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Enabling poor rural people to overcome poverty

President's memorandum

Proposed supplementary financing to the Federal Democratic Republic of Nepal for the

Poverty Alleviation Fund Project – Phase II

Note to Executive Board representatives

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For: **Approval**

Recommendation for approval

The Executive Board is invited to approve the recommendation for the proposed supplementary financing in the form of a loan and a Debt Sustainability Framework (DSF) grant to the Federal Democratic Republic of Nepal for the Poverty Alleviation Fund Project – Phase II, as contained in paragraph 16, and the modifications to the project grant agreement, as contained in paragraph 12.

President's memorandum

Proposed supplementary financing to the Federal Democratic Republic of Nepal for the Poverty Alleviation Fund Project – Phase II

I. Background

1. The Poverty Alleviation Fund was launched as a community-driven development instrument for addressing the interrelated problems of rural poverty and social exclusion. In April 2004, the International Development Association (IDA) provided a grant of US$15 million to finance the Poverty Alleviation Fund Project – Phase I (PAF-I). The project was designed as a pilot, operating in six districts that were chosen on the basis of their human development index, their geographic location and whether they were conflict-affected areas. Once the initial organizational phase of the PAF was complete, the implementation pace accelerated rapidly in response to greater than anticipated – and constantly growing – demands from rural communities. Following the peace process and the agreements reached among the political parties, there was a new commitment to address inequality and poverty in the country. PAF II is using the same targeting mechanisms and the same beneficiary profiles as PAF I, but is extending its scope nationally in a phased manner, increasing by 15 districts each year.

2. IFAD began supporting PAF II in 2007: the project was approved by the Executive Board on 13 December 2007 with financing of SDR 2.5 million in the form of a DSF grant (equivalent to US$4 million). The development objective of PAF II is to improve living conditions, livelihoods and empowerment among the rural poor, with particular attention to groups that have traditionally been excluded on the grounds of gender, ethnicity, caste and location. PAF II promotes improvements in infrastructure, income-generating activities and increased participation by citizens in community decision-making. Employment is being generated through income-generating activities and community infrastructure.

3. Given the project's successful performance both in financial and in technical terms by reaching out to the target groups and generating higher levels of income and welfare for them, the World Bank approved an additional allocation of US$65 million, complemented by US$10 million financed by the Global Food Crisis Response Programme multi-donor trust fund. Concurrently, the project completion date was extended until 30 June 2014 and the grant closing date until 31 December 2014.

II. Justification and rationale

4. In this context of globally impressive achievements, the main challenge facing PAF for the years ahead is to ensure the sustainability of benefits accruing to the target groups. The World Bank is considering the financing of a third and last phase (2013-2016), which would support the extension of PAF to the whole country, but

would also pave the way for the project's integration within government institutions and mechanisms.

5. In this context, IFAD's proposed supplementary financing will be used to fund the activities originally planned. It will provide support to strengthening the sustainability of PAF achievements in four key areas that have been jointly identified with the target group: (i) *community-based institutions:* the myriad of community organizations (COs) created by PAF still rely heavily on partner organizations to assist them in achieving their objectives. An organized approach is needed to strengthen the autonomy of COs through progressive graduation and federation into cooperatives, networks or small enterprises, and through enhanced linkages to local public bodies and service providers at the local level; (ii) *market linkages:* income-generating activities are extremely diversified and take little account of demand beyond local markets. To sustain increased incomes, CO members require better market information to create production clusters, develop business in response to market demand and access remunerative markets. PAF has recently adopted a new activity-based area development approach for this purpose; (iii) *access to financial services:* the average repayment rate for the revolving funds is low, at 76 per cent and the average interest rate is also low, at 6 per cent. Furthermore, the small size of membership, low business volume, and their scarce internal funds and managerial capacity limit the chances of most CO revolving funds to become sustainable. COs need to improve the management of their revolving funds to prevent fund erosion, but such efforts need to be complemented by stronger linkages with sustainable financial institutions in the cooperative or banking sector; and (iv) *targeting*: some very marginalized communities (representing about 2 per cent of the target population) do not benefit from project services because of distinct socio-cultural factors. Special measures will be used to reach out to this specific target group, through a new strategy recently adopted by PAF.

6. IFAD will contribute to the sustainability of PAF achievements by setting up a knowledge management system to capture and analyse good practices in the four areas described above, and promote their scaling up throughout the project using a range of knowledge-sharing instruments. IFAD will also support sustainable access by COs and members to financial resources, through strengthening the capacity of COs to manage their revolving funds effectively and connect to the formal financial sector. Despite the small size of the IFAD contribution, the proposed design should bring a clear added value to PAF by setting up approaches, capacity and tools that will support scaling up, also in new PAF intervention areas.

III. Financial management, procurement and governance

7. The project will continue to maintain accounts and records in accordance with appropriate accounting practices. It will follow the practice of other IFAD projects in Nepal of using a double-entry bookkeeping accounting system. Therefore, the project will adhere to the Government of Nepal's accounting system, and will also maintain a separate ledger and register to record project expenditures by category, project component, subcomponent or activity.

8. **Flow of funds.** A supplementary special account will be opened in a bank acceptable to IFAD through which the IFAD supplementary financing will be channelled.

9. **Audits.** IFAD requires that the consolidated project accounts be audited in accordance with auditing standards acceptable to the Fund and its Guidelines on Project Audits, and by independent auditors acceptable to the Fund.

IV. Project costs and financing

10. Total additional project costs (supplementary financing) are estimated at about US$11.26 million. These will be jointly financed by Nepal (in an amount of about US$1.26 million to cover taxes and duties) and IFAD. Given Nepal's status under the DSF, the supplementary financing will be provided on the basis of a loan of 50 per cent and a grant of 50 per cent: the loan will be equivalent to SDR 3.25 million (about US$5 million), and the DSF grant will be equivalent to SDR 3.25 million (about US$5 million) for a total of SDR 6.5 million (equivalent to US$10 million). The lending terms will be highly concessional and bear a service charge of 0.75 per cent per annum over 40 years, including a grace period of 10 years.

11. The supplementary financing will be allocated to the following expense categories: (i) capacity-building and technical assistance (6.8 per cent); (ii) revolving funds (17.8 per cent); (iii) training and workshops (59.9 per cent); (iv) equipment (2.7 per cent); (v) operating costs (4.4 per cent); and (vi) unallocated (8.4 per cent).

V. Proposed modifications to the project grant agreement

12. Upon approval by the Executive Board, the existing project grant agreement including schedule 1 and schedule 2, will be amended to reflect the supplementary financing and other required changes. The amendments include an extension of the project completion date to 30 June 2017 and the financing closing date to 31 December 2017. This supplementary financing does not imply any modification of the project description and it will be used to finance the activities originally planned.

VI. Legal instruments and authority

13. An amendment to the current project grant agreement between the Federal Democratic Republic of Nepal and IFAD will constitute the legal instrument for extending the proposed supplementary financing to the Federal Democratic Republic of Nepal.

14. Nepal is empowered under its laws to receive financing from IFAD.

15. I am satisfied that the proposed supplementary financing will comply with the Agreement Establishing IFAD.

VII. Recommendation

16. I recommend that the Executive Board approve the proposed supplementary financing in terms of the following resolution:

> RESOLVED: that the Fund shall provide a loan on highly concessional terms to the Federal Democratic Republic of Nepal in an amount equivalent to three million two hundred fifty thousand special drawing rights (SDR 3,250,000), and upon such terms and conditions as shall be substantially in accordance with the terms and conditions presented herein.
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> RESOLVED FURTHER: that the Fund shall provide a supplementary DSF grant to the Federal Democratic Republic of Nepal in an amount equivalent to three million two hundred fifty thousand special drawing rights (SDR 3,250,000) and upon such terms and conditions as shall be substantially in accordance with the terms and conditions presented herein.

Kanayo F. Nwanze
President