

Document: EB 2018/LOT/P.4
Date: 14 March 2018
Distribution: Public
Original: English

E



Investing in rural people

President's memorandum

Proposed additional loan and grant to the
Republic of Sierra Leone for the Rural Finance
and Community Improvement Programme –
Phase II

Note to Executive Board representatives

Focal points:

Technical questions:

Ndaya Beltchika
Country Programme Manager
West and Central Africa Division
Tel.: +39 06 5459 2771
e-mail: n.beltchika@ifad.org

Dispatch of documentation:

Alessandra Zusi Bergés
Senior Governing Bodies Officer
Governing Bodies
Tel.: +39 06 5459 2092
e-mail: gb@ifad.org

For: Approval

Contents

I.	Context and justification	1
	A. Background	1
	B. Justification and rationale for additional financing	1
	C. Status of programme implementation	2
II.	Description of activities to be supported	3
III.	Description and quantification of the expected benefits	5
IV.	Project costs and financing	6
V.	Financial management, procurement and governance	8
VI.	Proposed amendments to the financing agreement	8
VII.	Proposed amendments to the logical framework	8
VIII.	Legal instruments and authority	9
IX.	Recommendation	9

Recommendation for approval

The Executive Board is invited to approve the recommendation for the proposed financing to the Republic of Sierra Leone for the Rural Finance and Community Improvement Programme – Phase II, as contained in paragraph 18, and the amendments to the financing agreement, as contained in paragraph 13.

Proposed additional loan and grant to the Republic of Sierra Leone for the Rural Finance and Community Improvement Programme – Phase II

I. Context and justification

A. Background

1. The Rural Finance and Community Improvement Programme – Phase II (RFCIP II) in Sierra Leone was fully designed under the 2013-2015 cycle of the performance-based allocation system (PBAS). It was approved by the Executive Board in April 2013 for a total project cost of US\$38.1 million over a nine-year period (EB 2013/LOT/P.2/Rev.1). The financing plan as approved by the Board for RFCIP II included: an IFAD loan of SDR 7,375,000 (equivalent to approximately US\$11.2 million), a Debt Sustainability Framework (DSF) grant for SDR 7,375,000 (equivalent to approximately US\$11.2 million), counterpart funding from the Government of Sierra Leone of US\$4.5 million and a beneficiary contribution of US\$3.5 million. The cofinancing partners are the National Social Security and Insurance Trust (NaSSIT) for US\$6.9 million; and the International Finance Corporation (IFC) for US\$1 million. The project financing agreement was signed on 7 May 2013. The project completion date is 30 June 2022 and the financing closing date is 31 December 2022. The disbursement rate of both the loan and the grant stood at 86 per cent as at 15 December 2017.

B. Justification and rationale for additional financing

2. The cofinancing expected at design of US\$6.9 million from NaSSIT and US\$1million from IFC has not materialized, creating a financing gap of US\$7.9 million and hindering the progress of the rural finance network established under RFCIP I and II. To date, the network includes the supervising apex bank delegated by the Bank of Sierra Leone (BoSL), providing services to member institutions comprised of 17 community banks (CBs) and 59 financial service associations (FSAs) for a total 76 rural financial institutions (RFIs) with an outreach of 166,031 households as of 30 September 2017. At design, it was anticipated that with NaSSIT and IFC cofinancing, the apex bank would be profitable and self-sustainable by year three of implementation (2016).
3. In addition, profits were to be used to further capitalize the Agricultural Finance Facility approved under RFCIP I EB 2007/90/R.11/Rev.1, para. 18) and finance the working capital of the apex bank. The entire network (Apex Bank, CBs and FSAs) was also expected to be fully capitalized with expansion into agricultural finance. None of these assumptions have been realized, thus creating the need for additional financial support. Significant efforts have been made to mobilize funds from NaSSIT and IFC and have so far proven unsuccessful, as noted in various RFCIP II supervision mission reports and the midterm review conducted in March 2017. Both NaSSIT and IFC have cited diminishing available resources and conflicting investment priorities. In this context, a request for additional financing in the amount of US\$9 million is being made to: (i) capitalize the network;

(ii) strengthen the Agricultural Finance Facility; and (iii) provide working capital to the apex bank. It is possible that during the course of implementation the need for further funding may arise, in particular to finance the Agricultural Finance Facility. This will be revisited in 2019.

4. The request complies fully with the eligibility criteria for additional financing set in para. 8 of the President's bulletin on revised guidelines for additional financing for ongoing projects, dated 29 August 2014 (PB/2014/01/Rev.1), as follows: in compliance with the criteria set in para. 8(a), RFCIP II is not an actual problem project according to the latest portfolio review, and the status remains unchanged to date; the project exceeds the compliance criteria set in para. 8(b) with project disbursement above the projected disbursements as measured by the disbursement profile; in compliance with criteria set in para. 8(c) the project disbursement rate is more than 50 per cent of the original financing with a disbursement rate of 88 per cent as at February 2018; in compliance with criteria set in para. 8(d) the latest review has determined that the project fiduciary management is rated as moderately satisfactory (4) in the project status report; and in compliance with criteria set in para. 8(e) the latest portfolio review has determined that the ongoing project is compliant with all legal covenants, that the submission of audit reports is satisfactory to IFAD and that the audit report for the preceding year was submitted on time and without qualification. The original implementation and closing dates remain unchanged.

C. Status of programme implementation

5. As evidenced by the midterm review, the project is on track to achieve its development objectives. Project implementation is positive and encouraging with overall good performance and growth among the RFIs, as well as the establishment and operationalization of the apex bank, although the FSAs have performed better than the CBs.

- (a) Overall performance of the RFIs – Currently CBs are profitable, with an average operational self-sufficiency (OSS) of 198 per cent as at 31 July 2017, but have not attained the regulatory minimum capitalization requirements set by the BoSL due to the poverty of their owners; the failure of NaSSIT and IFC to follow through on their commitments to RFCIP II; and the economic hiatus caused by the Ebola crisis. Low capitalization constrains the CBs' ability to offer services—including agricultural finance. It also precludes CBs paying dividends to their existing shareholders, which hinders membership growth and further constrains capitalization. The story of the FSAs is similar. They are profitable, with an OSS of about 193 per cent as at 31 July 2017, but capital-constrained. However, their minimum capital is not regulated by the BoSL and thus they do not face the regulatory risk of being closed for inadequate capitalization. The low capitalization of these profitable institutions further impacts their apex bank's sustainability as their capacity to patronize the Apex Bank – buy shares, pay fees, etc. – is constrained by their own undercapitalization.

It is worth noting that the CBs and FSAs were the only RFIs to serve the rural population continually during the Ebola crisis. While this deteriorated the financial position and portfolio quality of the entire network of RFIs, in particular for CBs, it demonstrated the strength of its membership and the sense of ownership.

- (b) Assessment of the apex bank's performance – In 2014 the Apex Bank (Sierra Leone) LTD was established and incorporated as a private company, and is licensed by BoSL to provide financial and non-financial services to its network of RFIs. The services delivered by the Apex Bank are: (a) provision of inspection functions for RFIs; (b) provision of technical assistance to RFIs; (c) financial services such as remittances, treasury management and banker

to CBs and FSAs, including refinancing; and (d) support services to RFIs on legal matters, market research and product development. The quality of the services provided by the apex bank was assessed by the midterm review mission as good. A satisfaction survey conducted by the national project coordination unit (NPCU) indeed shows that 90 per cent of the RFIs are satisfied with the Apex Bank services, which is the target set in the logical framework. The Apex Bank OSS was low, at 14 per cent as of August 2017. This low performance is largely due to a lack of capitalization which precludes the Apex Bank from growing its RFI loan portfolio.

(c) Promotion of agricultural financial products – Although the funds to capitalize the Apex Bank, CBs and FSAs, as well as finance the development of the three agricultural financing products as envisaged by the RFCIP II design, have not yet materialized, the RFIs are, to a limited extent, providing agricultural financing along the value chains. It is estimated by the Apex Bank that about 16 per cent and 10 per cent of the total loan portfolio of CBs and FSAs, respectively, is being used to finance agriculture. Lending to agriculture, without adapted financial products, has contributed to the low number of RFIs achieving the portfolio at risk at 30 days (PAR) target of <5 per cent: 39 per cent for FSAs and 15 per cent for CBs as of 30 September 2017. The target of 175,000 households accessing agricultural financing is unlikely to be reached unless the Apex Bank, CBs and FSAs are properly capitalized and funds for agricultural financing are secured urgently, and a proper agricultural financing strategy is designed and implemented as soon as possible.

(d) Lessons learned

- Rural financial services: Investments in rural finance require long-term commitment over several project cycles. Challenges remain in the capitalization of RFIs and availability of term finance and finance for agriculture along the value chains.
- Rapid capitalization of FSAs and CBs is needed to meet rising demand from agribusinesses and farmers. BoSL needs to develop an appropriate policy on provision of such lines of credit from own and commercial banking sources.
- None of the CBs and very few FSAs have ever paid out dividends to shareholders, even though this was promised at the start. This turned out to be a mistake, as it made the RFIs less credible in the eyes of the shareholders. It also now makes it difficult to attract new capital, either to catch up with new regulatory requirements, as in the case of CBs, or to grant more loans, a precondition to reduce operating costs, as in the case of FSAs.
- Incremental approach: The phasing in of programme activities adopted has proven to be effective and allowed for mid-course adjustments and expansion.

II. Description of activities to be supported

6. In compliance with the criteria set in para. 4(b) of PB/2014/01/Rev.1, the activities to be funded with the additional financing are consistent with the ongoing project objectives. They will reinforce the financial and operational sustainability prospects of the Apex Bank and its network of RFIs to ensure the sustainability of programme outcomes at completion. This will be achieved through the viable and sustainable consolidation of the RFI network comprising FSAs, CBs and Apex Bank with clear objectives and strategies of delivering capacities and services to RFIs to ensure they continue to exist and service rural communities after project completion. The additional financing will thus focus on the following strategic thrusts:

- (a) Establishment of a temporary investment fund to capitalize CBs, FSAs and ultimately the network as originally planned at design – RFCIP II intends to use US\$5 million of the additional financing to establish a privately registered temporary investment fund targeting US\$2.5 million each for investment in CBs and FSAs. The fund will become a shareholder and invest tranches into the CB and FSA capital accounts. As these tranches are converted into performing loans, the fund will invest further. The US\$2.5 million for CBs will enable the CBs to specifically meet their minimum capital regulatory requirements and avoid closure. The US\$2.5 million for FSAs will increase their capital base and capacity to grow their business.

The investments will be reflected on the CB and FSA balance sheets as capital. Contractually, the CBs and FSAs will pay 10 per cent per annum to the Apex Bank general fund for the use of these monies. Thus, while the temporary investment fund will invest in the CBs and FSAs as a shareholder, the beneficiary of fixed dividends on the investments will be the Apex Bank. This income will contribute to covering the Apex Bank operating expenses. The temporary investment fund will be privately managed by a competitively recruited fund manager reporting to a board composed of representatives of the Apex Bank, RFCIP II project staff and the BoSL. The fund manager will advise CBs and FSAs on how to invest the additional capital; strengthen the governance performance of the CBs and FSAs; and ensure that the CBs and FSAs make payments to the Apex Bank.

At completion of RFCIP II, after five years of investment, CBs and FSAs will reimburse the principal of the investment to the fund, which in turn will give it to the Apex Bank as capital and between completion and closing the fund will be dissolved. This will leave the entire system – CBs, FSAs, Apex Bank – fully capitalized and strengthen their internal relationships. The proposal will have the following benefits: (i) CBs will no longer risk closure due to non-compliance with minimum capital requirement; (ii) relationships between the apex and member banks will become stronger; (iii) board representation of the temporary investment fund in CBs and FSAs will ensure compliance with investment guidelines, to be developed by June 2018, which will include development and growth of agricultural finance; (iv) the Apex Bank will incrementally increase its capital and sustainability with a vested interest in the performance of CBs and FSAs.

A fund to intermediate between the Apex Bank and RFIs will need to be set up for the following reasons: (i) in compliance with criteria set in para. 4 (c) of PB/2014/01/Rev.1, additional financing can only be used to finance activities that are financially and economically viable, i.e. where the incremental benefit-cost ratio is greater than 1.0. A direct investment in the Apex Bank is not possible since the Apex Bank is not yet financially and economically viable due to the lack of capitalization; and (ii) current BoSL regulations prevent the Apex Bank from having a direct representation in CBs and FSAs, which will be necessary to ensure that direct investment from the Apex Bank into CBs and FSAs is utilized as intended. Board representation is however possible for the fund. There is a precedent with similar instruments in Sierra Leone as reported by the Ministry of Finance and the BoSL, and the proposal was endorsed as documented by the meeting minutes.

- (b) Capacity-building support to Apex Bank and member institutions
- Support to the Apex Bank will cover: (i) technical expertise for agricultural product and strategy development for the Apex Bank and its member institutions; (ii) the down payment necessary for a mortgage for Apex Bank's premises; (iii) capacity-building; (iv) management information systems procurement and installation; and (v) modest recurrent costs.

- Support to CBs will cover: (i) development of an agricultural financing strategy and adequate skills in agriculture finance; (ii) compliance with all regulatory requirements for the BoSL; (iii) improved outreach and sensitization strategy to reach and attract more shareholders and clients; (iv) mainstreaming of gender into the programme and integration of nutrition activities; and (v) share mobilization.
 - Support to FSAs will cover: (i) development of financial products suited for agricultural production; (ii) capacity-building; and (iii) share mobilization.
- (c) Addition of US\$1 million to the existing Agricultural Finance Facility, brings the total investment capital to US\$6 million. Enhanced capacity-building for management of CBs, FSAs and Apex Bank, associated with a comprehensive agricultural financing strategy and additional funding will enhance agricultural lending.
- (d) Programme management and coordination will continue to be undertaken by the NPCU. The additional financing will support the hiring of consultants, to be supervised by the fund manager, to participate in board meetings of CBs and FSAs and support the expansion of agricultural lending. An investment analyst will also be hired for monthly reporting. The NPCU will coordinate policy dialogue with the Ministry of Finance and Economic Development in close collaboration with the Ministry of Agriculture, Forestry and Food Security (MAFFS) to increase government counterpart funding. Partnerships between the Apex Bank and its member institutions will be strengthened with the IFAD-supervised Smallholder Commercialization Programme – Global Agriculture for Food Security Programme – and will be established with the proposed IFAD-funded Agriculture Value Chain Development Programme currently under design.

III. Description and quantification of the expected benefits

7. The expected benefits to be derived from the additional financing are the same as for the initial financing. A total of 285,000 households will be targeted under RFCIP II, so that they become successful adopters and realize the expected project benefits. Further, it is expected that with the additional financing, the Apex Bank will expand its income sources to include dividend payments from investments in CBs and FSAs and interest on a larger loan portfolio under the Agricultural Finance Facility. The Apex Bank is projected to be self-sufficient by 2020. At midterm the project was assessed as viable with an expected internal rate of return of 26 per cent (11.3 per cent at design) mainly due to additional field data collected by the Apex Bank and changes in market conditions affecting the RFIs' onlending interest rates.

Table 1
Additional financing – Expenditure categories by financier
 (Thousands of United States dollars)

<i>Component</i>	<i>Additional IFAD financing</i>		<i>Additional Government financing</i>		<i>Total</i>	
	<i>Amount</i>	<i>%</i>	<i>Amount</i>	<i>%</i>	<i>Amount</i>	<i>%</i>
1. Consulting services	494	87%	76	13%	570	6%
2. Equipment and materials	225	80%	57	20%	282	3%
3. Training	599	89%	74	11%	673	7%
4. Investment capital*	6 000	100%	-	0%	6 000	65%
Total investment Costs	7 318	97%	207	3%	7 525	81%
5. Salaries and allowances	1 153	100%	-	0%	1 153	12%
6. Operating costs	529	93%	42	7%	571	6%
Total recurrent Costs	1 682	98%	42	2%	1 724	19%
Total	9 000	97%	249	3%	9 249	100%

* Investment capital will fund the temporary investment fund and the capitalization of the network (US\$5 million) as well as the additional financing for the Agricultural Finance Facility (US\$1 million).

Table 2
Additional financing - Components by financier
 (Thousands of United States dollars)

<i>Expenditure category</i>	<i>Additional IFAD financing</i>		<i>Additional Government financing</i>		<i>Total</i>	
	<i>Amount</i>	<i>%</i>	<i>Amount</i>	<i>%</i>	<i>Amount</i>	<i>%</i>
1. Component 1. Strengthening and expanding the rural finance system	9 000	97%	249	3%	9 249	100%
2. Component 2. Programme management and coordination	-	-	-	-	-	-
Total	9 000	97%	249	3%	9 249	100.0

8. The estimated recurrent costs for the additional financing is US\$1.7 million (19 per cent), which will be fully used to cover activities under component 1 implemented by the Apex Bank and the temporary investment fund used to capitalize CBs, FSAs and ultimately the network. No additional financing will be allocated to the NPCU or the programme management component (component 2).

IV. Project costs and financing

9. The additional financing of US\$9 million in the form of a loan and DSF grant will be allocated across all project activities and categories under component 1. The additional financing will be denominated in United States dollars. Tables 1 and 2 show the distribution of costs by component and by expenditure category.

Table 3
Project costs by component
(Thousands United States dollars)

	Original IFAD financing		Additional IFAD financing		Original Government financing		Additional Government financing		Beneficiaries		Total	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
A. Strengthening and expanding the rural finance system	17 575	52%	9 000	26%	3 705	11%	249	1%	3 477	10%	34 006	86%
B. Programme management and coordination	4 741	86%	-	-	760	14%	-	0%	-	0%	5 501	14%
	22 316	56%	9 000	23%	4 465	11%	249	1%	3 477	9%	39 507	100%

Table 4
Tentative project costs by expenditure category and financier
(Thousands of United States dollars)

Expenditure category	Original IFAD financing		Additional IFAD financing		Original Government financing		Additional Government financing		Beneficiaries		Total	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
1. Civil works	3 072	73%	-	0%	674	16%	-	0%	490	12%	4 236	11%
2. Equipment and materials including vehicles	2 931	62%	225	5%	1517	32%	57	1%	-	0%	4 730	12%
3. Consulting services (including TA and studies)	3 212	77%	494	12%	365	9%	76	2%	-	0%	4 147	10%
4. Training (including workshops and radio campaign)	2626	72%	599	16%	367	10%	74	2%	-	0%	3 666	9%
5. Investment capital	-	0%	6000	67%	-	0%	-	0%	2987	33%	8 987	23%
Total investment costs	11 841	46%	7 318	28%	2923	11%	207	1%	3 477	13%	25 766	65%
6. Salaries and allowances	7 218	77%	1153	12%	966	10%	-	0%	-	0%	9 337	24%
7. Operation and maintenance	3 257	74%	529	12%	576	13%	42	1%	-	0%	4 404	11%
Total recurrent costs	10 475	76%	1 682	12%	1542	11%	42	0%	-	0%	13 741	35%
Total PROJECT COSTS	22 316	56%	9 000	23%	4 465	11%	249	1%	3 477	9%	39 507	100%

V. Financial management, procurement and governance

10. Financial management. In accordance with IFAD guidelines, a financial management assessment has been undertaken of the RFCIP II. Despite the high inherent country risk, the overall programme risk is assessed as medium, due to the mitigation actions put in place at the NPCU. Currently, the NPCU has financial management arrangements in place that meet IFAD's minimum requirements, including qualified staff, segregated accounts in United States dollars and local currency, a computerized accounting software, internal control systems and regular financial reporting arrangements. Furthermore, the programme is audited annually by the MAFFS internal audit function and external annual financial audits are conducted by the Sierra Leone Audit Service in accordance with INTOSAI/ISSAI standards and IFAD audit guidelines. The past external audit reports have been submitted in a timely manner and have been unqualified. In addition, the IFAD client portal is currently being rolled out in the country, which is expected to reduce the time required for disbursements and to facilitate access by the NPCU and ministries to relevant financial information.
11. The existing financial management arrangements will be modified to account for the investment activities undertaken by the investment fund under the additional financing, as follows: (i) a separate account will be opened in a commercial bank and operated under double signatures, one from the fund manager and one from the NPCU; (ii) specific financial reports will be produced by the fund manager on a monthly basis; (iii) the NPCU financial management manual will be duly updated; and (iv) the external audit terms of reference will be modified to include all funds disbursed to the fund manager.
12. Procurement. The procurement processes are consistent with the IFAD Procurement Guidelines and Procurement Handbook and the Sierra Leone government procurement framework, as applicable. Procurements generally follow prevailing procedures commencing with invitation and running through to contract award and signature. In addition, NPCU management is working to improve documentation, record keeping and utilization of the procurement software.

VI. Proposed amendments to the financing agreement

13. Once the additional financing is approved, the original financing agreement will be amended accordingly. The additional financing will be used to scale up current activities and achieve planned programme activities. In this regard, the following changes will be introduced: (i) schedule 2 will be revised to include the additional financing; (ii) a new investment capital expenditure category will be created to capture the investments undertaken by the investment fund; and (iii) specific disbursement conditions for the investment capital category will be introduced to ensure that no funds are transferred to the investment account until the operational modalities, flow of funds and contractual arrangements have been established and received IFAD's non objection. No extension of programme completion or closing date is being sought.

VII. Proposed amendments to the logical framework

14. The request for additional financing by the Government of Sierra Leone was formally made after the joint midterm review by the Government and IFAD, which assumed it would be granted. As 88 per cent of the proposed additional financing of US\$9 million is to close the financing gap left by NaSSIT and IFC, there is no change to the logical framework other than retrofitting three existing indicators into new Results and Impact Measurement System (RIMS) core indicators by rewording and adding two new core indicators: "Outreach" (CI 1) and "Number of persons in rural project areas trained in financial literacy" (CI 1.1.7). Retrofitting applies to all ongoing projects with implementation duration standing at less than 60 per cent, which is the case of RFCIP II.

VIII. Legal instruments and authority

15. An amendment to the current financing agreement between the Republic of Sierra Leone and IFAD will constitute the legal instrument for extending the proposed financing to the borrower.
16. The Republic of Sierra Leone is empowered under its laws to borrow and receive funding from IFAD.
17. I am satisfied that the proposed financing will comply with the Agreement Establishing IFAD and the Policies and Criteria for IFAD Financing.

IX. Recommendation

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

RESOLVED: that the Fund shall provide a loan on highly concessional terms to the Republic of Sierra Leone in an amount equivalent to four million five hundred thousand United States dollars (US\$4,500,000), and upon such terms and conditions as shall be substantially in accordance with the terms and conditions presented herein.

RESOLVED FURTHER: that the Fund shall provide a grant under the Debt Sustainability Framework to the Republic of Sierra Leone in an amount equivalent to four million five hundred thousand United States dollars (US\$4,500,000) and upon such terms and conditions as shall be substantially in accordance with the terms and conditions presented herein.

Gilbert F. Hougbo
President