, with a focus on agriculture and other rural activities to develop infrastructure; improve access to and quality of social services; improve governance; and integrate policies on HIV/AIDS, gender and the environment. Within the rural sector, the poverty reduction strategy is based on: improving rural infrastructure; creating rural employment opportunities through encouragement of large-scale agricultural, agro-processing and tourist ventures; strengthening the linkages of smallholders to large-scale producers and agribusiness enterprises through contract farming operations; stimulating rural enterprises; providing services to help poor rural people with limited possibilities to engage in market-based activities improve their access to food; and strengthening social services in education, health and sanitation. Successful implementation of the poverty reduction strategy will require further development of policies, strategies and action plans.

8. **IFAD's operational strategy in Zambia**. As lessons were being learned from the interventions implemented within the framework of the Agricultural Sector Investment Programme, and as further progress was being achieved in agricultural sector liberalization, the primary strategic focus of IFAD's support was directed towards supporting smallholder commercialization, including the establishment of improved market linkages between smallholders and agribusiness and improved access to rural financial services. In addition to the primary strategic thrust, a second thrust will be to assist isolated rural populations to raise their productivity, food production and income levels. The second thrust will focus on expanding the outreach and relevance of services and investments for the poorest productive rural households, including female-headed and HIV/AIDS-affected households.

9. **Activities of other major donors**. Bilateral donors are engaged in a range of activities to support agricultural and rural development. The United States Agency for International Development (USAID) and SIDA both support numerous activities that directly or indirectly promote smallholder commercialization and agribusiness development. USAID is supporting farmer group development, community based natural resource management, technical assistance for agribusiness development and dairy development. SIDA is supporting an Agricultural Support Programme (ASP) promoting smallholder commercialization and is assisting in building capacity for policy development and planning in the Ministry of Agriculture and Cooperatives. SIDA is also preparing a programme to

support the implementation of the Financial Sector Development Plan. The Netherlands has been supporting livestock development and is currently supporting research and development for innovative farming systems, livestock development, training related to growing and exporting high-value crops with the Norwegian Agency for Development Cooperation. The Department for International Development will be supporting an intervention to improve the enabling environment for business, focusing on agricultural enterprises. The Department for International Development is also planning a programme of support for the Financial Sector Development Plan. Finland is preparing an agribusiness promotion project for the Province of Luapula. Other than IFAD, the main multilateral organizations supporting or planning to support agricultural and rural development are the World Bank and the African Development Bank. Support from the World Bank has greatly diminished since the conclusion of the Agricultural Sector Investment Programme, however a follow-up intervention is being planned. The African Development Bank has supported extension, a rural credit fund and small scale irrigation development, and is preparing a project to expand production on outgrower schemes, including investments in irrigation infrastructure and extension services.

10. **Programme rationale**. The agricultural and rural sector is becoming increasingly important as a source of economic growth and as a vehicle to reduce poverty. Reducing rural poverty requires increasing the participation of poor rural people in the emerging market economy. This process remains at an early stage compared with those in other countries in the region. Several initiatives are empowering smallholders with skills and technical knowledge, enabling them to participate in the market economy. Other initiatives are supporting agribusiness development. To be effective, improved linkage of smallholders to markets needs to be combined with improved access to financial services. To date, most donors have avoided involvement in the rural finance subsector, partly because macroeconomic conditions have not been conducive and partly because this is a difficult area. Unless access to financial services for rural producers and economically-active poor people is improved, smallholder commercialization cannot proceed. Similar reasoning applies to small and medium-sized rural enterprizes. While there are risks associated with rural finance programmes, it is the responsibility of agencies such as IFAD to assist Governments in finding workable solutions for a critical but neglected sector.

PART II – THE PROGRAMME

A. Programme Area and Target Group

11. The programme is national in scope and programme support will be available anywhere in the country. Individual components will be implemented, however, in areas that are best suited for these activities. The development of community-based financial institutions will likely have limited spatial coverage, focusing initially on expanding the operations of non-governmental organizations/MFIs in and around their current areas of operation. The areas served by NSCB will expand along with the expansion of its branch network. The expansion and intensification of contracted small-scale production, supported by the Credit Facility for Contracted Small Scale Production, will likely concentrate on current areas of operation, mainly along the line of rail.

12. The target group consists of the entire rural population. The direct beneficiaries will be: poor or relatively poor rural households and individuals participating in Community-Based Financial Institutions (CBFIs); contract farming companies and contracted smallholders benefiting from credit for new or intensified production activities; salaried workers and others opening accounts at the NSCB; rural households including the poorest segments of the population such as woman-headed households; and HIV/AIDS affected households benefiting from access to rural financial services established with the support of the programme. The programme components have been designed to ensure that the poorest rural households will be able to benefit as much as possible from the programme.

B. Objectives and Scope

13. The programme's development goal is to improve the livelihoods of rural households. Central to achieving this goal and as its overall objective, the programme aims to increase the use of sustainable financial services in rural areas. This will be achieved through investments in five components to: (i) develop the use of sustainable community-based financial institutions; (ii) promote rural banking services; (iii) increase and intensify small-scale production in contract-farming operations; (iv) develop new and expanding existing financial service products in rural areas; and (v) establish a more conducive policy and institutional framework for rural finance.

C. Components

(a) Development of Community-Based Financial Institutions

14. The purpose of this component is to improve economically active poor rural households' access to financial services on a sustainable basis. It contains the following three sub-components: creation of new community-based financial institutions; strengthening of existing savings and credit groups; and thematic technical assistance.

15. **Creation of New Community-Based Financial Institutions.** One or more specialized local NGOs or MFIs will be contracted as CBFI promoters by the project management unit (PMU) to provide training and advisory services supporting the establishment of 1 500 to 2 000 Accumulative Savings and Credit Associations (ASCAs), each with 10 to 20 members. The CBFI promoters will initially employ and subsequently develop their methodologies; this involves generation of savings from members' small but regular deposits, to form the basis for internal lending. They will employ field staff to form and train groups, and guide them for 8 to 12 months. Following this, ASCAs will operate independently, only requiring occasional assistance to help resolve technical or organizational issues. As with existing savings and credit organizations, ASCAs will have a high proportion of women to men. They will also be relevant to HIV/AIDS-affected households by providing opportunities to build up assets in order to reduce the load on household labour. CBFI promoters will test promising modifications. Where the opportunity exists, this will include advanced Accumulative Savings and Credit Associations in which continuous savings replaces redistribution of funds at the end of the cycle.

16. **Strengthening of Existing Savings and Credit Groups.** Support will be provided to savings groups formed under other development programmes in conjunction with private sector and market support initiatives. Support will initially focus on 300 to 400 groups developed under the SIDA-supported ASP. These groups have started savings activities and some are carrying out limited lending among members. But procedures and safeguards ensuring that the groups will develop into sustainable organizations have not been developed because the implementers of the ASP do not have the necessary specialized skills. These groups will be developed into Accumulative Savings and Credit Associations by CBFI promoters contracted under arrangements similar to those for the first sub-component. While the facility will be available to assist a range of development programmes, implementation during the first two to three years will focus on supporting groups formed under the ASP.

17. **Thematic Technical Assistance**. To bring incorporate experience from Zambia and the region, the programme will organize annual thematic workshops, cross-cutting studies, study tours and specialized training using links created with MicroSave Africa and other regional initiatives.

(b) Promotion of Rural Banking Services

18. The purpose of this component is to develop sustainable banking services in rural areas. This is directly linked to, and in support of, the overall objective of increasing the use of sustainable rural

financial services. The component will support the development of the NSCB into a sound and professionally managed financial institution that makes services available to a large portion of the rural population, including the poor households and small-scale entrepreneurs. This component is based upon a comprehensive institutional development plan for the NSCB that constitutes the bank's development strategy and includes measures to: strengthen the capital structure; improve management and operating systems; expand the branch network; develop new financial products and organization; and develop manpower.

19. The component will provide additional equity capital to NSCB as follows: The Government will swap existing NSCB debt to Government of USD 1.3 million into equity and provide USD 1.23 million in new cash resources to NSCB. A memorandum of understanding will be signed between NSCB and BoZ and the NSCB Act will be harmonized with the Banking and Financial Services Act to ensure that BoZ will have full supervision authority in the period until NSCB is registered as a company. On this basis, IFAD loan proceeds equivalent to USD 2.2 million will be used to improve the NSCB's accounting, management information and internal control systems and to expand its rural branch network. The loan proceeds will be used to acquire assets and will be introduced in the accounts as Government equity. The programme will provide short-term and long-term technical assistance to NSCB in implementing the institutional development plan.

(c) Credit Facility for Contracted Small-Scale Production

20. The component aims to improve access to credit for smallholders and other rural producers through linkages with companies involved in contracted small-scale production. It will provide a credit facility that commercial banks can access for onlending, on their own terms, to companies for projects to expand or intensify contracted small-scale production operations. Financing will take the form of seasonal loans available over several years.

21. DBZ will manage the facility on an agent basis and act as trustee of the credit line revolving accounts against a fee. DBZ will sign a memorandum of understanding with the Ministry of Finance and National Planning (MFNP) for the credit facility's management and enter into a framework lending contract for each borrowing commercial bank. The credit facility will amount to USD 4 million and comprise two financing windows, one in USD and the other in local currency. Funds will be lent to commercial banks at an interest rate that provides the banks with a sufficient spread to hedge against possible loan defaults. The commercial banks will onlend funds for projects eligible for funding by an expansion or intensification of smallholder-based contracted production activities. Items eligible for financing will include production inputs and small investment items such as irrigation pumps, bee hives and fishing gear. The companies will be able to borrow funds in either currency. The DBZ will monitor the progress of each financed operation and critically assess compliance and impact on intensification and expansion of participating small-scale producers' activities. This assessment will determine whether the borrowers qualify for follow-on loans. As an incentive for commercial banks to provide loans to smaller companies, a maximum outstanding amount per borrower will be set at the equivalent of USD 500 000.

22. A technical advisor will be provided to work with DBZ from programme start-up. The technical advisor will promote a proactive approach to encouraging the involvement of female-headed households and other households with limited participation in such schemes. The detailed operational modalities for the facility, including responsibilities, terms and conditions, and spreads will be detailed in an operations manual. This manual will also describe the process in which an on-lending agreement with DBZ, assuming the on-lending responsibility and thus bearing the risk, could replace the memorandum of understanding if recommended in the programme mid-term review.

(d) Innovations and Outreach Facility

23. The purpose of this component is to promote the development and up-scaling of sustainable and appropriate rural finance operations, especially those reaching vulnerable households. The facility will reduce the financial risk of developing or extending financial services in rural areas by financing a portion of the establishment and the initial operational costs of such services up to a maximum amount through matching grants. A total of USD 1 million will be available under the facility, which will be backed by limited technical assistance to assist participating financial service intermediaries develop proposals for funding from the facility.

24. The facility will be demand based; the initiatives to be financed are therefore not known. Based on experience from Zambia and elsewhere, the facility is expected to support projects to: design, pilot and mainstream new products appropriate for rural environments; establish rural branches for MFIs or sub-branches for financial institutions; pilot rural banking windows for women; test the viability of operating mobile banking operations; support the establishment of new rural finance institutions; and transform the legal/organizational status of existing financial institutions in order to enable them to operate effectively in rural areas. The facility will include a special window for services targeting vulnerable clients, including women-headed households with severe labour constraints and HIV/AIDS affected households. The facility will finance 50% of the investment costs and a portion of the first year's operational deficit up to a maximum amount of USD 100 000 for projects expanding outreach, and USD 50 000 for proposals constituting an innovation. For proposals specifically targeting vulnerable clients, the facility will finance 75% of investment costs. Proposals constituting an innovation will be financed up to an amount of USD 100 000 The PMU will prepare an operations manual detailing the criteria for reviewing, approving and financing projects.

(e) Policy, Institutional and Management Support

25. The purpose of this component is to create a conducive and supportive policy and institutional environment for the development of rural finance and to manage the programme. The component includes two sub-components: support for rural finance, and programme management.

26. **Support for Rural Finance.** A Rural Finance Unit (RFU) will be established within the Department of Investment and Debt Management of MFNP. The RFU will work closely with the PMU. It will have two senior officers and be the main catalyst of policy and legislative dialogue, and provide guidelines and norms for public-sector operators. The programme will finance the establishment and operations of the RFU in addition to staff training. The unit will interact with sector ministries and financial intermediaries, NGOs, donors and other parties. At programme start up, the unit will initiate a process to develop a better understanding of the rural finance subsector and the policies and strategies required for developing the subsector, based on a dialogue with BoZ, Government institutions, financial intermediaries and users of rural financial services. This will lead to the preparation of a strategic framework for rural finance, including a draft rural finance policy. The policy will deal with: issues confronting the development of rural finance, the processes needed to tackle the issues and coordinate initiatives; the roles played by different parties; the requirement for an ongoing structured dialogue to solicit feedback on existing policies and legislation; recommendations of action to be taken and the means to implement these actions; and the means to regularly review and update the documentation. The preparation of the strategic framework will involve the main stakeholders from smallholder farmers and traders to commercial banks. The work will result in practical guidelines and costed action plans. On this basis, policy dialogue and institutional strengthening will be initiated to include a policy user response dialogue, strengthening of ministries' capacity, facilitated linkages with regional organizations and a Rural Finance Forum.

27. **Programme Management.** A PMU will be established within MFNP and charged with day-to-day management of the programme. PMU staff will include: a programme manager, a financial controller and a monitoring and evaluation and planning specialist. In addition to the PMU, the

programme will finance short term consultants, workshops and media support, the establishment of a monitoring and evaluation system, action research and impact assessments. The day-to-day management of the promotion of rural banking services and credit facility for contracted small-scale production components will be the responsibility of the NSCB and DBZ. The main tasks of the PMU will be implementing the innovation and outreach facility, facilitating policy, institutional and management support and ensuring performance of the service providers implementing the first component.

D. Costs and Financing

28. Total programme costs including contingencies, duties and taxes amount to USD 17.43 million. Physical and price contingencies add 4% to the base costs. Taxes and duties have been calculated at prevailing rates and amount to USD 1.36 million, or 8% of total programme costs. Foreign exchange costs represent 21% of the total programme costs.

TABLE 1: SUMMARY OF PROGRAMME COSTS[a]
(USD '000)

Components	Local	Foreign	Total	% of Foreign Exchange	% of Base Costs
(a) Development of Community-Based Financial Institutions	2 280	20	2 300	1	14
(b) Promotion of Rural Banking Services	3 515	1 432	4 947	29	30
(c) Credit Facility for Contracted Small-Scale Production	4 300	248	4 548	5	27
(d) Innovation and Outreach Facility	1 196	299	1 495	20	9
(e) Policy, Institutional and Management Support	1 977	1 495	3 473	43	21
Total Base Costs	**13 268**	**3 494**	**16 762**	**21**	**100**
Physical contingencies	27	10	37	27	-
Price contingencies	479	151	630	24	4
Total Programme Costs	**13 774**	**3 655**	**17 429**	**21**	**104**

[a] Discrepancies in totals are due to rounding.

29. The programme will be financed by an IFAD loan of USD 13.81 million, a contribution from financial institutions of USD 431 000, a Government contribution of USD 3.04 million and a beneficiary contribution of USD 144 000. The Government will finance duties, taxes, RFU staff salaries and an incremental capital injection to NSCB. Participating financial institutions will contribute a proportion of the costs of activities supported by matching grants under the Innovation and Outreach Facility. The beneficiaries will contribute fees for training provided to their CBFIs.

TABLE 2: FINANCING PLAN[a]
(USD ’000)

Component	IFAD		Financial Institutions		Beneficiaries		Government		Total		Foreign Exchange	Local (Excl. Taxes)	Duties and Taxes
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%			
(a) Development of Community-Based Fin. Institutions	2 349	93.4	-	-	144	5.7	22	0.9	2 515	14.4	22	2 471	22
(b) Promotion of Rural Banking Services	2 585	52.1	-	-	-	-	2 378	47.9	4 963	28.5	1 448	2 699	816
(c) Credit Facility for Contracted Small-Scale Production	4 585	100.0	-	-	-	-	-	-	4 585	26.3	258	4 327	-
(d) Innovation and Outreach Facility	1 161	72.0	431	26.8	-	-	19	1.2	1 611	9.2	322	1 269	19
(e) Policy, Institutional and Management Support	3 123	83.4	-	-	-	-	624	16.6	3 756	21.5	1 605	1 645	506
Total programme costs	**13 811**	**79.2**	**431**	**2.5**	**144**	**0.8**	**3 043**	**17.7**	**17 429**	**100.0**	**3 655**	**12 411**	**1 363**

[a] Discrepancies in totals are due to rounding.

E. Procurement, Disbursement, Accounts and Audit

30. **Procurement.** All procurement of goods and services financed by IFAD will be in accordance with the IFAD *Procurement Guidelines*. Each contract for goods and services costing USD 100 000 or more will be procured on the basis of International Competitive Bidding. Goods and services costing USD 20 000 or more but less than USD 100 000 will be procured using National Competitive Bidding. Goods and services costing less than USD 20 000 and individual short-term consultancies will be procured using Local Shopping. Matching grants to financial service intermediaries will be awarded according to agreed eligibility criteria.

31. **Disbursement.** Two Special Accounts (A and B) in foreign currency will be opened in a commercial bank acceptable to IFAD. The accounts will be established, operated and replenished in accordance with IFAD's guidelines. Special Account A will have an authorized allocation of USD 700 000 and be used for all loan-financed expenditure except direct payments by IFAD and funds for onlending. Special Account B will have an authorized allocation of USD 500 000 and be used for funds for onlending. Withdrawals from the loan account may be made against statements of expenditure for categories of expenditure jointly determined by the Government, IFAD and the cooperating institution. The documentation will be made available for audits and review by supervision missions.

32. **Accounts and Audit**. A Central Programme Account in local currency will be established in a commercial bank acceptable to IFAD and be used for payments to local suppliers. Funds will be transferred on a quarterly basis from Special Account A into the Central Programme Account against approved annual workplans and budgets, and converted into local currency at the prevailing exchange rate. DBZ will open two accounts: the DBZ Revolving Fund Account A in USD; and the DBZ Revolving Fund Account B in local currency. Funds will be drawn from Special Account B at DBZ's request upon approval of the PMU financial controller and be deposited into the DBZ Revolving Fund Accounts. The auditor-general will audit the accounts in accordance with International Standards for Auditing and IFAD guidelines on project audits. The audited accounts and financial statements will be submitted to IFAD within six months after the close of each Government fiscal year.

F. Organization and Management

33. MFNP will be the lead agency for the programme. Executive responsibility will rest with the MFNP Permanent Secretary of Budget, who will also chair the sessions of the Quarterly Review Committee. The Quarterly Review Committee will be composed of representatives of MFNP and the PMU. All major strategic decisions regarding programme implementation will be agreed by this committee, which will also review the programme's progress reports and annual workplans and budgets. The Rural Finance Sub-Committee to the National FSDP Committee will both support FSDP and play an advisory role as programme reference group. RFU will be secretariat for the Rural Finance Sub-Committee. A rural finance forum, comprising stakeholders in rural finance, will be convened once a year. Although the FSDP's arrangements for coordinating donor activities in the finance sector will be also used for rural finance. Should the need arise, special sessions of the donor financial sector group will be organized for rural finance on an informal basis.

G. Economic Justification

34. The expansion of CBFIs will benefit 30 000 economically active rural poor people, especially women, and include social empowerment. By increasing liquidity, it will also bring benefits to the communities. Experience with existing Accumulative Savings and Credit Associations indicates returns on investment in the order of 30 to 40% for the first component. The benefits from successful development of the NSCB will be substantial for existing clients and for 100 000 additional rural households accessing savings facilities, Government and rural enterprises. The Credit Facility for

Contracted Small Scale Production will enable 60 000 smallholders to commence more profitable and secure production activities. The Innovation and Outreach Facility will benefit an unknown additional number of rural households and specifically target HIV/AIDS-affected and female-headed households.

35. Financial analysis confirms that contracted production activities generate substantially higher returns than traditional smallholder production activities. The financial impact on the programme's financial intermediaries will also be substantial. Under the financial projections in the institutional development plan, NSCB's expansion will lead to nominal before-tax profits of USD 4 million in 2010, making the bank a highly attractive financial institution. DBZ will benefit through the management fee for administering the credit line and will increase its capacity for wholesaling commercial and development finance. Commercial banks will expand their business with profitable companies engaged in contracted smallholder production. The availability of funds targeted to the sector and available over the long term will facilitate intensification and expansion of contracted small-scale operations.

H. Risks

36. The main risks to the programme are the budgetary and institutional risks associated with the recapitalisation and development of the NSCB and the economic risks associated with the credit facility. If the Government does not contribute to recapitalising the NSCB as scheduled, or cannot establish a satisfactory legal basis for BoZ's supervision of NSCB, the component cannot be implemented. The risk that NSCB might not develop into a sustainable financial institution is mitigated by the memorandum of understanding (MOU) with BoZ and the harmonization of the NSCB Act with the Banking and Financial Services Act while the MOU is in place. The Government's commitment to implement these measures is reflected in the FSDP and the measures have been reviewed extensively during programme design. Two risks are associated with the third component. First, the credit facility might not lead to additional bank lending. This risk is mitigated by the incentives provided. Second, credit uptake might be limited because commercial banks, which have limited experience with rural lending, might show limited interest. Mitigating the latter risk are the simple procedures used for the credit facility and the decline in the treasury-bill rate during 2004, which has made the banks keen to expand lending operations.

I. Environmental Impact

37. Although the programme will have little negative impact on the environment, it involves improving access to finance for purchased inputs and has been classified in category B. Any negative impacts would likely result from the credit facility. Enforcement of environmental protection cannot be undertaken directly by the PMU, but appropriate instruments will be developed in cooperation with the Environmental Council of Zambia, with which a protocol will be established as part of the monitoring and evaluation system. The strategy for implementing mitigation measures is based upon informing participating companies and banks about best practices, assisting the Environmental Council of Zambia to carry out inspections and ensuring that proposals for financing will detail potential environmental impacts.

J. Innovative Features

38. In isolation, the first three components are not very innovative. The programme's main innovative feature is to combine investments to improve and expand the financial services available with investments to develop a strategic framework for rural finance, within an organizational setup that is well integrated with that for the financial services sector. This provides a good basis for developing high-quality, evidence-based strategies and policies, and for improving government and private sector capacities.

PART III – LEGAL INSTRUMENTS AND AUTHORITY

39. A loan agreement between the Republic of Zambia and IFAD constitutes the legal instrument for extending the proposed loan to the borrower. A summary of the important supplementary assurances included in the negotiated loan agreement is attached as an annex.

40. The Republic of Zambia is empowered under its laws to borrow from IFAD.

41. I am satisfied that the proposed loan will comply with the Agreement Establishing IFAD.

PART IV – RECOMMENDATION

42. I recommend that the Executive Board approve the proposed loan in terms of the following resolution:

> RESOLVED: that the Fund shall make a loan to the Republic of Zambia in various currencies in an amount equivalent to nine million two hundred and fifty thousand Special Drawing Rights (SDR 9 250 000) to mature on or prior to 1 November 2044 and to bear a service charge of three fourths of one per cent (0.75%) per annum, and to be upon such terms and conditions as shall be substantially in accordance with the terms and conditions presented to the Executive Board in this Report and Recommendation of the President.

Lennart Båge
President

SUMMARY OF IMPORTANT SUPPLEMENTARY ASSURANCES INCLUDED IN THE NEGOTIATED LOAN AGREEMENT

(Loan negotiations concluded on 30 November 2004)

1. The Government will open and thereafter maintain in a bank acceptable to IFAD a current account denominated in Zambian kwachas for programme operations (the “central programme account”).

2. DBZ will open and thereafter maintain in a bank acceptable to IFAD a current account denominated in United States dollars for programme operations and an account denominated in Zambian kwachas for programme operations to receive loan proceeds and other funding for lending under the credit facility for contracted small-scale production component.

3. The Government will harmonize the National Savings and Credit Bank Act and the Banking and Financial Services Act to bring the NSCB within the same requirements as commercial banks in relation to central bank supervision, including the corporate governance provisions of the Banking and Financial Services Act, before 31 December 2005.

4. **Gender focus.** Each programme party will ensure that women are represented in programme activities and that women receive appropriate benefits from the programme’s outputs.

5. **Insurance of programme personnel.** The Government will ensure that key programme personnel are insured against health and accident risks to the extent consistent with sound commercial practice.

6. **Tax exemption.** The Government will exempt from taxes the importation, procurement and supply of all goods and services financed by the loan. The value of such exemptions will be credited against the obligation of the Government to provide counterpart funds from the programme.

7. **Pest management practices.** As part of maintaining sound environmental practices as required by IFAD, the Government will ensure that all implementing agencies maintain appropriate pest management practices under the programme and, to that end, the Government will ensure that pesticides used under the programme do not include any pesticide proscribed by the Food and Agriculture Organization of the United Nations or by the World Health Organization.

8. **Monitoring.** The monitoring, evaluation and planning specialist of the PMU will be responsible for the definition and management of the programme’s monitoring system, which will be organized by programme component and a list of indicators. The PMU staff and programme parties will report quarterly to the monitoring, evaluation and planning specialist on: (a) programme activities undertaken in the preceding quarter (for regular quarterly reports) and cumulatively over the preceding fiscal year (for annual reports); (b) all movements (deposits and withdrawals) on the special and programme accounts made during the relevant reporting period; (c) physical acquisitions made; and (d) monitoring and evaluation results. The programme parties will submit their quarterly reports to the PMU no later than the end of the month following the relevant quarter.

9. The following are specified as the conditions for disbursement of funds from the loan:

   (a) no withdrawals may be made from the loan account in respect of expenditures for any fiscal year until the annual workplan and budget (AWP/B) for that year has been approved by IFAD and the cooperating institution;

(b) no withdrawals may be made in respect of expenditures for equipment and materials for NSCB branches and the Rural Finance Unit until the Government has duly:

(i) approved the institutional development plan for NSCB, satisfactory to IFAD;

(ii) completed the debt swap (approximately ZMK 5.3 billion) with NSCB;

(iii) provided ZMK 3.0 billion to NSCB as incremental equity for its purchase of vehicles (inclusive of taxes); and

(iv) provided IFAD with a copy of the signed memorandum of understanding between the Government, NSCB and the Bank of Zambia detailing the responsibilities of the respective parties prior to NSCB's compliance with the Banking and Financial Services Act.

(c) No withdrawals may be made in respect of expenditures for the financial services grant facility for matching grants to participating institutions until IFAD has duly approved the innovation and outreach facility operations manual, including a model agreement between the PMU and the grant recipient;

(d) no withdrawals may be made in respect of expenditures for service providers for community-based financial institution promoters and DBZ management fees until IFAD has approved the community-based financial institutions programme manual; and

(e) no withdrawals may be made in respect of expenditures for incremental credit until IFAD has approved the draft operations manual for the implementation arrangements for the credit facility for contracted small-scale production component, and IFAD has received a signed copy of the memorandum of understanding between the Government and DBZ detailing the responsibilities of DBZ for programme implementation.

10. The following are specified as conditions precedent to the effectiveness of the loan agreement:

(a) the AWP/B for programme year one has been prepared and approved;

(b) the PMU has been duly established including the appointment of the programme manager, the financial controller, and the monitoring, evaluation and planning specialist with qualifications and experience satisfactory to IFAD;

(c) the Government has duly opened the special accounts and the central programme account in the name of the programme;

(d) the loan agreement has been duly signed, and the signature and performance thereof by the Government have been duly authorized and ratified by all necessary administrative and governmental action; and

(e) a favourable legal opinion, issued by the Attorney General or other legal counsel approved by IFAD in form and substance acceptable to IFAD, has been delivered by the Government to IFAD.

COUNTRY DATA

ZAMBIA

Land area (km^2 thousand) 2002 1/	743	**GNI per capita (USD) 2002 1/**	340
Total population (million) 2002 1/	10.24	**GDP per capita growth (annual %) 2002 1/**	1.6
Population density (people per km^2) 2002 1/	14	**Inflation, consumer prices (annual %) 2002 1/**	22
Local currency	Kwacha (ZMK)	**Exchange rate: USD 1 =**	ZMK 4 700

Social Indicators	
Population (average annual population growth rate) 1996-2002 1/	2.0
Crude birth rate (per thousand people) 2002 1/	39
Crude death rate (per thousand people) 2002 1/	23
Infant mortality rate (per thousand live births) 2002 1/	102
Life expectancy at birth (years) 2002 1/	37
Number of rural poor (million) (approximate) 1/	n/a
Poor as % of total rural population 2/	n/a
Total labour force (million) 2002 1/	4.39
Female labour force as % of total 2002 1/	45
Education	
School enrolment, primary (% gross) 2002 1/	79 a/
Adult illiteracy rate (% age 15 and above) 2002 1/	20
Nutrition	
Daily calorie supply per capita, 1997 2/	n/a
Malnutrition prevalence, height for age (% of children under 5) 2002 1/	47 a/
Malnutrition prevalence, weight for age (% of children under 5) 2002 1/	28 a/
Health	
Health expenditure, total (as % of GDP) 2002 1/	6 a/
Physicians (per thousand people) 2002 1/	n/a
Population using improved water sources (%) 2002 3/	64 a/
Population with access to essential drugs (%)1999 3/	50-79
Population using adequate sanitation facilities (%) 2002 3/	78 a/
Agriculture and Food	
Food imports (% of merchandise imports) 2002 1/	14
Fertilizer consumption (hundreds of grams per ha of arable land) 2002 1/	70 a/
Food production index (1989-91=100) 2002 1/	109
Cereal yield (kg per ha) 2002 1/	1 413
Land Use	
Arable land as % of land area 2002 1/	7 a/
Forest area as % of total land area 2002 1/	42 a/
Irrigated land as % of cropland 2002 1/	1 a/

Economic Indicators	
GDP (USD million) 2002 1/	3 697
Average annual rate of growth of GDP	
1982-1992	1.1
1992-2002	1.5
Sectoral distribution of GDP 2002 1/	
% agriculture	22
% industry	26
% manufacturing	12
% services	52
Consumption 2002 1/	
General government final consumption expenditure (as % of GDP)	12
Household final consumption expenditure, etc. (as % of GDP)	84
Gross domestic savings (as % of GDP)	4
Balance of Payments (USD million)	
Merchandise exports 2002 1/	970
Merchandise imports 2002 1/	1 270
Balance of merchandise trade	-300
Current account balances (USD million)	
before official transfers 2002 1/	-585 a/
after official transfers 2002 1/	-553 a/
Foreign direct investment, net 2002 1/	122 a/
Government Finance	
Overall budget deficit (including grants) (as % of GDP) 2002 1/	n/a
Total expenditure (% of GDP) 2002 1/	n/a
Total external debt (USD million) 2002 1/	5 969
Present value of debt (as % of GNI) 2002 1/	121
Total debt service (% of exports of goods and services) 2002 1/	27
Lending interest rate (%) 2002 1/	45
Deposit interest rate (%) 2002 1/	23

a/ Data are for years or periods other than those specified.

1/ World Bank, *World Development Indicators*, CD ROM 2004
2/ UNDP, *Human Development Report*, 2000
3/ UNDP, *Human Development Report*, 2004

PREVIOUS IFAD LOANS TO ZAMBIA

Project Name	Initiating Institution	Cooperating Institution	Lending Terms	Board Approval	Loan Effectiveness	Current Closing Date	Loan Acronym	Approved Loan Amount	Disbursed Amount (%) as at 15 Sep 2004
Eastern Province Agricultural Development Project	World Bank: IBRD	World Bank: IBRD	I	22 Apr 81	11 Mar 82	30 Jun 88	L-I-66-ZA	SDR 9 000 000	100.00
North Western Province Area Development Project	IFAD	World Bank: IDA	HC	14 Sep 82	03 Mar 83	31 Jul 92	L-I-104-ZA	SDR 11 950 000	100.00
Smallholder Services Rehabilitation Project	IFAD	World Bank: IDA	HC	09 Sep 87	15 Apr 88	31 Dec 95	L-I-206-ZA	SDR 9 100 000	100.00
			HC	09 Sep 87	27 Apr 88	31 May 96	L-S-7-ZA	SDR 7 100 000	100.00
North Western Province Area Development Project Phase II	IFAD	UNOPS	HC	11 Dec 91	26 Jun 92	31 Dec 00	L-I-293-ZA	SDR 9 250 000	100.00
			HC	09 Sep 87	26 Jun 92	31 Dec 00	L-S-28-ZA	SDR 2 750 000	100.00
Southern Province Household Food Security Programme	IFAD	UNOPS	HC	05 Dec 94	28 Mar 95	30 Jun 03	L-I-368-ZM	SDR 10 400 000	95.11
Smallholder Irrigation and Water Use Programme	World Bank: IDA	UNOPS	HC	12 Apr 95	09 Apr 96	31 Dec 02	L-I-377-ZA	SDR 4 300 000	91.64
Forest Resource Management Project	IFAD	UNOPS	HC	09 Dec 99	26 Jun 02	31 Dec 08	L-I-520-ZM	SDR 9 150 000	30.00
Smallholder Enterprise and Marketing Programme	IFAD	IFAD	HC	09 Dec 99	07 Nov 00	30 Jun 08	L-I-521-ZM	SDR 11 550 000	39.45

LOGICAL FRAMEWORK

Objective Hierarchy	Target Indicators[2]	Monitoring Mechanisms and Sources	Assumptions
DEVELOPMENT GOAL Improved livelihoods of rural households	- Increase in social and productive assets of rural households - Reduction in child malnutrition prevalence (weight for age)	- Sample household surveys (baseline, mid-term, end of project) - Impact monitoring reports - Analysis of relevant government statistics	- Programme benefits are not offset by declining government services and social benefits - Health and economic impact of AIDS is reduced
OVERALL OBJECTIVE Increased use of sustainable financial services in rural areas	- Number of rural households financing consumption and productive activities with loans - Number of additional rural households using savings accounts or services	- Sample household surveys (baseline, mid-term, end of project)	- Government regulations and policies allow for the continued growth and stability of the financial sector - Stability in the macroeconomic climate allows for the continued viability of the financial sector
OUTCOMES 1. Rural households using expanded and sustainable community-based financial services	- Number of regular savers - Number of current borrowers	- Financial and loan portfolio records of CBFI, compiled by CBFI promoters - Quarterly monitoring reports by CBFI promoters to the PMU - Evaluation studies by PMU	- Internal technical capacity of CBFIs is sufficient to ensure viability without dependence on external assistance - Sufficient external credit is available to allow CBFIs to expand and graduate
2. Households, groups and enterprises in rural areas using banking services	- Number of low income rural households as active clients of NSCB	- Quarterly monitoring reports by NSCB to the PMU - Evaluation studies by PMU	- Government supports NSCB and meets its proposed financial obligations - An increasingly independent board eliminates the risk of political interference
3. Production by smallholders and other small-scale producers increased	- Number of new smallholders and other small-scale producers involved in new or intensified contract production schemes - Total volume and value of inputs procured during the period for smallholders and other small-scale producers by outgrower companies	- Quarterly monitoring reports by DBZ to the PMU - Records of producer credit disbursed by participating outgrower companies - Evaluation studies by PMU	- Government refrains from interference in agricultural input and output markets - Creation of an effective legal system including fast-track local courts - Marketing systems are in place to handle increased rural production
4. New financial products mainstreamed and additional services operating sustainably in rural areas	- Number of new rural products mainstreamed and additional clients reached - Portfolio at risk (>30 days) of borrowers using new services	- Evaluation studies by PMU	- Institutional capacity exists to mainstream piloted products
5. More conducive policy & institutional framework in place for rural finance	- Number of rural households actively using financial services - Number of viable rural financial service providers - Profits generated by financial institutions in rural areas	- Regular reports from the Rural Finance Unit - Evaluation studies by PMU	- MFNP makes the necessary commitment to develop rural finance and provides the budget and technical support for the effective operations of the RFU - Adequate counterpart funds available

[2] Where possible, indicators will be disaggregated by gender and by HIV/AIDS affected households.

Objective Hierarchy	Target Indicators[2]	Monitoring Mechanisms and Sources	Assumptions
OUTPUTS **Development of Community-Based Financial Institutions**			
1.1. New CBFIs established	- Number of CBFIs operating independently (>75%) - Number of new CBFIs established - On-time repayment rate (>90%) - Profit of CBFIs (positive) - Number of CBFIs audited on-time - Number of members (25,000) - Savings rate (USD 2/person/month) - Number of loans outstanding - Principal balance of loans outstanding	- Financial and loan portfolio records of CBFI, compiled by CBFI promoters - Quarterly monitoring reports by CBFI promoters to the PMU - Number of regular savers - Number of current borrowers	- Sufficient experienced CBFI promoters available to be contracted to support the targeted number of CBFIs
1.2. Existing CBFIs improved	- Number of CBFIs independently operating (>75%) - Number of existing CBFIs supported (300) - On-time repayment rate (>90%) - Profit of CBFIs (positive) - Number of CBFIs audited on-time audits - Number of members (5,000) - Savings rate (USD 2/person/month) - Number of loans outstanding - Principal balance of loans outstanding	- Financial and loan portfolio records of CBFI, compiled by CBFI promoters - Quarterly monitoring reports by CBFI promoters to the PMU	- Sufficient experienced CBFI promoters available to be contracted to support the targeted number of CBFIs - CBFI promoters are willing and able to support existing CBFIs
1.3. Knowledge and capacity of MFIs/NGOs increased	- Number of new studies produced and disseminated - CBFI promoters applying new methodologies	- Evaluation studies by PMU	
2. Promotion of Rural Banking Services			
2.1. NSCB well managed and financially viable	- Profitability of operations (reached in 2005, then gradually increasing) - Solvency as defined by BoZ (reached in 2005, then gradually improving) - Share of non-performing loans of portfolio (throughout the period, not more than 5%)	- Quarterly NSCB monitoring reports to PMU - Audited accounts and financial management reports of NSCB	- NSCB able to attract/maintain professional management and recruit well qualified personnel to staff its rural branches
2.2. Financial services by NSCB more readily available	- The number of operational NSCB branches, sub-branches and money windows (target by 2010: 84, covering a large majority of districts)	- Quarterly monitoring reports by NSCB to the PMU	- Sufficient demand for services in proposed rural branches

Objective Hierarchy	Target Indicators[2]	Monitoring Mechanisms and Sources	Assumptions
in rural areas	- The number and type of rural products and services developed and offered from rural branches - The volume of deposits and number of savings accounts (2010: USD 50 million, 260,000 accounts) - Total and rural portfolio growth (2010: total portfolio USD 30 million)	- Audited accounts and financial management reports of NSCB	- NSCB able to attract/maintain professional management and recruit well qualified personnel to staff its rural branches
Credit Facility for Contracted Small Scale Production			
3.1. DBZ operating as a viable management agency	- Number and volume of loans financed/repaid by the facility	- Quarterly monitoring reports by DBZ to PMU	- Commercial banks find the credit facility attractive
3.2. Outgrower companies accessing credit for smallholders and other small-scale producers	- Number of loans disbursed by the banks - Volume of loans disbursed by the banks - Recovery status and arrears position of the loans issued by banks to outgrower companies	- Quarterly monitoring reports by DBZ to the PMU	- Programme credit is used for intended purposes
Innovation and Outreach Facility			
4.1. New products successfully tested	- Number of tested new rural products assessed as successful - Number of additional clients reached by the new products	- I&O facility records	- Interest in the I&O facility by financial institutions
4.2. Additional financial services operating in new areas and vulnerable households participating	- Number and type of additional clients using newly established rural services - Total savings balance of the additional savers	- I&O facility records	- Interest in the I&O facility by financial institutions
Policy, Institutional and Management Support			
5.1. Rural finance unit operating effectively	- Rural finance strategy drafted and agreed (*indicating gender and HIV/AIDS provisions/sub-strategies*)	- Regular reports from the Rural Finance Unit	- Rural finance sub committee operational
5.2. Programme Management Unit operating effectively	- Projected results and impact being met on a timely basis - Projected disbursement rate being achieved	- Regular reports from the PMU	- Funds disbursed by IFAD in a timely manner - Review committee meets on a regular basis

PROGRAMME COSTS AND FINANCING

Table 1: Expenditure Accounts by Components – Base Costs (USD '000)

	Development of Community-Based Fin. Institutions	Promotion of Rural Banking Services	Credit Facility for Contracted Small Scale Production	Innovation and Outreach Facility	Policy, Institutional and Management Support	Total	Physical Contingencies %	Physical Contingencies Amount
I. Investment Costs								
A. Civil Works	-	217	-	-	-	217	-	-
B. Vehicles	-	638	-	-	70	708	0.5	3
C. Equipment, Software and Material								
1. Equipment and Materials for New NSCB Branches	-	1 336	-	-	-	1 336	-	-
2. Other Equipment, Software and Material	-	1 064	-	-	60	1 124	0.3	3
Subtotal Equipment, Software and Material	-	2 400	-	-	60	2 460	0.1	3
D. Workshops	-	-	-	20	214	234	5.0	12
E. Technical Assistance and Training								
1. Local Technical Assistance and Training	100	191	-	75	1 540	1 906	-	-
2. International Technical Assistance	-	372	248	-	970	1 590	-	-
Subtotal Technical Assistance and Training	100	564	248	75	2 510	3 496	-	-
F. Matching Grants /a	-	-	-	1 400	-	1 400	-	-
G. Service Contracts /b	2 200	-	300	-	-	2 500	-	-
H. Onlending Funds	-	-	4 000	-	-	4 000	-	-
I. Government Debt Swap	-	1 128	-	-	-	1 128	-	-
Total Investment Costs	2 300	4 947	4 548	1 495	2 854	16 143	0.1	18
II. Recurrent Costs								
A. Allowances	-	-	-	-	101	101	-	-
B. Staff Remuneration	-	-	-	-	137	137	-	-
C. Operating & Maintenance	-	-	-	-	381	381	5.0	19
Total Recurrent Costs	-	-	-	-	619	619	3.1	19
Total Baseline Costs	2 300	4 947	4 548	1 495	3 473	16 762	0.2	37
Physical Contingencies	-	-	-	1	36	37	-	-
Price Contingencies	215	16	37	115	247	630	0.4	3
Total Programme Costs	2 515	4 963	4 585	1 611	3 756	17 429	0.2	40
Taxes	22	816	-	19	506	1 363	0.5	7
Foreign Exchange	22	1 448	258	322	1 605	3 655	0.3	11

PROGRAMME COSTS AND FINANCING

Table 2: Disbursement Accounts by Financiers (USD ’000)

	IFAD		Financial Institutions		Beneficiaries		Government		Total		For.	(Excl.	Duties And
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%	Exch.	Taxes)	Taxes
A. Civil Works for New NSCB Branches	184	85.0	-	-	-	-	33	15.0	217	1.2	-	184	33
B. Equipment, Software, Materials and Vehicles													
Equipment, Materials and Vehicles for New NSCB Branches	1 136	57.5	-	-	-	-	839	42.5	1 974	11.3	383	1 187	405
Other Equipment, Software, Materials and Vehicles	750	68.0	-	-	-	-	353	32.0	1 103	6.3	662	88	353
Subtotal Equipment, Software, Materials and Vehicles	1 886	61.3	-	-	-	-	1 192	38.7	3 078	17.7	1 045	1 275	758
C. Training, Workshops and Short-term TA	718	83.2	-	-	-	-	145	16.8	864	5.0	229	489	145
D. PMU Management Contract and Long-term TA	3 220	89.5	-	-	-	-	377	10.5	3 597	20.6	2 047	1 173	377
E. Matching Grants	1 078	71.4	431	28.6	-	-	-	-	1 509	8.7	302	1 207	-
F. Service Contracts	2 588	94.7	-	-	144	5.3	0	-	2 732	15.7	-	2 732	-
G. Onlending Funds	4 000	100.0	-	-	-	-	-	-	4 000	22.9	-	4 000	-
H. Government Debt Swap	-	-	-	-	-	-	1 128	100.0	1 128	6.5	-	1 128	-
I. Salaries, Allowances, Operating and Maintenance	136	44.7	-	-	-	-	169	55.3	305	1.8	31	223	50
Total Programme Costs	13 811	79.2	431	2.5	144	0.8	3 043	17.5	17 429	100.0	3 655	12 411	1 363

IMPLEMENTATION ARRANGEMENTS AND RESPONSIBILITIES

1. This Appendix provides some additional information about implementation arrangements for individual programme components.

Development of Community-Based Financial Institutions

2. Within the framework of terms of reference, the approach adopted will be based on those approaches that the tendering NGOs/MFIs have found to be most successful in Zambia. The service providers will be contracted following a transparent tender and selection process in which experienced NGOs and MFIs, or other suitably qualified contractors, will be shortlisted. The initial contracts will be for three years, with subsequent contracts based on performance. Field implementation will commence in the second half of the first programme year.

Promotion of Rural Banking Services

3. The NSCB will implement the component. Implementation will be based on two documents: (i) the Institutional Development Plan; and (ii) the MoU between NSCB and BoZ.

4. **Institutional Development Plan**. An Institutional Development Plan (IDP) prepared by NSCB has been reviewed by BoZ and MFNP and comments and recommendations have been incorporated. A final version approved by NSCB's management is available. The IDP will be the base document for implementation of the component. It also sets out NSCB's objectives and details how performance will be monitored. Specifically, it covers:

a) the planned expansion of bank branches, sub-branches and money windows in rural areas specifying the phasing and locations though 2010;
b) the recapitalization of the bank by: (i) the government debt swap of ZMK 5.3 billion by the end of 2004; (ii) a government cash injection of ZMK 5.8 billion in 2005, to be inscribed in the 2005 government budge, with the funds transferred to NSCB by 30 June 2005; and (iii) additional capital resources made available through IFAD financing in 2005 and 2006, totalling ZMK 10.4 billion equivalent;
c) continued growth in savings so that NSCB will not require funds from wholesale sources and on the assets side expansion of the loan portfolio from 13% of deposits in 2003 to 60% of incremental annual savings, plus continued growth in guaranteed employment loans with ZMK 7.5 billion as an annual target;
d) installation and operation of a new MIS/accounting system by mid-2005; and
e) sale of NSCB building in Lusaka by the end of 2006.

5. **Memorandum of Understanding**. The BoZ will prepare a draft MoU to be signed between NSCB and BoZ. The MoU will spell out the responsibilities of the NSCB during the period before it comes fully under the Banking and Financial Services Act (BFSA). The intention is to harmonize procedures with those of the BFSA. Included will be a requirement that NSCB has a professional board operating without political influences and that NSCB meets full prudential requirements like commercial banks operating under the BFSA.

Credit Facility for Contracted Small Scale Production

6. An Operations Manual laying out terms and framework conditions, procedures and criteria is being prepared by DBZ.

7. **Start-up**. At programme start-up, a MoU will be signed between MFNP and DBZ detailing the rights and obligations of DBZ as the management agent of the RFP credit facility. The MoU will outline the tasks of DBZ in the operation of the facility and define the method for calculating DBZ's management fee. It will also refer to the planned process that will take place to convert the initial 'agency arrangement' to an on-lending agreement (with DBZ assuming the on-lending responsibility and thus bearing the risk), in the event the scheme success and the institutional strength of DBZ as assessed during the Mid Term Review justifies a change of this type.

8. At the beginning of implementation, DBZ, with assistance from the technical advisor within DBZ and the Programme Manager of the PMU, will make the potential implementation partners and borrowers aware of the availability of the facility. First, DBZ will organise a round of negotiations with the commercial banks, inform them about the rules and conditions of the scheme and solicit their interest to participate. DBZ will review the financial condition of the interested commercial banks and with the support of the BoZ's assessment of the banks, select those that qualify to participate. With each of the participating banks, DBZ will sign a Framework Lending Contract defining the rules and conditions of the financing arrangements as detailed in the Operations Manual. The financing of each sub-loan to will fall under this Framework Lending Contract.

9. DBZ will also organise a national start-up workshop for agro-marketing and processing companies and other related organisations and programmes to inform them about the facility. The aim will be to inform the potential market of the benefits that the new financing window could provide to companies aiming at the intensification and expansion of existing or establishment of new operations for contracted small-scale production. During programme implementation, DBZ and the Facilitator will be in continuous contact with the potential borrowers to keep the market well informed about the improved business opportunities created by the new financing window. An especially important area for this proactive work will be to assist in linking the numerous rural marketing and business support programmes that are working with smallholders with such agro-companies that could, with the funding from the new credit window, expand their operations into areas where these programmes are training farmers' groups and associations.

10. Based on the Operations Manual, DBZ will provide participating commercial banks with guidelines on how to operate the scheme. As onlending will largely follow the standard lending practices of each commercial bank they are likely to find that using the RFP credit line will be relatively straightforward. However, each participating bank shall assign one person to be responsible for the facility operations in the bank, as previous experience has shown that without this arrangement, commitment by the commercial banks to this type of credit windows can be difficult to sustain. Companies involved in contracted small-scale production could apply for loans from any of the participating commercial banks. As the banks will carry the full credit risk on the loans, they will evaluate the applications using their standard criteria when assessing the project viability and risk and when defining the terms and conditions and collateral requirements. If the review process leads to a positive decision by the commercial bank, it will approve the loan on the condition that it will be refinanced from a RFP credit line facility. As the commercial banks carry the full credit risk, the main task of DBZ will be to verify that the proposed project fulfils the key eligibility criteria of the scheme and is aimed at intensification or expansion of small-scale contracted production.

11. **Interest Rate Structure**. The interest rate structure will reflect both the developments in the macro-economic situation in the country and various factors internal to the scheme. The commercial banks will be provided with a borrowing rate that will allow them a sufficient interest rate spread to adequately hedge against possible loan defaults in their on-lending operations and will provide an incentive for the commercial banks to get involved financing smallholder-based production activities.

12. Loans will be available both in USD and in local currency. When the commercial banks borrow from the facility, the interest rate for their USD loans will be 1%-1½%. At August 2004 rates, they

will lend the USD funds to companies at 6%-7%. It has been confirmed by commercial banks that the resulting spread (5% to 5.5%) provide adequate incentive to participate in the scheme and sufficient compensation for their operational costs and credit risk. The interest rates for local currency-based lending will be determined at programme start-up. During programme implementation, the appropriateness of the lending rates will be periodically reviewed. Based on their interactions with commercial banks, and to reflect changes in the financial market, adjustments in interest rates will be made. Any change in interest rates will be approved by the Quarterly Review Committee.

13. **Use and Eligibility**. The question of limits and loan exposure for borrowing companies will be detailed in the Operations Manual. The main guideline for use of the RFP credit line financing will be that the projects financed lead to an expansion or intensification of smallholder-based contracted production activities. The intention is to provide stability to the financing of such activities by stressing the long-term development perspective that the credit facility provides for participating companies. One of the crucial tasks of DBZ will be to monitor the progress of each financed outgrower operation and critically assess the impact they have on the intensification of the activities of participating small-scale producers and on the expansion of contract farming schemes. The results of these on-going field visits and reviews will determine whether financed companies qualify for follow-on loans under the facility.

Innovation and Outreach Facility

14. The Facility will be administered by the PMU, which will:

a) develop the working practices and procedures for the Facility and document them in a detailed Operations Manual, including developing the criteria for reviewing and approving/rejecting the proposals;
b) actively promote the Innovation and Outreach Facility and its services among financial sector stakeholders;
c) provide direct support and/or organise required external resources to assist the financial sector operators in the preparation of proposals for support from the Facility;
d) review the proposals against the agreed criteria and present them with recommendations of approval or rejection to an I&O Screening Committee;
e) perform the functions of contract management and accounting; and
f) actively follow-up/monitor the progress in the implementation of the assisted projects/ activities.

15. **Operations Manual and Approval Criteria**. This manual will be the reference document for the PMU in managing the Facility. It will be developed by the PMU at the beginning of the programme and discussed in an open forum with the main stakeholders – the prospective financial intermediaries. During this session the detailed criteria for reviewing and approving/rejecting proposals by the Facility will be discussed and a draft version of the criteria agreed. The Operations Manual will be approved by the Quarterly Review Committee. For those activities eligible for support under the Facility aimed at developing **innovative financial products** and their delivery mechanisms, criteria will be included to ensure that the applicants could demonstrate that:

a) the products/projects have a clear rural relevance;
b) they are innovative in their conception or geographic/social application;
c) each product will have the potential to respond to the demand of a large number of rural clients;
d) the delivery of the product has the potential to become profitable in the foreseeable future; and

e) the applicant has the intention and capacity to carry out the project and to integrate a successfully tested product into its mainstream operations.

16. For proposals to be considered for eligibility that aim to **increase the outreach of the financial institutions** in rural areas, the following information will be needed:

a) a comprehensive business plan for the proposed expansion, including a detailed budget and cash flow projections for the proposed investment;
b) realistic calculations showing that operational sustainability could be reached in the foreseeable future in the new areas of operation;
c) evidence of the rural dimension of the expansion (area coverage, clientele profiles, etc.);
d) detailed reports on the investing institution's operational and financial status using standard accounting, financial and performance indicators of the industry; and
e) information on potential commitments of additional financial and technical support to the expansion plan, from own resources or from other sources.

17. For the special window for vulnerable clients, it will be necessary in addition to demonstrate that the products/services are targeted clearly at identifiable and particularly vulnerable sections of the rural population and that the submitting financial institution has the capacity to work effectively with such clients and include them in their regular operations if the project is successful.

18. **Screening Committee and Application Approval Process**. An I&O Screening Committee will be set up at the beginning of the programme. It will consist of: representatives of the MFNP, the Association of Microfinance Institutions of Zambia, the Zambian Bankers Association, and two additional persons to be appointed by the Committee who have an in-depth knowledge of the sector. The Committee will meet at least quarterly to review applications against the agreed criteria. Upon approval, a contract will be prepared between the PMU and the recipient and funding made available in tranches based on implementation performance and achievement of targets detailed in the contract.

Policy, Institutional and Management Support

19. For the management of the **Support for Rural Finance** sub-component, the PMU together with MFNP will identify potential candidates for the Rural Finance Unit (RFU) once the loan has been signed so as to allow time to find the appropriate high-level officers and ensure that they will be able to work with the PMU after the programme has been launched. They will work as an integral part of the PMU for the first few years as the strategic framework for rural finance is being developed and the follow-up actions to implement the agreed policy initiatives are developed. The work involves organization of policy user response dialogues and a Rural Finance Forum. During the first year, one responsibility of the unit will be to establish working relationships with the main government partners, including BoZ, MACO and other ministries concerned. The work of the unit will be closely aligned with that of the FSDP and the work of the Rural Finance Sub-Committee and the other committees involved in the definition, elaboration and execution of policies for the financial sector.

20. The key to the effectiveness of the second sub-component, **Programme Management**, is the PMU. The PMU with contracted staff will be established within MFNP.

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