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IFAD
INTERNATIONAL FUND FOR AGRICULTURAL DEVELOPMENT
Enabling the rural poor to overcome poverty

Corporate Level Evaluation of IFAD's Rural Finance Policy

Executive Summary

Executive Board — Forty-sixth Session
Rome, 8 December 2006

For: **Review**

Note to Evaluation Committee Members

This document is submitted for review by the Evaluation Committee.

To make the best use of time available at Evaluation Committee meetings, Members are invited to contact the following focal point with any technical questions about this document before the session.

Caroline Heider
Deputy Director, Office of Evaluation
telephone: +39 06 5459 2052
e-mail: c.heider@ifad.org

Queries regarding the dispatch of documentation for this session should be addressed to:

Deirdre McGrenra
Governing Bodies Officer
telephone: +39 06 5459 2374
e-mail: d.mcgrenra@ifad.org

Contents

Abbreviations and acronyms

AsDB	Asian Development Bank
CGAP	Consultative Group to Assist the Poor)
CIs	Cooperating Institutions
CLE	Corporate Level Education
COSOP	Country Strategic Opportunities Paper
CPM	Country Programme Managers
EB	Executive Board
FINCA	Foundation for International Community Assistance
GNI	Gross National Income
IADB	InterAmerican Development Bank
IEE	Independent External Evaluation of IFAD
IFAD	International Fund for Agricultural Development
IFC	International Finance Corporation
IFI	international financial institution
MBB	MicroBanking Bulleting
MFI	Microfinance institution
MIX	Microfinance information exchange
NGO	non governmental organization
OE	Office of Evaluation
OSC	Operational Strategy and Policy Guidance Committee
PDT	project development team
PFI(s)	partner financial institutions
PMU	project management unit
PT	Technical Advisory Services
RFP	Rural Finance Policy
TAG(s)	technical assistance grants
TRC(s)	Technical Review Committee
TSP	technical service provider
UNCDF	United National Capital Development Fund
UNDP	United Nations Development Programme Microfinance
USAID	United States Agency for International Development

Executive Summary

I. Introduction

A. The Rural Finance Evaluation: overview, objectives, and methodology

1. This report presents the findings, conclusions and recommendations of a Corporate Level Evaluation (CLE) of IFAD's Rural Finance Policy (RFP). Undertaken at the request of the Executive Board (EB) of the International Fund for Agricultural Development (IFAD), the CLE was motivated by concerns over the performance of rural finance projects, as reported in a number of evaluations.

2. The objective of the CLE is to assess the quality and effectiveness of the RFP in guiding IFAD's rural finance assistance. It addresses three main questions: (i) does the RFP meet best practice standards of the rural/microfinance industry and provide practical guidance to IFAD operations; (ii) has the RFP been put into practice; and (iii) has IFAD deployed the right resources, instruments, and processes to implement the RFP? The evaluation assesses rural finance operations between 1996 and 2005, to compare the quality of projects five years prior to and after the adoption of the RFP in 2000. Such comparison is necessary to determine whether the RFP has had an impact on the choice and design of IFAD-supported rural finance projects. The CLE undertook in-depth work in 20 countries, of which ten were visited, in all regions assisted by IFAD. In addition, desk reviews were conducted of projects in an additional eight countries. In total, 58 projects were analysed and included reviews of IFAD documents and secondary sources, and interviews with key external stakeholders. Semi-structured interviews and structured focus groups involved over 30 IFAD staff. This analysis of IFAD's operations was complemented by an analysis of the RFP and associated instruments, and of IFAD's organizational arrangements for implementing the RFP[1]

3. This report has six sections: Section I introduces the topic of rural finance and IFAD's evolving work in the field; Section II assesses the RFP, its relevance to international best practices in the rural finance industry and to IFAD's operations, and the extent to which it provides strategic guidance for rural finance operations. Section III assesses how the RFP has affected project performance and Section IV identifies design and implementation challenges of the RFP to meeting its standards. Section V examines whether IFAD has the right resources for supporting RFP objectives, while Section VI provides conclusions and recommendations.

B. The rural poor and their financial service needs

4. Despite their poverty, most poor people, including the very poor, require and actively manage a variety of financial services[2] In the virtual absence of pro-poor financial services, however, they often resort to using inappropriate and/or usurious service providers -- much to their own economic detriment and to that of rural economies in general.

5. Rural financial systems have never served the poor well, favoring instead large farmers and agri-businesses. Traditionally, rural credit has been provided through unsustainable state-owned banks, as few commercial institutions have had the capacity or interest in serving rural markets. The advent of economic liberalization and financial sector reform in most developing countries, however, fostered decreased direct state involvement in rural economies generally, and finance specifically. Change has led to stronger financial systems generally, but has not resulted in greater access for the rural poor: market penetration in rural areas is

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[1] See Annex I for more details on the evaluation approach.

[2] For an invaluable account of how the poor manage their finances, see Stuart Rutherford's The Poor and Their Money (New Delhi: Oxford University Press, 2000).

extremely low, indicating a large potential and an significant unmet demand among IFAD's target groups.

6. As these changes swept the developing world, microfinance emerged as an alternative to traditional finance. From a modest credit-only beginning, microfinance grew into a range of sophisticated pro-poor financial products and services from micro savings, insurance, services for remittance transfers, to a range of credit products including housing, school, and consumer loans. Advances have been primarily made in urban areas. However, microfinance experience has been applied increasingly to the financial needs of the rural poor, although with limited and varying degrees of success. Examples exist across the world, such as the Khan and XAS banks in Mongolia, Prodem in Bolivia, Self Help Groups in India, and community-managed village savings and credit organizations in West Africa, of financial institutions that serve the rural poor to a certain degree. However, replicating these models with scale in most rural areas has been difficult. Even so, a set of "best practice" approaches to urban and rural microfinance has emerged, providing guidance to development agencies wishing to support the development of "pro-poor" financial services.

C. Transferring microfinance to rural areas is not a financial system panacea

7. Distance, low population density, and credit risk are the main challenges to providing sustainable, pro-poor financial services. High transaction costs are compounded by risk management tools that are ill-suited to rural environments, suffering from frequent exogenous economic shocks, natural disasters, crop failures, and other covariant risk events. At the household level, traditional financial service provision is challenged by unreliable borrower information, lack of collateral and seasonal income/loan demand cycles. Inhospitable policy, legal and regulatory environments overlie these challenges. The result: pro-poor market penetration in most rural areas is often less than 10 per cent.[3]

8. Figure 1 shows a simple view of pro-poor finance penetration in most rural markets. In areas with higher population density, a variety of sustainable rural finance approaches have been developed – from non governmental organizations (NGOs) to technology-driven commercial banks. In lower density areas, penetration declines and is highly correlated with transportation infrastructure. Even within each area, most institutions must serve clients with a range of income levels to achieve sustainability and very few financial institutions serve only the poor. Beyond the rural-urban frontier, there is little certainty about how to provide sustainable financial services and frustratingly, what works well in some areas often fails in others.

Box 1: Ten Characteristics of Pro-poor Financial Institutions Successful in Rural Areas

- Repayment not linked to loan use
  Character based lending combined solid lending criteria
- Savings mechanisms available
- Portfolio risk diversified
- Loans adjusted to household income cycles
- Contractual produce relations between farmers and buyers
- Strategies for reducing transaction costs
- Tap into membership organizations (e.g., producer cooperatives)
- Employ area based index insurance where appropriate
- Insulate finance from political interference

Robert Peck Christen and Doug Pearce, Managing risk and designing products for agricultural microfinance Features of an emerging model, CGAP and IFAD, 2005.

9. Nonetheless, the understanding of development agencies about models that work in a given market for pro-poor financial services has advanced greatly in recent years. Some general elements of success have emerged: first, to understand risk and market conditions, service provision must be close to the market; second, providers

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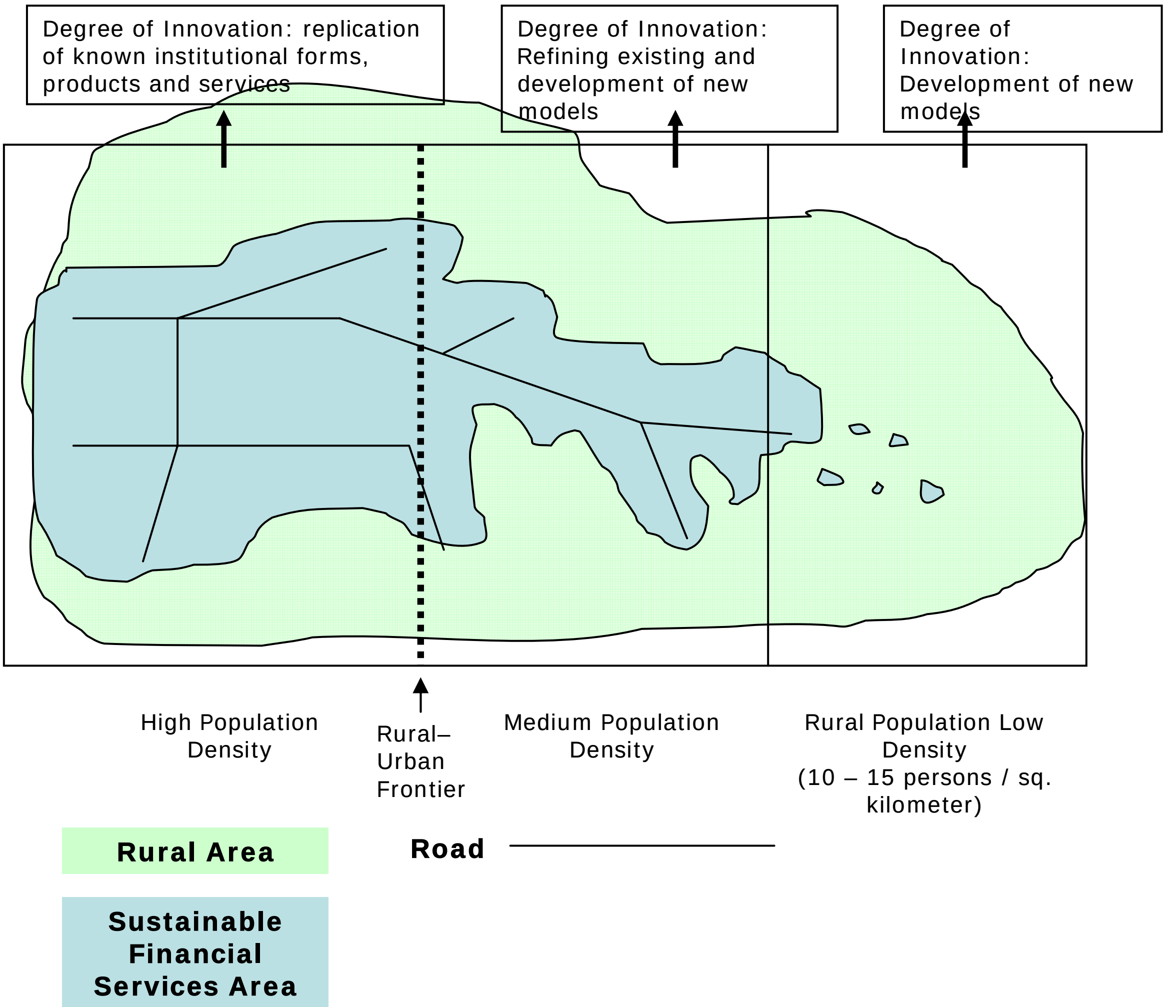
[3] See Consultative Group to Assist the Poor (CGAP) & IFAD, (2005) "Emerging lessons in Agricultural Microfinance. Selected case studies," December 2005.

must have efficient transaction systems (e.g., mobile banking, cell phone banking, palm pilot technologies, or self-managing models such as self-help groups). Besides these general traits, there are ten characteristics of successful pro-poor rural financial institutions, each of which are important depending on the institution and market[4] (Box 1).

Figure 1: Serving the Rural Poor and the Rural Financial Frontier



D. Development agencies and rural finance

10. Until the mid 1980s, many development agencies provided subsidized credit programmes as an input to agricultural production. Funds were managed either by local project staff, government, or state banks. This approach seldom resulted in sustainable services or poverty alleviation, and was largely replaced in the 1990s by government-funded commercially-oriented credit projects operated by state development banks or commercial banks.[5] Programmes almost always focused on highly-targeted populations with tightly-defined credit use. Most programmes did not cover costs or emphasize loan recovery, reinforcing an already prevailing culture of non-payment.

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[4] Peck Christen, Robert and Douglas Pearce, (2005) Managing Risk and Designing Products for Agricultural Microfinance: Features of an Emerging Model, CGAP Occasional Paper, No 11. CGAP, 2005

[5] Commercial banks provided teller services and governments or state banks accepted credit risk and defined eligibility.

11. More recently, agencies have applied best practice microfinance to rural finance projects, many taking a "financial sector" development approach, which means that a range of interventions from institutional support to regulatory change is implemented, focusing on macro, meso, and micro-level issues (Box 2, page 5). The approach often seeks to integrate pro-poor financial services into the formal financial sector. A variety of agencies ascribe to sector development[6], some with significant rural finance commitments, though none are as specialized as IFAD in rural finance, as explained in the following paragraphs.

E. Rural finance at IFAD

12. IFAD is a pioneer of rural microfinance and is currently one of the world's largest, if not the largest, lender in rural finance for poverty reduction, lending US$821 million for rural finance between 1996 and 2005. This total represents over 27 per cent of all IFAD loan allocations, and does not include an additional US$912 million provided to IFAD loans by co-financiers. Of the number of loans approved during the same period, 194 had rural finance components, which represent 70 per cent of the total number of projects. However, comparing the first five years of this period with the second shows that the total number of loans and total lending resources approved declined (Table 1). In addition to loans, IFAD also provides technical assistance grants (TAGs). During the period 1996–2005, US$21.5 million in grants were approved for global, regional and project level rural finance activities. This represents 3.3 per cent of rural finance loans during the same timeframe. Grants ranged in size from US$10 000 for workshops to US$1.8 million to support the CGAP.

Table 1: Rural Finance Allocations Per Region and Timeframe
(Loan amounts in US$ million)

Divisions	1996-2000			2001-2005			1996-2005		
	Number of projects	IFAD Loan amount for RF	% of Total	Number of projects	IFAD Loan amount for RF	% of Total	Number of projects	IFAD Loan amount for RF	% of Total
PA	19	55.3	11.7	18	25.6	7.3	37	80.8	9.8
PF	15	45.2	9.6	13	77.4	22.1	28	122.5	14.9
PI	30	185.9	39.5	25	154.4	44.0	55	340.3	41.4
PL	22	75.3	16.0	9	16.9	4.8	31	92.2	11.2
PN	21	109.4	23.2	22	76.6	21.8	43	186.0	22.6
Total	107	471.0	100.0	87	350.9	100.0	194	821.8	100.0

PA = Western and Central Africa; PF = Eastern and Southern Africa; PI = Asia and the Pacific; PL = Latin America and the Caribbean; PN = Near East and North Africa and Central and Eastern Europe and Newly Independent States.
Note: This table does not include additional funding generated from co-financiers.

13. The adoption of the RFP in 2000 further underpinned IFAD's commitment to rural finance by formalizing a policy framework. The policy's objective is to support rural finance systems to increase access of the poor to sustainable financial services. It focuses on four main challenges: enhancing sustainability and outreach of partner financial institutional (PFIs) to the poor, ensuring general and broad-based stakeholder participation; supporting rural financial sector differentiation (which the CLE referred to as sector diversification, involving the diversification of service

[6] The Inter-American Development Bank (IADB), the Asian Development Bank (ASDB), the International Finance Corporation (IFC), the United States Agency for International Development (USAID), and the United National Capital Development Fund (UNCDF) were interviewed. CGAP, which is the focal point for microfinance for the World Bank, was also interviewed. Specific rural finance data from these agencies was not available.

providers and of services and products); and promoting regulatory environments. Subsequent to the RFP, IFAD developed the Rural Finance Decision Tools to provide practical guidance and interpretation to the RFP, and a Rural Finance Action Plan to follow up the donor peer review conducted by CGAP and numerous project design and implementation resources. Rural finance has also been integrated into the regional strategies of each regional division

II. Assessing the quality of IFAD's rural finance policy

14. To assess the quality of the RFP and the tools designed to ensure its implementation, the evaluation addressed three questions: (i) how does the RFP compare to international microfinance best practices;[7] (ii) is the RFP aligned with other operational policies of IFAD; and (iii) does the RFP provide a guiding framework for operations, balancing programmatic choice and flexibility against normative prescriptions?

A. International Best Practices and the RFP

15. Best practice microfinance typically involves:

- A sector development approach (paragraph 11) advocating strategic interventions based on a sound understanding of macro, meso and micro development needs (Box 2). The RFP meets this requirement to a certain extent: it speaks about interventions at many levels, including the stakeholder, institutional (including sustainability of institutions and their outreach as well as their diversification), and macro or policy levels. However, by not using an analytical framework (such as that of CGAP, Box 2), it did not provide sufficiently specific attention to meso-level issues. It also fell short of introducing an analytical framework that would need to be used to ensure right choices are made about the point of entry of IFAD assistance.
- Supporting sustainable, demand-driven financial institutions with generous grant-funded, long-term technical assistance (TA). The RFP focuses on supporting sustainable financial service providers, or making them financially sustainable, but is less clear on the provision of TA.
- A range of sustainable, pro-poor appropriate financial services – credit, savings, insurance, leasing, housing, services for transfers of remittances – with potential outreach to significant numbers of poor, often including a focus on women.[8] The RFP aims to support the

> **Box 2: Pro-poor Financial Sector Development: Macro, Meso, Micro Best Practice Framework**
>
> A macro, meso micro framework assesses a financial sector holistically, seeking to understand the challenges, constraints, and opportunities at each of these levels. Donors use this approach to understand how best to support pro-poor financial sector development by identifying strategic interventions suited to their resource capacity.
> **Macro level** considerations include macro economic conditions, government policy affecting private and public sector business development. Regulatory and supervisory regimes affecting finance are of particular interest, as are general economic and legal policies.
> **Meso level** considerations focus on a range of actors that affect the health of a financial sector. They include capital providers, credit bureaus, information and technology companies, payment clearing systems amongst sector associations etc, or those organizations that help facilitate and or support retail level financial sector activities.
> **Micro level** considerations include a range of retail financial from banks and cooperatives, to self help groups. They also include insurance companies, non-financial private lenders and leasing companies. Retail level market conditions and trends are also important micro considerations.
> *Building Inclusive Financial Systems: Donor Guidelines on Good Practices in Microfinance, CGAP, December 2004.*

[7] Microfinance best practices do not necessarily translate entirely to rural microfinance best practices Differences are pointed out in when relevant.

[8] Pro-poor appropriate is defined by products and services that provide utility to the poor or those that help to increase household income or asset value. Care must be taken to ensure that credit products, for example, do not unnecessarily overburden the poor with debt and that savings products provide positive interest, etc

diversification of rural financial services, including the types of products and services offered. However, it is less clear about establishing goals for strong outreach, specifying a focus on the rural poor. It also does not set targets for rapid expansion that are typical for international development agencies. Nor was gender a strong focus of the RFP.

- Demand-driven services that are not tied or narrowly targeted to a particular credit use or population. The RFP spoke of the need to offer demand-driven services as part of the challenge to reach PFI sustainability. It introduced, in addition, the concept of more generic stakeholder participation in project design and implementation. This participatory approach was elevated to the level of one of the four challenges. However, in the case of rural finance projects, such participatory approaches do not necessarily provide requisite information on market demand. Instead, the impression is created that clients of rural financial service providers should be participating in the management of such institutions. The latter is the case only if the institution is user-owned and managed in a participatory way. For commercial service providers, such participation is unrealistic and potentially detrimental to the functioning of the service provider and thus the quality of rural financial services provided to the rural poor; and
- A regulatory regime that promotes pro-poor appropriate regulations, interest rate setting freedom, and prudential, transparent supervision. The RFP foresaw that IFAD's assistance programme would cover this aspect as well.

B. Policy and Strategy Alignment

16. The CLE compared the RFP against major policies and strategies within IFAD to test whether RFP principles permeated other relevant corporate policies and strategies. The analysis showed strong alignment and mutual support between the RFP and the IFAD Strategic Framework and policies for private sector development and rural enterprise development. However, the RFP lacked a comprehensive integration of gender issues in line with the Gender Plan of Action, and was silent on the need to ensure environmental sustainability (which may be reflective of the absence of an explicit IFAD policy on environment).

17. The Action Plan for Rural Finance and Decision Tools for Rural Finance (paragraph13) go partially to overcome the shortcomings of the RFP observed in paragraph 15 and thus tighten the alignment of the RFP with international best practices for rural finance. But the Decision Tools do not have the normative power of policy. Therefore, their influence is correspondingly limited. In addition, these supporting mechanisms could benefit from a more systematic framework for analyzing the financial sector (such as CGAP's best practice analytic framework in Box 2) and for assessing rural finance projects in this context (do IFAD-supported projects address key sector development issues, and do they do so in a systematic and well sequenced way?).

18. With the exception of the Western and Central Africa Division (PA), which has a separate rural finance strategy, regional strategies provide little specific guidance or insights on how rural finance will be applied in the regional context. They do not present an analysis of region-specific rural finance issues and how the principles of the RFP would be applied, or connect rural finance to strategic regional activities or goals. In some regional strategies, rural finance coverage is so slight that it provides no value added. By contrast, establishing specific rural finance targets has helped PA concentrate divisional interest and activities while encouraging compliance with the RFP. Similar weaknesses (insufficient analysis of sector issues, absence of specific rural finance goals, and inadequate integration of rural finance into IFAD's country

strategies) were observed in most Country Strategic Opportunities Papers (COSOPs), although more recent examples (Benin, China and Zambia) show improvements.

C. Guiding Framework

19. As a strategic guide, the RFP is neither entirely perfect or completely inadequate. Its main flaws are that it: (i) provides little guidance on how IFAD assistance should be prioritized within a rural finance sector framework. Instead, it presents all four challenges as equal and does not suggest an analytical framework for determining how priorities should be set in the case of a specific country; (ii) articulates several key financial concepts with insufficient clarity with the resultant ambiguity that allows room for misinterpretation, including the use of credit lines, understanding the financial needs of the rural poor and responding to them in a sustainable fashion; and (iii) is unclear concerning prescribed PFI performance standards and enforcement mechanism. Furthermore, the RFP did not provide a costing for its implementation (discussed further in paragraph 51), nor did it foresee retrofitting, i.e., specifying the requirement for redesigning already approved projects to meet RFP requirements.

Summary – Assessing RFP Quality. The RFP is in line with best practice standards in a number of important areas, such as sustainability of financial institutions and contributing to the diversification of the financial sector (institutions and services/products). In the area of outreach, the RFP focuses on the rural poor, but neglects the objective of large-scale expansion. It diverts attention from the more important issue of designing and delivering services and products that meet the needs of the poor by introducing a generic approach participation in project design and implementation. The spirit of the RFP is reflected in IFAD's corporate policies and strategies. In principle, the RFP provides a guiding framework for operations, but leaves areas open to interpretation that, as shown in section III, have led to non-compliance with RFP principles (in ongoing and newly approved loan projects) and subsequent shortfalls in performance.

III. IFAD project performance and impact

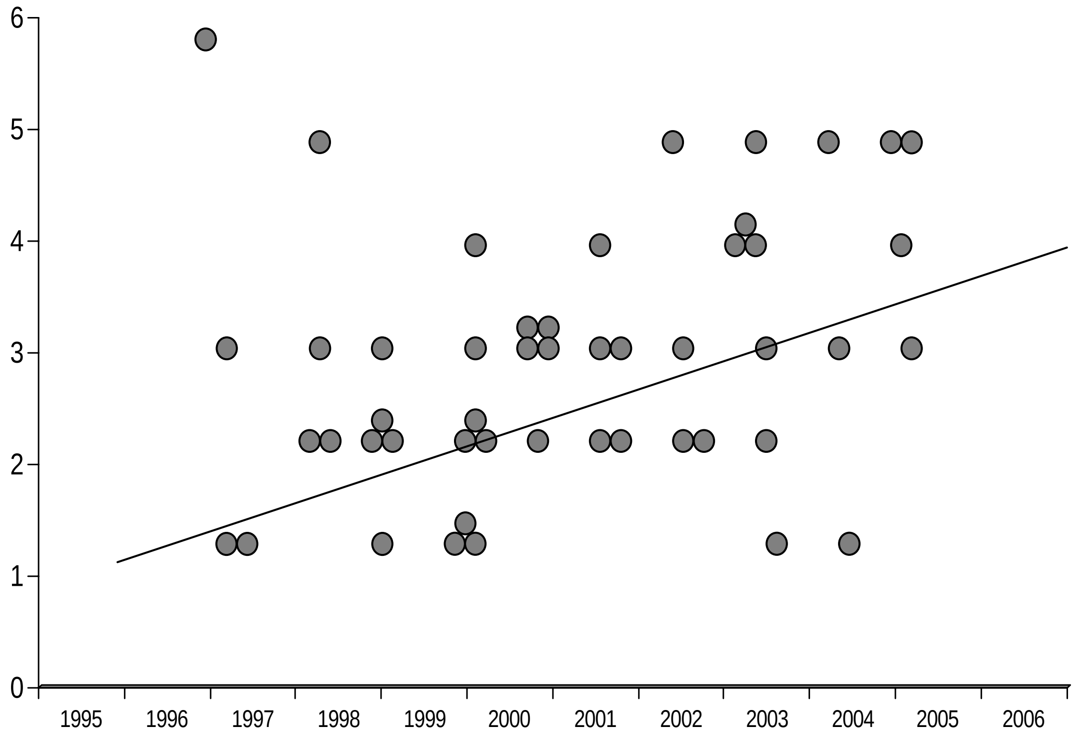
20. To understand how the RFP influenced IFAD-supported rural finance projects, the CLE compared the quality of rural finance projects approved in the five years prior to the adoption of the RFP with those approved five years after. For the CLE, project quality was defined as the extent to which projects met the challenges of the RFP and what results were achieved. One of the challenges (sustainability and outreach) was split into two, resulting in the following performance criteria: (i) the extent to which PFIs achieved sustainability; (ii) whether stakeholder participation was meaningful; (iii) whether financial sector diversification was achieved; (iv) whether the policy framework was influenced through appropriate policy dialogue; and (v) whether the rural poor were served (outreach impact).

A. Overall quality of projects

21. Projects are increasingly meeting the RFP challenges, although overall performance falls short of satisfactory. Figure 2 shows a positive trend line in the quality of projects over the entire evaluation period. However, starting from a low base, the trend reached a performance rating of 2.7 at the end of the first five-year period (1996–2000), indicating that, as a group, projects had not meet the RFP challenges. For the second period (2001–2005) the rating reached to 3.2 in 2005, indicating that positive performance characteristics only marginally outweighed the negative. This positive trend began just before the RFP, suggesting projects were benefiting from a growing institutional focus on rural finance at the time when the policy was articulated. Figure 2 also demonstrates that some of the early projects (Philippines and Venezuela) embodied good practice standards long before these were articulated in the RFP. The number of well performing projects (rated 5 or better) increases

from two, before the approval of the RFP, to five after (Bangladesh [2], Benin, China and Uganda).

Figure 2: IFAD Rural Finance Project Ratings



Rating By Year (N=50)

Note: The scale has six levels: (1) Seriously detract from RFP objectives; (2) Detracts from RFP objects; (3) Net sum zero support of RFP objectives; (4) Some support of RFP objectives; (5) Good support of RFP objectives; and (6) Significant support of RFP objectives.

22. While projects increasingly met RFP challenges, i.e., project quality improved over time, it did so unevenly across the four RFP challenges:

- **Sustainability.** Only 24 per cent of PFIs met the RFP goal of financial self-sufficiency, with another six per cent expected to reach financial sustainability in the near future. However, while being disappointing in absolute terms, these findings are similar to those of UNDP microfinance projects, where 22 per cent of PFIs were sustainable[9], although they operate in urban and peri-urban areas where sustainability should be easier to attain than in rural areas with lower population densities. PFIs are expected to increase reporting of financial data, which will expand the database for monitoring sustainability and improve performance in this respect.
- **Stakeholder participation** remained largely unchanged for project design, implementation and monitoring activities. The poor typically participate in all of these stages of projects, though primarily in the design phase. However, in practical terms, their participation was limited, typically to one-time-only focus group encounters. By contrast, serious analyses of the financial needs of the poor was, by and large, lacking. The participation of other stakeholders, in particular of government and PFIs, were consistently found to be more meaningful.

[9] Rosenberg, Rich, Review of UNDP Microfinance Portfolio, April 2005. Available at: http://www.microfinancegateway.org/content/article/detail/30203.

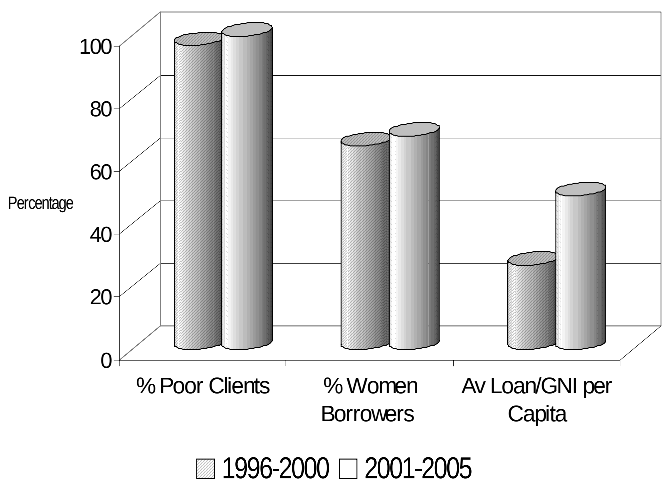
- **Diversification.** IFAD's rural finance portfolio has seen a positive movement towards promoting a greater variety of financial products and services. There was a modest increase in off-farm credit for rural micro-enterprises and in a range of other products, including savings, insurance and services for remittances' transfers. There has also been a modest but clear shift away from state banks towards a growing number of other more "rural friendly" financial services providers from community-owned and self-help organizations to commercial banks.

- **Promoting Regulatory Frameworks.** Tracking and evaluating the impact of policy dialogue and its results is particularly difficult in any development intervention as they are highly susceptible to exogenous factors (e.g., change of government personnel, priorities, etc.) and difficult to measure. The CLE found, however, that while the number of policy-related activities was unchanged, there was some improvement in the quality of some specific engagements. This was particularly the case when IFAD partnered with regional or local stakeholders.

B. Outreach – Pro-Poor Impact

23. Conducting a full impact assessment at the household level would have considerably increased the cost of the CLE, (without necessarily providing better insights into impact) given the dearth of baseline and other self-evaluation data (paragraph 33). For this reason, the Office of Evaluation (OE) opted for a less ambitious but more cost-effective approach to use proxy indicators that are commonly employed in the microfinance industry. These are: (i) the ratio of average loan size to Gross National Income (GNI) per capita[10]which measures how poor the borrowers are (depth of poverty); and (ii) the number of women served, which is a proxy indicator for the nature of impact (i.e., women are generally more inclined to reinvest the proceeds of income-generating activities in household assets' development and enterprise). Project performance against these indicators was complemented by assessments by the CLE team, relying on a variety of sources, including product design, client surveys, secondary studies, PFI data and focus groups[11]

Figure 3: IFAD Poverty Outreach



24. The CLE found IFAD was reaching the poor both before and after RFP approval (Figure 3), although fewer than 10 per cent of those reached were the poorest of the poor. This achievement in terms of outreach is in line with best practices of the microfinance industry, which recognizes that the poorest may not benefit from microcredit. The CLE also observed that between 2001-2005, 60 per cent of PFI clients were women, a slight increase over 1996-2001. This percentage is above the 57 per cent global average for MFIs with clients with middle-

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10 The formula for average loan balance per borrower per average gross national income is the institutions average loan balance per borrower divided by the gross national income in which it is resident. See www.mixmbb, definitions for more details and most current global benchmark figures.

11 The RFP does not distinguish between types of poor, which in microfinance are typically placed into two categories: the productive poor (those with some assets with which to produce a livelihood), and the poorest of the poor (those with few means of production).

to-low incomes, but below the average of 87 per cent for MFIs that serve only low income clients. Equally for the GNI Indicator, the percentage of IFAD-supported PFIs is above that of MFIs dealing solely with low-income clients, but below that for MFIs with a mixed clientele of middle to low income clients (IFAD = 49 per cent; MFIs with low-income clientele = 25 per cent; and MFIs with mixed clientele = 64 per cent).[12] This change is attributed to IFAD working with more established financial service provides who are serving a broader client income mix[13]

Summary – Performance and Impact. The quality of projects, measured in terms of meeting RFP challenges, has continuously improved over the evaluation period. However, it still falls short of meeting all RFP standards. Performance was better in working with PFIs (achieving sustainability of 24 per cent of PFIs and making inroads into diversification of service providers and types of products and services). It showed no change for stakeholder participation, which in part can be explained by the ambiguous definition of this challenge (paragraph 15), advocating generic participation rather than a focus on pro-poor, demand-driven financial services. Performance was least discernable in the area of policies and regulatory frameworks, in part because this work is undertaken without resource allocation and often goes undocumented, although an improvement in quality of policy interactions was noted in a number of cases. The outreach of IFAD-supported PFIs is accurately focused on the poor, although the clientele of these institutions increasingly includes a mix of poor and non-poor (which increases chances for PFI sustainability), with 60 per cent of their services assisting women.

IV. Design and implementation performance issues

25. Design and implementation are key to ensuring that the RFP is adequately implemented through rural finance projects and that the desired results are achieved. This section of the CLE summarizes issues observed concerning IFAD's project cycle in general and presents observations on design and implementation issues from the analysis of 58 rural finance projects included in the CLE sample. This section aims to identify reasons that explain the performance reported in Section III above.

A. Project Cycle

Project Design

26. Design quality is the responsibility of country programme managers (CPMs), Division Directors, and the borrowers. Each division manages the development process differently between CPMs and directors, with little lateral consultation with other CPMs. A Project Development Team (PDT) is formed at the inception stage providing important input, although of variable quality depending on who participates on the team. Overall, the design process and quality depend on the degree of technical knowledge of CPMs and the single technical expert for rural finance in the Technical Advisory Division (PT), who is not always available to PDTs. The amount and timing of specialized rural finance expertise involved in the design of IFAD-supported projects is limited in comparison to other development agencies working in the same field (paragraph 52).

27. The Inception Report is the first formal output during design, and has the objectives of defining the type of assistance required and developing a conceptual outline of a project (i.e., if a financial component is required). Formulation stage follows, where the broad strokes of project details are determined (i.e., what type of financial component and who might be involved, what target market etc.). Appraisal follows,

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12 Comparisons were drawn from MicroBanking Bulletin 11 (MBB) (2005) available at http://www.mixmbb.org/en/index.html. Particular figures are found on MBB 11 data charts available at http://www.mixmbb.org/en/mbb_issues/11/Online%20Tables/2003%20MFI%20Benchmarks.xls#OutAvg. Figures are from 2003 and are based on a global sample of 91 institutions.

13 Figures taken from the MicroBanking Bulletin 11, available at:www.themixmarket.org.

where key project details are developed, but due to the need to maintain project flexibility in the face of lengthy project approval and start-up processes, designers are often unable to detail several key elements of rural finance projects, such as PFI selection, and performance objectives. PT's technical reviews assess projects against RFP compliance at this stage, but despite their uniformly high quality, recommendations were not materially taken into account 50 per cent of the time. This can be explained by the late timing of the technical review, when major redesigning would delay project approval by the EB, by the non-binding nature of technical reviews, which limits influence on design, and by the considerable "sunk" design cost incurred to bring projects to the Appraisal stage (Box 3).

Box 3: Estimated Project Design Costs

Inception Report	US$ 40 000 – 60 000
Formulation	US$140 000 – 160 000
Pre appraisal	US$ 60 000 - 80 000
Appraisal	US$ 60 000 - 80 000
Loan Negotiation	US$ 15 000

Source: Engelhardt, Achim, Second Draft, Progress Report Review of Quality Enhancement Process in IFAD's Loan Project Cycle prepared for IFAD, May 2006.

28. The final stages in the design process, namely the Operational Strategy and Policy Guidance Committee (OSC) and EB approval, should not have to deal with project designs that do not meet the requirements of the RFP. The overall rating of 3.2 in terms of project quality (paragraph 21) indicates that a number of projects are cleared by the OSC and approved by the EB that do not meet RFP standards. There is no evidence that non-compliant project proposals are returned for redesign to improve the quality of rural finance components at these stages of the project cycle, suggesting that no quality assurance mechanism is in place that supports decision-making of the OSC and the EB.

Design to Loan Effectiveness

29. IFAD's project design cycle is a complex process taking from 29 to 36 from inception to loan effectiveness, far longer than most institutions with similar projects (Box 4)[14] This is far too long for many projects to remain relevant to the relatively rapid pace of change within financial sectors or to be of interest to PFIs, which cannot afford to wait several years for the start-up of a project, be it for TA or to provide capital. If projects are to remain relevant they must be informed and shaped by ***current*** business environment analysis. It is difficult to objectively estimate how many rural finance components of IFAD-supported projects in the CLE sample have been affected by lengthy disbursement delays, but it is likely between 30 to 50 per cent.

Box 4: Time Required from Design to Effectiveness
(Estimates)

Direct Investments into PFIs	
IADB	8 to 18 months
IFC	6 to 12 months
Private Fund	3 months
Sector Development and PFI Investment	
IFAD	29 – 36 months
Sector Development Projects	
UNCDF	12 to 24 months
USAID	12 to 30 months

Source: interviews with senior project officers and managers.

Management and Supervision

30. Once approved, the responsibility for IFAD-supported projects lies with national governments while project supervision is the responsibility of cooperating institutions (CIs)[15] Management responsibility falls to project management units (PMUs) which are beset by a host of shortcomings (e.g., staff seconded rather than selected competitively, lack of technical capacity, politically constrained or motivated). The CLE found most PMUs and CIs to have limited financial capacity and even less *pro-*

14 See the Independent External Evaluation (IEE), page 31, Table 6 and assuming a conservative one year minimum from inception to loan approval.

15 The number of directly-supervised projects in the sample was too small to allow a comparative analysis of IFAD versus CI-supervised projects. The analysis is based on the operating model in place until 2006, but the evaluators were aware of forthcoming changes to the supervision and implementation model of IFAD.

poor finance experience. This limitation is compounded by supervisory missions that are too infrequent for adequate performance monitoring of financial institutions. Mid-term reviews are important and have led to some adjustments in project design and implementation, but their late timing in the project life made them an inadequate tool to prevent or correct problems in a timely way. Periodic portfolio reviews – undertaken only by few divisions – and evaluations undertaken by OE are useful, but not frequent enough for ongoing oversight. And, most critically, even when non-compliance of a project was observed, corrective actions were seldom taken. Only two of the 58 projects assessed by this CLE were significantly redesigned to meet RFP standards, although around 70 per cent of projects overall were not in full compliance with RFP requirements.

31. Supervision has been hampered by a lack of consistently-applied performance indicators. The RFP provides a set of indicators, but lacks clarity on which should be applied and how. This has limited the effectiveness of the RFP and performance criteria provided therein. CIs, PMUs and CPMs seldom have the technical expertise to assess performance, even when data is available. The current initiative of PT to have PFIs sign up and report under the Microfinance Information Exchange (MIX) – a monitoring system for market performance – is a step toward creating a reporting system that employs industry standard indicators consistent with RFP measurement goals. However, a full monitoring framework has yet to be developed that would, *inter alia*, facilitate the strategic decision-making by senior management and the oversight function of the EB.

32. Performance monitoring challenges are exacerbated by a lack of qualified, on the ground supervision staff. Successful microfinance projects typically employ internationally qualified technical service providers (TSPs) on a permanent or semi-permanent basis.[16] IFAD *de facto* relies on Rome-based CPMs to monitor projects, regardless of their technical qualifications and workload. The NGOs partner network created by PT to support PFIs will improve monitoring (see paragraph 54), but will not achieve the same results of having dedicated TSPs.

33. Monitoring impact is more complex than measuring project or PFI performance. Best practice impact analysis integrates social performance measurement into an institution's management information system which can simultaneously produce social impact and business management information.[17] Very few examples exist, with IFAD or other development agencies, to apply these approaches. The most accurate means to assess rural finance impact, however, is long-term, longitudinal client welfare studies. No IFAD project has rigorously employed either of these approaches.

B. Ten years of design and implementation challenges

Design Issues

34. Project design in the period prior to the RFP was characterized by a few star projects contrasted by a majority of supply-driven projects. Some star projects (paragraph 21) included those that focused uniquely on rural finance, provided funding directly to PFIs, supported self-help lending and savings groups, or provided capital to PFIs via demand-driven apex-funding organizations. Supply-driven projects often had loan terms and conditions that were determined on the basis of project interests rather than to meet the needs of the rural poor. Criteria for loan eligibility and for the use of credit often defined target populations so narrowly that sustainability was made impossible. Credit delivery agents were seldom vetted for their potential to attain sustainability, and performance monitoring systems were perfunctorily defined.

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[16] See Rosenberg, Richard, (2006) Review of UNDP Microfinance Portfolio, CGAP, 2006: available at http://www.microfinancegateway.org/content/article/detail/30203

[17] See discussion of best practice standards, IFAD (2006), Assessing and Managing Social Performance Indicators.

35. After adopting the RFP, project design saw various improvements: (i) a growing emphasis on financial sector development based on an understanding of macro, meso, and micro-level issues; (ii) a slight shift from line ministries to the somewhat more appropriate finance ministries, which improved, albeit modestly, government involvement in project management; (iii) increased attention to PFI sustainability, including a move away from state banks and PMUs as financial service providers toward more commercially-oriented and locally-appropriate self-help group models, commercial banks and cooperatives; (iv) a modest reduction in the provision of credit lines and an increase in provision of grant assistance for technical capacity building of PFIs; and (v) meeting the needs of the rural poor for financial services with demand-driven products and services. A number of factors contributed to these improvements, such as an increase in IFAD's rural finance capacity, an increasing number of stand-alone rural finance projects, and working with other development agencies through joint projects and co-finance arrangements.

36. However, a number of design issues still remain to be solved. Firstly, the quality of sector analysis was uneven and caused project designers to overlook potentially important interventions. In several projects, for example, a traditional credit approach was favored over other, more complex macro or meso level interventions that would have had greater potential to improve the rural financial system with commensurate larger rural poverty impacts. Secondly, project design still focuses too much on credit and not sufficiently on the need for a broader range of products (e.g., remittances, micro insurance, micro leasing, and savings for asset building). Thirdly, target groups continue to be over-defined, which frustrates the demands of the rural poor and hampers goals to attain PFI sustainability.

Implementation Issues

37. Pre-RFP implementation was highly constrained by a lack of management and supervision capacity. PMUs seldom had the capacity or training opportunities to learn about financial project management. State banks had better capacity, but tutored by decades of subsidized credit, underdeveloped credit risk and portfolio management, and poor collection habits, often led projects to replicate their generally poor performance. Lack of management capacity was greatly complicated by inadequate monitoring tools. Few projects established regular monitoring reporting systems beyond annual reports and mid-term reviews. CIs and CPMs normally did not have the experience required to calculate and assess financial performance ratios of PFIs, or even interpret those that existed. Irregular and long intervals between supervision reports intensified monitoring and implementation challenges. Even when projects were found not to be meeting RFP standards, enforcement of the policy was minimal.

38. Implementation became more difficult after the adoption of the RFP for those projects that pursued more complex and innovative designs (e.g., involving more sophisticated and numerous PFIs and a greater range of financial products). Managing this complexity required significantly improved technical capacity within IFAD, CIs and PMUs. The introduction of the MIX Market (paragraph 31) has helped to sharpen IFAD's and PFIs' focus on real time performance monitoring and provides CPMs with exposure to best practice performance standards and benchmarks. In addition, IFAD established regional partnerships with specialized microfinance agencies to provide implementation support to projects, play a role in policy reform processes, and facilitate capacity building and learning. Positive results were also achieved by working with other development partners with qualified technical expertise in the field. In other cases, the lack of qualified financial experts on the ground continued to be a key impediment to RFP implementation – particularly in cases where policy work was required.

39. While having made some inroads into changing responsible government agencies for project oversight, IFAD-supported projects still struggle to work with the appropriate

line ministry, ensure appropriately skilled PMU staff is selected, and convince governments to invest in quality support for technical capacity building of PFIs. Government partners and bureaucracy often had negative effects on projects through implementation delays and project management issues.

Summary – Implementation and Design Issues. Compared to best practices, IFAD's project cycle is too long for projects to remain relevant to sector changes and the needs of PFIs. There are too few binding technical checks to ensure that project design meets RFP standards (or best practices), and these often occur too late in the design process. Nonetheless, project design improved over the evaluative period showing that: (i) more recent projects undertake better sector analysis (although the quality of analysis varies due to the lack of an IFAD-wide accepted analytical framework); (ii) there is a discernable shift towards government agencies better equipped to exercise oversight over rural finance projects and towards PFIs that share RFP aims of sustainability; (iii) there is a slight shift from credit lines to TA, although TA provision still falls short of actual needs of PFIs working (or wanting to work) in rural areas; (iv) somewhat more demand-driven service provision that meets the needs of the rural poor, although greater product and service diversification is desirable; and (v) still too many projects over-define clients and terms and conditions of financial products. With increasingly complex project design, the demands on implementation and in particular, implementation support, have increased. IFAD's technical in-house capacity improved to a certain extent and arrangements were made for regional technical partners. These provisions fall short of best practice of having internationally qualified technical expertise in the field.

V. Corporate arrangements supporting rural finance activities

40. Corporate support for rural finance projects has an important influence on the quality of operations. To understand how these influences guide, constrain, or support project quality, the CLE assessed three institutional support arrangements: IFAD's founding agreement, human and financial resources, and knowledge and innovation management processes.

A. IFAD's Founding Agreement

41. The founding agreement specified IFAD would finance agricultural development projects designed by other organizations to support food production for the rural poor in developing countries. The founding agreement did not anticipate taking a high degree of responsibility for design or implementation support of projects. Thus, many of the operational prescriptions in the founding agreement that constrain operations in general also apply to rural finance projects in particular. While a number of these founding principles are changing (e.g., a new operating model is under development which will, inter alia, change the supervision and implementation support arrangements). The CLE nonetheless analyzed the arrangements governing the projects under evaluation to determine whether and how they affected project performance. Issues such as lending only to government, limited provision of TA through TAGs, no field presence, and no direct supervision are discussed in detail in the following paragraphs.

Leadership and Governance

42. IFAD's founding agreement gives the EB full authority to set strategic directions, including the nature of programming and approval of projects and grants. It also adopts and recommends actions, pending final approval of the Governing Council, on matters related to policy, and the annual administrative budget. Once policy is set, the EB must ensure the strategic objectives of the policy are being met over the long term.

43. In terms of rural finance, the EB has been at once supportive and under-prepared. It has approved a relatively solid RFP, lending importance and priority to rural finance

at IFAD. The EB has not, however, familiarized itself with best practices in rural finance or required the establishment of a reliable quality assurance mechanism that would reassure it of technical compliance. In the past, this shortcoming resulted in the EB approving numerous projects that do not, in fact, meet RFP standards. An overloaded EB agenda, absence of adequate quality assurance mechanisms, and inadequate executive reporting mechanisms that inform the EB of compliance of new projects and retrofitting of existing ones are all responsible for an inconsistent application of the RFP, including the approval of a number of non-compliant projects.

Government as Borrowers

44. A litany of failed or seriously underperforming state banks in developing countries provides significant evidence that financial institutions and governments do not generally mix well. The reasons are many, some specific to finance and some not, the most obvious being that the *modus operandi* of government is more often than not incompatible with private-sector initiatives. For instance, governments often allow political interests to enter decision making, such as imposing interest rate caps, inappropriately large loans and long loan term conditions, targeting lending to specific communities, any one of which can impede the provision of pro-poor financial services or the sustainability of PFIs

45. 45. Instead, best practice suggests that the most effective role of government lies in ensuring a supportive enabling policy environment that facilitates the provision of best possible financial services to the rural poor, the provision of capital to micro/rural finance institutions through independent wholesale funds, or by using external funding (such as that provided by IFAD) to build the technical capacities of financial service providers. Governments are also reluctant to use borrowed funds for TA, particularly for international level quality TA. This choice is unfortunate as the need for quality TA is typically more frequent than it is for portfolio finance (i.e., funds for lending), and possibly even more pronounced in a technically demanding sector such as rural finance.

Minimal Grant Funding for Technical Assistance and Lack of IFAD Country Presence

46. CGAP donor peer reviews pointed out in 2003 and 2006 that loan and grant instruments limit IFAD's ability to offer a full range of financing options required to support best practice rural finance. In particular, IFAD has not provided sufficient volumes of grant-based funding required for PFI capacity building. Complex, sector development projects require a good deal of TA, particularly in rural areas. USAID has impressive returns on a grant-based approach in Uganda, Peru, the Philippines, Jordan, and Mongolia, among other countries. The German Development Organization's (GTZ) long-term support for the *Cajas Municipales* in Peru is a celebrated example of TA success. The World Council of Credit Unions' USAID-supported turnaround of the million member *Caja Popular Mexicana* in Mexico also relied on long term, on-the-ground TA. The majority of these examples operate in far less challenging urban and peri-urban markets, suggesting TA is even more necessary in more challenging rural environments.

47. Quality, on-the-ground TA is also critical particularly when new, smaller or innovative institutions are involved, or when very poor markets are being served – all typically associated with rural finance development. Other agencies have several levels of presence, from local representatives to permanent technical staff.[18] Instituting a field presence along the lines of IFAD's Field Presence Pilot Project (FPPP) would be a positive step towards better supervision and implementation support, though an ideal solution for rural finance projects would be full-time dedicated rural finance expertise in the field.

[18] Many agencies take multiple approaches.

Box 5: Investment Portfolio Technical Support
(Based on estimated annual investment disbursements and TA expenditures US$)

	Technical Experts to Annual Disbursements	TA Budget to Investments
IFAD	1 : 82.1 million	1: 38.2 million
IFC	1 : 11.5 million	1: 10 million
USAID	1 : 22 million	Most in TA
UNDP	1: 6 million	Majority in TA

Sources: Executive Interviews

48. The RFP also calls on IFAD to consider using a fuller range of instruments including equity, convertible debt, guarantees, and even structure finance. IFAD loan instruments do not preclude these financing options, though their use is quite complicated, as neither governments nor development agencies such as IFAD tend to have the ability to support their use.[19] There are exceptions, such as the successful subordinated debt investment in an Armenian bank and support of apex funding organizations such as Palli Karma-Sahayak Foundation (PKSF) in Bangladesh[20]

Cooperating Institutions

49. The role of CIs has focused more on a fiduciary role than on supervision or implementation support. This was appropriate when IFAD was investing in projects managed by other institutions, but has been found wanting as the organization has taken to developing its own projects – an arrangement that requires closer supervision. In rural finance, direct supervision of projects by funding agencies has emerged as part of best practice interventions. As noted (paragraphs 30 and 37), infrequent supervision reports provide some oversight, but do not replace frequent and structured reporting suggested by rural finance best practices.

Enforcement of Non-Compliance

50. As noted in paragraph 26, responsibility for project design and implementation is shared between IFAD and the borrowers, with greater responsibility for the implementation phase resting with the latter. This arrangement limits IFAD's ability to enforce project performance standards. IFAD can intervene to enforce loan conditions, but in practice has not done so, even when projects were clearly not in compliance with project agreements and RFP standards. Instead, IFAD tends to overlook non-compliance or wait until mid-term reviews to redress difficulties. Even then, few projects have been redesigned. By contrast, the UNDP microfinance policy suggests PFIs be dropped from programming for irresolvable non-performance problems.[21]

B. Financial and human resources

51. The RFP provides no direct guidance on financial and human resources that would need to be allocated to rural finance operations. In other words: there was no costing of the RFP's implementation requirements. Instead, the RFP assumed that its ambitious objectives could be attained without specific or additional resource allocations

Financial Resources for Rural Finance

[19] Lacking instruments also limits IFAD's vision of what financing can accomplish. Financing is not an end, but a means. It can help institutions become sustainable, an important part of which, as the RFP rightly points out, is to become resource independent. Properly and consciously used, financing can leverage sustainable access to new finance; some argue that this in fact should be a major goal of all funding from development agencies. Appropriately monitored and provided on a competitive basis, financing can also improve loan portfolio and business management. Improperly delivered and managed, loan capital can create dependencies, operating inefficiencies, and distract institutions from finding sustainable sources of finance. Lending to governments, poor supervision, and lack of qualified presence only abets potential negative impacts of lending to microfinance institutions (MFIs), including rural ones. See de Sousa- Shields, Marc and Cheryl Frankiewicz, (2005) Financing Microfinance Institutions: The Context for Transitions to Private Capital, USAID, 2005, available at http://www.microlinks.org/ev_en.php?ID=5967_201&ID2=DO_TOPIC under Theme 5, Access to Capital

[20] IFAD's recent attempt to provide a more "flexible" loan instrument addressed some broader programmatic concerns, but ultimately did not address the need for more rapid, strategic and accountable lending. More "flexible" in the context of PFIs is rapidly available funding linked to strong TA.

[21] UNCDF Microfinance Policy page 2, http://www.uncdf.org/English/microfinance/UNDP_MFpolicy.php

52. Modest improvements in the quality of rural finance projects were accomplished with an administrative budget that represents 0.01 per cent of IFAD's rural finance loan commitments. Variable, or non-permanent financial and staff resources, by contrast are more significant, as considerable CPM, consultants' and senior management's time is spent on rural finance projects. While IFAD cannot calculate staff resources applied to rural finance, interviews that the CLE team conducted suggest resource are not proportionate to rural finance loan volumes. Comparisons with other development agencies found permanent full-time technical expert to annual loan volume ranged from 1 officer to US$ 6 million to 1 to US$23 million. At IFAD it is 1 to US$88 million (Box 5).

53. Grants also provide significant support of the RFP. Between 1996 and 2001 rural finance grants totaled US$23 million were used to support rural finance activities. PT sourced US$6.2 million to 21 regional and international partnership initiatives helping PFIs better serve clients and leveraging regional market intelligence, policy development, networking, and project monitoring capacity. Grants to CGAP gave IFAD *entre* to the leading international microfinance forum. Grants supported the important rural finance research publications as well as the MIX Market reporting system.

54. During the evaluative period, a total of US$16.8 million in grants or US$1.7 million per year were sourced by regional divisions to support rural finance projects. Uses varied, though approximately 60 per cent was for TA.[22] Regionally, use of grants ranged from US$1.5 million in PA to US$5 million in PF, which amounts to little on a per country basis. This level of grant funding has been helpful, but is modest compared to that provided by other institutions with similar activities. IFC's annual microfinance investments of US$100 million to US$120 million, for example, are supported by a TAG budget of US$10 to US$15 million per year for a 1:10 grant to investment ratio. IFAD's ratio of 1:38 is much less generous. Other agencies engaged in sector development, typically have much larger TAG budgets than investment budgets.

Human Resource Capacity

55. IFAD has one full-time rural finance technical expert. This position is responsible for providing technical support on a US$830 million portfolio (plus some US$900 million in cofinancing), providing technical input to PDTs and Technical Review Committees (TRCs), supporting regional strategies, maintaining partnerships and developing rural finance strategies. This capacity is augmented by Regional Directors and CPMs, several of whom have a good knowledge of rural finance best practices. Expert consultants also are commonly employed to support rural finance projects. Due to lack of data, the CLE could not systemically assess the quality of consultants used, although anecdotal evidence suggests it is mixed. This is so for a number of reasons including CPMs being unable to assess consultant experience, IFAD not being considered as an elite MFI, and comparatively low levels of fee rates. A Thematic Group for Rural Finance bolsters internal capacity but its voluntary participation and lack of formalized terms of reference reduces its overall effectiveness. Recent efforts to improve capacity have seen some results, but efforts are hampered by limited time resources of staff and typically lengthy microfinance training courses.

56. Another resource for PT is the aforementioned rural finance partner network (paragraph 38 and 53). This grant-based network ostensibly supports IFAD PFIs. It also acts to "outsource" IFAD capacity needs in rural finance, a reasonable strategy given resource constraints. The MIX Market offers a similarly efficient means of extending IFAD's capacity as an outsource agent for managing PFI performance data. The MIX work has been supported by the Innovation Mainstreaming Initiative (IMI) and is set to expire at the end of 2006. This relationship will require ongoing

[22] Data was not available to determine what type of assistance was budgeted for or that allowed categorization of use.

funding if it is to be the basis of a PFI monitoring and evaluation and a senior management information system.

C. Knowledge Management

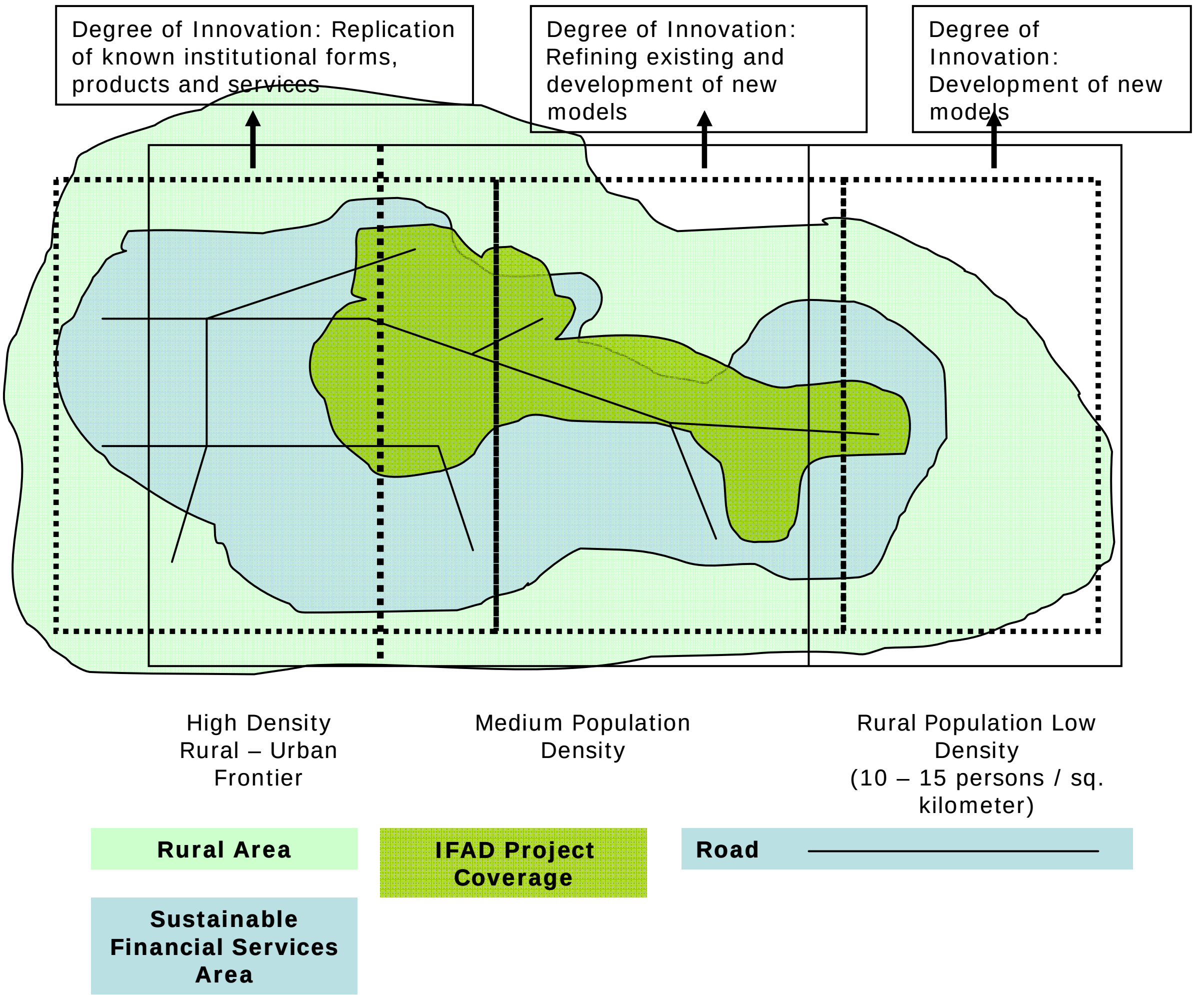
57. IFAD is an organization with a clear thirst for knowledge but not clearly organized to satisfy it. This observation is true to a point for rural finance; IFAD has collated a good deal of industry leading experience for rural finance in a series of documents published in cooperation with industry leaders. Unfortunately, there is little accountability for “learning performance”, meaning that there are no corporate requirements to keep up with professional state-of-the-art knowledge. Over half of the CPMs with rural finance projects interviewed for this CLE had not read the RFP or fully reviewed the Decision Tools. Fewer still have read IFAD’s industry-leading rural finance publications or have interacted with regional partners.

58. Because CPMs are free to learn selectively, IFAD’s rural finance knowledge base is uneven. If IFAD is to remain a demand-driven knowledge organization, its professionals must learn and keep abreast of latest developments in the profession. A challenge remains to balance the required competencies and skills among the various subsectors in which IFAD operates, including the rural finance sector, which is highly technical and complex. At the same time, corporate policy needs to be internalized and adapted to regional, country and project operations. The regional rural finance strategy of PA (paragraph 18) is an example of such adaptation. Because it was developed by CPMs, most are conversant with the strategy, and more so than those familiar with the RFP. Both positive and negative career performance incentives could be imagined to encourage more targeted learning.

D. Innovation

59. IFAD rural finance engages in a good deal of innovation, particularly at replicating microfinance models in rural areas (Figure 1, page 3). IFAD’s core innovation contribution has focused on medium density areas and replicating successful urban pro-poor models (Figure 4). There are exceptions where IFAD has pioneered products and institutions in very poor and/or low density areas. Consistent with the industry at large, however, IFAD has made much less progress in innovating for micro agricultural financial products and services (i.e., on-farm financing) and for reaching very low density populations.

Figure 4: Innovation and Project Penetration



Managing Innovation

60. The RFP recognizes the importance of innovation in rural finance, but is largely silent on how to manage innovation and associated risks. It does not suggest a process for innovation. Financing innovative initiatives in new or low density markets has been likened to providing venture or risk capital, which relies on a host of techniques to assess investment risk. The most common techniques use comparable deals (or projects in this case) which are assessed on the basis of a number of standard variables that together define the nature and level of risk inherent in a particular deal. IFAD does not have an organization-wide risk management system, despite an IMI call to develop one[23]

61. Without a systematic approach, the innovation maxim of IFAD's rural finance activities might appropriately be "we know it when we see it."[24] This tenet is not necessarily a bad approach, if those doing the "seeing" are experts in rural finance and if corporate memory is retrievable and precise. Both conditions generally do not apply to IFAD, and the institution, as a result, can hardly be expected to take full advantage of its wealth of rural finance innovation experience

23 IFAD, Initiative for Mainstreaming Innovation, Operational Framework for the Main Phase, (2004), page 5.

24 See for example, IFAD, Supporting Innovation in the Field, The Role of IFAD's Support in the Sustainabilility and Commercial Transformation of FINCA's Village Banking Programmes, (2005).

Summary – Corporate Arrangements. IFAD's founding agreement and *modus operandi* are not very supportive of working in the rural finance sector. The RFP did not cost its implementation, but implied its requirements could be met with existing human and financial resources. In reality, the sector is technically complex and requires increasingly expert knowledge. This on its own requires systematic training, a culture of learning accountability as well as the establishment of an adequate number of technical staff positions. Furthermore, IFAD's lending instruments are not in line with best practice for working in the microfinance sector, which require direct lending to PFIs. This would enable IFAD to be more selective and insist on performance standards, both in terms of sustainability and outreach to IFAD's target group with demand-driven appropriate financial services and products. In addition, investment decisions are not based on criteria that recognize the need for taking calculated risks associated with investments into innovative rural finance operations. Grant resources are too limited for providing the technical assistance that is required for PFI capacity building. This problem is further compounded by limited and arms-length supervision and implementation support absence of field presence. All three factors limit the extent to which PFIs can be strengthened or adequate oversight can be exercised over their performance.

VI. Conclusions and recommendations[25]

A. Conclusions

62. Financial systems have seen great changes in the past ten years that have left most developing country national financial systems generally stronger, but not typically to the benefit of the rural poor. Microfinance has emerged as a potential pro-poor financial sector counterweight to these developments, but its application to rural areas has neither been straightforward nor rapid.

63. IFAD's pioneering rural finance work has faced great challenges helping to establish pro-poor financial systems. This experience, the impressive volumes of IFAD lending, the existence of a RFP and commitment to improved development effectiveness leaves IFAD potentially the most important global actor in rural finance. However, efforts are required for IFAD to be transformed from a potential to an actual leader in Rural Finance. For the time being, IFAD is leading mostly in terms of the sizable level of its overall investment in this sector.

64. The RFP has proven to contain a number of elements that are best practice, although some areas of the Policy lack clarity and need to be improved to meet latest best practice standards. The RFP provided a general framework to develop regional and country strategies and project design, but without setting clear policy directions for expected norms and standards. The RFP is not sufficiently normative and prescriptive. The permissive character and ambiguity of the RFP resulted in an only limited, albeit increasing reflection of RFP principles in regional and country strategies and contributed to projects that are not fully compliant with RFP requirements. Two other main shortcomings of the RFP lie in the absence of a costing for its implementation and a requirement to retrofit ongoing projects to meet RFP standards.

65. In meeting the four challenges of the RFP, IFAD-assisted projects performed moderately well across all dimensions. PFI sustainability was achieved in the case of 24 per cent of partner institutions – a low percentage, but comparable to that of some agencies that work in less challenging urban areas. The diversification of financial products and services and financial intermediaries showed positive, but modest results. Against the challenges of stakeholder participation and promoting conducive regulatory frameworks, little change in performance has been noted. IFAD's rural finance assistance is meeting the RFP goal of serving rural poor (albeit not the poorest of the poor) and by serving 60 per cent women.

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25 Management's response will finalize action to be taken in answer to these recommendations through an agreement at completion point

66. Modest advances made by rural finance projects towards greater RFP conformity can be ascribed to a number of factors, which include (i) Decision Tools which set out frameworks of best practice; (ii) the CGAP donor peer reviews and subsequent rural finance action plans, which brought greater attention and focus to the strategies for improving rural finance operations; and (iii) IFAD's increasing general knowledge of best practice in rural finance, supported by publications and efforts to improve capacity. The continuous trend in improving project design and progress made in resolving some project implementation issues provides a good platform from which IFAD can address a number of outstanding issues that will further improve the performance of its rural finance assistance.

67. Other significant factors impeding improved performance include insufficient resource allocations, in particular from the administrative budget, to ensure an adequate amount of technical in-house expertise in rural finance. IFAD is well below par in this area compared to other international agencies active in microfinance. Human resources, though improving, still fall short of what is needed in qualitative as well as quantitative terms to provide the necessary support to the sizable and complex IFAD rural finance portfolio. Moreover, while the CLE recognizes the collective effort to improve rural finance activities at IFAD, by concentrating the responsibility for rural finance into the responsibility of a single staff (i.e., rural finance technical expert in PT) the institution now faces significant key person risk. Conversely, because support for rural finance activities has been built on highly personalized relationships and need to be institutionalized.

68. Funding has also fallen short of requirements for the provision of TA, which is a key factor in the success of many microfinance projects.

69. Finally, there are a number of barriers to the effectiveness of IFAD assistance for rural finance. These barriers stem from IFAD's founding agreement and entails inter alia: the impossibility to lend directly to PFIs, limited IFAD field presence and constraints on IFAD to provide direct supervision and implementation support. The forthcoming policy on supervision and implementation support is likely to change the limitations on IFAD in this respect. Whether these changes are sufficient to address the requirements of technically qualified rural finance expertise in the field remains to be seen

B. Recommendations

70. The following recommendations seek to build upon ongoing improvements to rural finance projects to ensure further progress can be made to meet best practice standards that will benefit IFAD's target group – the rural poor – by providing them with access to sustainable rural finance services. The recommendations propose two options: the first, pursuing modest and incremental changes; the second, more rapid expansion of sustainable pro-poor financial services to the rural poor.

Option 1: Help More Poor People but Slowly

71. Incremental change can bring IFAD's rural finance projects into greater compliance with the RFP and can be achieved with a small number of relatively simple alterations to current operating processes and organizational arrangements. The recommendations proposed under this Option must be considered the bare minimum in terms of changes that need to be made to protect IFAD investments in rural finance operations. If the recommendations under Option 1 cannot be accepted and implemented, IFAD will need to reconsider its exposure in the rural finance sector and scale back new project approvals.

72. **Recommendation 1: Clarify the RFP Norms and Standards and Supporting Instruments.** IFAD must clarify the normative prescriptions of the RFP. This can be done through a complete revision of the RFP or through an overview laying out the main points of the RFP in simple and clear terms. In either case, the document should be brief and prescriptive. The Decision Tools and other resources supporting

the RFP should also be updated and improved to achieve simplification and greater clarity. A sector analysis framework (in line with CGAP best practice standards) should be introduced and made mandatory prior to taking investment decisions to ensure right choices are made for investing IFAD's scarce lending and grant resources.

73. **Recommendation 2: Ensure Rural Finance Operations meet RFP Norms and Standards.** IFAD Management needs to send a clear signal both internally to project designers and externally to borrowers that policy norms matter and must be met. To do this, Senior Management and the EB must begin to apply the norms and standards of the RFP by rejecting projects found not to be in compliance with the RFP. This is perhaps the single most effective and efficient means to improve rural finance project quality. IFAD's forthcoming quality assurance mechanism needs to be designed to include minimum standards for rural finance projects. The extent to which projects meet these standards needs to be reported to Senior Management and the EB prior to the approval of new projects.

74. **Recommendation 3: More Systematic and Earlier Provision of Technical Expertise in the Design Process.** IFAD must improve quality assurance earlier in the design process when investments in project design are relatively small. It can do this by testing RFP compliance during or even prior to formulation. TRC reviews must also be made at this stage and recommendations must be addressed and approved before design moves to appraisal. To avoid conflict of interest, the rural finance expert on PDTs should not write the TRCs.

75. **Recommendation 4: Build Greater Capacity.** A means to improving RFP effectiveness is to build greater internal technical capacity at all levels in IFAD. The Rural Finance Action Plan includes provisions for staff development, which needs to be reviewed, expanded with appropriate, short-term training opportunities, and with requirements that set an "accountability for learning" framework, which recognizes the need, obligation, and allocation of time for developing the needed technical competences and skills. This capacity building must be understood as a continuous process, rather than one-off training courses. The need for commitment to building technical competencies and skills for rural finance is even more pronounced, if IFAD were to decide to become an industry leader in the sector (see Option 2).

Option 2: Help a Larger Number of Rural Poor, Faster with a Greater Chance of Sustainability

76. The above recommendations do not have significant process change or budget implications. However, choosing Option 1 would be an extremely disappointing response to the needs of the rural poor for appropriate financial services. Option 1 would also fall short of recognizing the significant unmet demand for appropriate rural financial services (paragraph 5) – and the potential leadership role that IFAD could play. Other development agencies play important roles in the microfinance sector, but without reaching into rural areas in the ways IFAD does. By contrast, IFAD's sole mandate is to work with and for the rural poor, and has approved significant amounts of loan money and mobilized cofinance into rural finance. Hence, this second option aims at a more rapid expansion of sustainable pro-poor financial services through a series of actions aimed at resolving fundamental constraints at a number of levels. These recommendations must be enacted together with recommendations under Option 1 to achieve the objectives of this option.

77. **Recommendation 5: Decide to Take a Leadership Role and Define a Strategy to Get There.** The updated RFP should provide the normative framework for rural finance operations (recommendation 1). In addition, IFAD will need to decide on a strategy for becoming a leader in the sector, including (i) positioning itself vis-à-vis other partners in the sector; (ii) defining regional priorities that translate the principles of the RFP into meaningful objectives for each of the regions (these regional strategies have to be developed by the regional divisions to ensure

complete understanding of key challenges to rural finance in the region, and full ownership and implementation of the rural finance strategy for each region); and (iii) committing to making changes such as those detailed below that will ensure the quality of rural finance operations.

78. **Recommendation 6: Allocate Commensurate Resources to Rural Finance and Reduce Key Person Risk.** The CLE demonstrated that IFAD's human and financial resources dedicated to a rural finance portfolio of the size that IFAD has approved are minute in comparison to other development agencies. Being dependent on one full-time technical expert risks loosing a good deal of institutional capacity and of corporate knowledge, should this key person leave. The CLE recommends creating a rural finance unit, consisting of a total of up to four new professional rural finance experts, each with a cross-section of additional specializations over their rural finance expertise (e.g., rural finance ***and*** gender). In addition, administrative budget resources are required to fund essential work, such as regional partnerships, and continued work on the MIX which are currently funded from grant resources with limited timeframes.

79. **Recommendation 7: Develop More Relevant Instruments, Better Delivery, and Stronger Supervision.** IFAD needs to change its lending policy to allow for direct lending to PFIs and must be able to deliver a range of technical support services to build PFI capacities (ideally, on-the-ground dedicated rural finance expertise). These services should be sourced competitively and use performance-based grants/contracts to ensure TA is effectively used. Such new instruments will demand closer supervision and technical support than is currently available from PMUs and CIs. The forthcoming change in supervision and implementation support modalities need to ensure that requirements for working in the rural finance sector are addressed.

80. **Recommendation 8: Gain Greater Relevance through a More Efficient and Effective Process.** IFAD's project cycle greatly affects the relevance and effectiveness of rural finance projects, as explained in paragraph 80, simply due to the length of time it takes to develop and launch projects. The CLE recommends bringing the IFAD project cycle (at least for rural finance projects) down to one year.

Rationale, Evaluative Framework and Methodology

1. **Rationale.** There are several reasons for evaluating the RFP and related operations: (i) the Policy has been in place since 2000, a sufficiently long period to assess whether it has had an impact on IFAD's operations; (ii) being one of IFAD's strategic objectives, it is important to assess whether IFAD is fulfilling its objectives and to feed evaluative data into the process of updating the Strategic Framework; and (iii) rural finance is a major area of IFAD's operations and received considerable funding, thus it is important for accountability reasons to assess whether these funds have been well spent.

2. **General Objectives.** At IFAD, all evaluations fulfil two basic objectives: (i) assess the performance and impact of IFAD-assisted rural finance operations, and thus serve accountability purposes vis-à-vis IFAD's member countries; and (ii) generate insights and learning – within IFAD and outside – from IFAD's experience with regards to its rural finance operations, and therefore contribute to improving ongoing and future operations funded by IFAD.

3. **Specific Objectives.** The CLE aims to assess the quality and effectiveness of the Policy in guiding IFAD's operations, whether the Policy was implemented and what the results were, and whether IFAD's resources, processes and instruments are aligned to deliver against the Policy. The CLE will generate evaluative information and assessments against the following three questions:

   (i) How well were the Policy and its instruments designed, i.e., with a clear purpose in mind and positioning IFAD strategically in the industry, finding a mutual alignment with other corporate policies and strategies, and providing a guiding framework for operations?

   (ii) Were the Policy and its instruments implemented, i.e., translated into regional and country strategies, and lending and non-lending operations, and what has been the impact thereof?

   (iii) What are the consequences of the Policy and its instruments in terms of IFAD's human and financial resources, lending and grant instruments, and processes: are the latter conducive to implementing the Policy and delivering effective assistance to the rural finance sector?

4. **Evaluation Framework.** The evaluation framework (Figure on next page) explains how these three questions will be responded to, and illustrates the three main components of the evaluation.

5. **Geographical Scope.** The CLE will have a global coverage, including projects from a number of countries across all regions borrowing from IFAD. To make the scope of the CLE manageable, the evaluation will cover four countries per each regional division, i.e., 20 countries. While this even number of countries for each regional division does not reflect differences in portfolio size (number of projects or total loan approvals) between the regions, it was important to represent all regions evenly in the CLE. All 20 countries will be covered through detailed review and analyses of existing reports and data, while a subset of this group of countries will also be visited by the evaluation team (at least two countries per regional division) to verify the findings of the desk review and add first-hand evaluative information to the analysis. The countries were selected following the selection process and criteria set out in paragraph 11.

6. **Scope across Institutional Dimensions**. The CLE will cut across all dimensions – from IFAD corporate-level policy to client levels (rural poor households or individuals), and thus involve reviewing documents and collecting information from sources across all of these levels. However, the extent to which client-level information can be collected will be limited, as time and financial resources available for the CLE are not sufficient to undertake large-scale survey work.

Quality of the Rural Finance Policy and its Instruments

How good are the Policy and its instruments as strategic management tools?

Positioning IFAD

Are the Policy and its instruments relevant to the state-of-the-art of the industry and the needs of IFAD's client countries and target groups?
Does the Policy present strategic choices for IFAD's position in the international domain?

IFAD Corporate Policies

How are the Rural Finance Policy and other corporate policies and strategies aligned with each other?

Operational Guidance

Do the Policy and its instruments provide strategic guidance to operations, especially terms of choice of types of interventions, prioritization and sequencing, and design of rural finance assistance?

Implementing the Rural Finance Policy

How well were the Policy and its instruments put into practice?

Regional and Country Strategies

Are regional and country strategies aligned with the Policy?
Is there a gap between Policy and strategies?
What is the quality of strategies for rural finance?

Lending and Non-Lending Activities

Are design and implementation arrangements of lending and non-lending activities in line with the Policy and its instruments?

Impacts of Operations

What the key success factors to have an impact and do the projects contain them?
What has been the impact on M/RFIs performance and on rural poverty?

IFAD's Resources, Instruments, and Processes for Policy Implementation

Does IFAD have the right resources, instruments and processes for delivering against the Policy?

Resources and Instruments

What are the human and financial resources that IFAD allocated for Policy implementation? Are they sufficient and deployed in the right places?

Does IFAD have the right instruments for delivering effective assistance to the rural finance sector?

Processes

What are the processes for ensuring Policy compliance, knowledge management, feedback and learning?

Non-Lending Activities

What are the resources and processes to engage in policy dialogue and partnerships for rural finance?

7. **Time Scope**. The evaluation covers operations approved between 1996 and 2005, i.e., a ten-year timeframe to date. This time-frame enables the evaluation to compare the situation prior to and after the approval of the Policy, i.e., policy directions of IFAD operations, typical portfolio, typical project design, etc. Such a comparison is necessary to determine whether the Policy has had an impact on the choice and design of IFAD-financed projects. It is also needed to determine whether projects approved within a few years prior to the adoption of the Policy have been retrofitted (redesigned) to meet IFAD policy requirements. Finally, the ten-year timeframe was necessary to include projects in the sample that are in an advanced stage of implementation so that it is possible to assess project impact on R/MFIs and households.

Methodology

8. **Country versus Project Focus.** The CLE has chosen a country focus rather than a project focus. This will enable the evaluation to analyze the evolution of the rural finance portfolio in a country and thus compare whether lessons have been learned and the portfolio has been adjusted in line with Policy requirements. This approach also means that a larger number of projects can be covered at a lower cost; assuming each of the 20 countries has at least two projects, the evaluation will cover at least 40 projects (in all likelihood more), including around 50% with field visits. A random selection of projects across all countries would increase chances that a larger number of countries have to be covered and visited to achieve the same level of coverage, while not necessarily generating insights into the evolution of the portfolio.

9. **Building Blocks of the Methodology.** The evaluation methodology is set out in: (i) a scoping analysis, which provides an overview of data that is needed and will be analyzed, and data that needs to be collected or verified by the evaluation team; (ii) country selection process and criteria; (iii) a benchmarking analysis; (vi) a discussion of indicators that will be used in the evaluation; and (v) a summary of data collection techniques that the evaluation team will employ.

10. **Scoping Analysis.** Within the defined scope, the CLE will review and analyze documentation – background information on the sector, corporate policies and strategies of IFAD, country-specific documents (IFAD and other agencies working in the microfinance and/or rural finance sector), and project-specific data – and collect primary data from a variety of sources. Secondary data will be reviewed, verified and analyzed prior to use in the evaluation report, where the source of data will be acknowledged. The scoping analysis provides detailed information on the type of data to be collected and analyzed, but will be further refined once the countries have been selected. The scope of primary data collection through visits to selected countries will be determined after the desk reviews have been completed and the scope of data collection needs has been determined.

11. **Country Selection**. The CLE considered stratified random sampling and purposive sampling techniques. Random sampling would entail selecting from each region four countries from the group of countries that borrowed for rural finance over the last ten years at least twice (once before and once after the Policy was adopted) to meet the evaluation design requirement in paragraph 8. The criteria for stratification resulted in a group of 40 countries from which a total of 20 (four for each region) will be selected randomly. The alternative purposive sampling technique would have required assembling data for all countries that borrowed for rural finance (a total of 80 countries) against a range of selection criteria[26], which would have been time-consuming and labour-intensive without necessarily generating a more

[26] Country-specific criteria would have included: income level (grouping as per the World Bank low/middle-income grouping), country size, percentage of rural population over total population, and Human Development Index as a proxy indication of poverty. IFAD-specific criteria would have included existing rural finance programme (size of portfolio in terms of number of projects and total loan amount) and future pipeline for rural finance

representative sample than the stratified random sampling technique used for the CLE.

12. **Benchmarking.** The CLE will benefit from existing benchmarking information: the CGAP donor peer review of 2002 covered 17 development agencies and presented a comparative analysis; a number of impact evaluations have been undertaken and a comparative analysis of these has been published by the Grameen Foundation USA[27] These studies will be used, to the extent possible and meaningful, to benchmark IFAD's performance against those of others. In addition, the CLE will aim to identify and analyze country-specific examples for benchmarking IFAD against others who provide assistance to the rural finance sector.

13. **Indicators.** Specific indicators will be developed for each of the questions in the evaluation framework. They will be based on typical evaluation indicators of relevance, efficiency, effectiveness, impact, and sustainability, but adapted to the particular question. For instance, to assess whether the Policy functions as a management tool, criteria will be adapted from good practice standards for corporate strategies and policies. In addition, the CLE will benefit from performance indicators that the industry established as good practice standards and is advocating through the CGAP network, including IFAD. Indicators exist for measuring sustainability of MFIs and data is, to some extent, collected and reported through the MIX system[28]. To measure impact at the client level (households and/or individuals), the evaluation will use M/RFI-based indicators (such as outreach and poverty level of clients[29]) and indicators that assess impacts on financial assets of clients (savings, investments, and expenditure smoothing), possibly using client impact assessment tools such as "The Savings and Loan Use Strategies over Time Interview[30]" and existing evaluative information.

14. **Evaluation Techniques.** The CLE will employ qualitative analysis of documentation, and qualitative and quantitative research tools. The analysis will be based on desk reviews, which will result in data collection instruments for fieldwork, including semi-structured questions for key informant interviews and focus group discussions, checklists and questionnaires for M/RFI analyses (against MIX indicators), and questions or survey formats for client assessments (the latter will be undertaken only to a limited extent). Secondary data will be used to inform the evaluation, for instance the Grameen Foundation's study to determine key success factors[31]

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27 Nathanael Goldberg. Measuring the Impact of Microfinance: Taking Stock of What We Know. Grameen Foundation USA. 2005.

28 The MIX is a global information portal providing Data Sourcing, Benchmarking and Monitoring tools and Information Services for the Microfinance Industry.

29 Definitions and measure developed by others, such as SEEP/AIMS, Microsave and Social Performance

30 See the Impact Assessment Resource Center at www.microfinancegateway.org

31 Key success factors will include those factors where experience has shown that they are necessary to achieve impact at MFI and/or client level. Using these key success factors, a rapid assessment can be done to determine whether IFAD projects include design features and implementation arrangements that meet these good practice standards as indication of likely impact.