

Document: IFAD11/2/R.4/Rev.1  
Agenda: 6  
Date: 7 July 2017  
Distribution: Public  
Original: English

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## Enhancing the relevance of IFAD operations to country context

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Consultation on the Eleventh Replenishment of IFAD's Resources —  
Second Session

Rome, 29-30 June 2017

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For: Review

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## Abbreviations and acronyms

IFAD11	Eleventh Replenishment of IFAD's Resources
LIC	lower-income country
LMIC	lower-middle-income country
M&E	monitoring and evaluation
PBAS	performance-based allocation system
PoLG	programme of loans and grants
SDG	Sustainable Development Goal
SIDS	small island developing states
SIF	Smallholder and SME Investment Finance
SME	small and medium-sized enterprise
UMIC	upper-middle-income country

# Enhancing the relevance of IFAD operations to country context

## I. Introduction

1. This paper builds upon the report presented to the Executive Board in April 2017, "Tailoring operations to country context – a holistic approach", and the documents "Enhancing IFAD11 business model to deliver impact at scale" and "Financial strategy for IFAD11 and beyond", which are also being presented at the second session of the Eleventh Replenishment of IFAD's Resources (IFAD11). It presents a consolidated view of how IFAD will remain relevant amid the challenges and opportunities associated with investing in smallholder agriculture in different country contexts. To ensure IFAD's continued relevance and effectiveness, the Fund will need to evolve in line with changes at the national and international levels, notably those required to achieve the Sustainable Development Goals (SDGs) and meet the challenge of leaving no one behind.
2. IFAD should capitalize on the diversity of its member-based foundation, beginning with the premise that each of its beneficiary members is eligible for the Fund's services to eradicate poverty and eliminate hunger, wherever they exist. IFAD's Strategic Framework and operational policies apply to all countries irrespective of their income level, geography or degree of fragility. What does change, however, is that whether one talks of pervasive poverty or pockets of poverty, the country conditions and needs vary considerably, including countries' capacity to finance their own development efforts.
3. IFAD will increasingly differentiate the type of services it provides and offer a selection of activities that are effective in low-income countries (LICs), lower-middle-income countries (LMICs), upper-middle-income countries (UMICs), fragile situations and small island developing states (SIDS). This will make the Fund more effective in addressing development challenges and transforming rural areas while maintaining its comparative advantage and sector-wide focus. Other sources of differentiation will include: the terms and conditions under which countries will be able to access IFAD financing and the set of tools and financial options that IFAD will be able to offer. This is especially important as IFAD expands its programme of work in response to national demands and its capacity to borrow resources in order to finance its programme of loans and grants (PoLG), and not just through core contributions from its Member States. In this respect, IFAD11 will be critical for enabling IFAD to become a leader in smallholder financing contributing to rural transformation and achieving the SDGs.
4. The combination of adapted operational approaches and countries' own efforts is expected to steer IFAD beneficiary countries towards higher income levels and reduced fragility. This transition will need to be supported by IFAD in a dynamic manner, including through the revision of lending terms once per cycle (and not every year as per the current practice) so that IFAD's financing priorities remain where needs are greatest. The availability of diverse funding sources and financing terms will make the dialogue on a transition strategy easier since IFAD will be able to use its borrowing capacity to facilitate an evolution from concessional to ordinary terms without needing to tap into its core resources. This process will be subject to continuous dialogue with national governments and will be embedded in countries' own development strategies. A new transition framework will be presented to the Executive Board in 2018 to clarify the approach to transition and introduce phasing out/phasing in periods on the basis of objective criteria.

## II. Different needs, adapted responses

5. There is a need to recognize the wide variety of countries needs and conditions. However, the divisions between the characteristics and poverty profiles of LICs,

LMICS and UMICs are blurred. For example, much like LMICs and UMICs, LICs are looking for innovative financial solutions, opportunities for private-sector involvement and assistance with building social capital and farmers' organizations. This would make an all-encompassing "package" that offers specific interventions for each country grouping operationally irrelevant.

6. Instead, the diversity of requirements necessitates that IFAD develop the flexibility to respond to country-specific issues as defined in each country strategy and project pipeline development. Decentralization has enhanced IFAD's capacity to align its assistance with country priorities and resolve bottlenecks in a more cost-effective way. By the end of IFAD11, major products and services will be planned, prepared and delivered at the country and sub-regional levels. Country strategic opportunities programmes and project designs will better reflect the diversity of needs and situations, and provide tailored solutions. Through their different demands, LICs, LMICs and UMICs will shape IFAD's portfolio of activities, and it is possible that some approaches or thematic areas will be in higher demand by certain typologies of countries.
7. Sector and thematic selectivity. To remain relevant, IFAD will need to strike a balance between the following:
  - (a) IFAD must remain loyal to its core competence of being the champion of smallholder agriculture as the *raison d'être* of its activities. This includes preserving its targeting approaches that put poor rural women and men at the centre of its interventions and build the soft skills that facilitate the growth of stronger rural institutions. The Fund will build these skills through projects focused on agriculture and food security, value chains and rural business development, rural infrastructure, rural financial services and natural resource management.
  - (b) At the same time, IFAD needs to integrate into its portfolio the important issues and priorities that have emerged over the last decade, and that will help to translate the concept of rural transformation into IFAD's operations according to country context. These include:
    - (i) The pervasive impact of climate change on agriculture, resilience and natural resources management, and the need to develop new risk management and adaptation tools;
    - (ii) The increasingly predominant role of women in agriculture, food security and nutrition, and the need to address gender equality and inclusion;
    - (iii) The negative and persisting impacts of malnutrition during the initial years of children's development, and the need to deal with adverse health effects at the household level through food-based interventions;
    - (iv) The serious challenges posed by rural youth unemployment and the urgent need for alternative solutions to migration; and
    - (v) The expanding role of the private sector in agricultural financing and the need for IFAD to use scarce public resources to mobilize private investments.
8. LICs, LMICs and UMICs. More than its sector-specific and thematic areas of intervention, what will differentiate IFAD's work in LICs, LMICs and UMICs is the dynamic combination of financing, knowledge and policy instruments that the Fund can provide. Looking at the two ends of the spectrum, in the poorest countries this may translate into providing financing in the form of grants as part of the debt sustainability framework, while in UMICs, reimbursable technical assistance can be offered, with the costs of IFAD's knowledge and technical assistance fully recovered.

9. In line with recent trends, domestic cofinancing will be an important means to leverage IFAD's services, particularly in LMICs and UMICs, where cofinancing has increased considerably in recent years, albeit unevenly. IFAD will explore with its Member States new ways of securing cofinancing that are congruent with each country's income status in order to boost government ownership of projects and financial leveraging.
10. Examples of different access to IFAD services include the following:
  - (a) Mix of services. In UMICs and possibly LMICs, the composition of IFAD's instruments and services will lean more towards knowledge management and policy engagement than lending. Most UMICs acknowledge that they are seeking IFAD's knowledge of rural poverty, experience in project design, supervision tools and policies related to the agriculture and rural sectors (e.g. targeting, rural financial services, decentralized and participatory rural development, and natural resource management). On the other hand, satisfying the financing needs will prevail in LICs, and often in LMICs, given their reduced capacity to access and mobilize funds. These countries will remain IFAD's priorities in terms of allocation of core resources.
  - (b) Absorption capacity. While there is demand for a higher level of IFAD's financial services, countries' absorption capacity will be a major factor in determining how effectively a larger PoLG can be delivered. In UMICs and many LMICs, the possibility of expanding lending is significant and will mostly be derived from IFAD's ability to offer better products at competitive rates through the development of its borrowing and on-lending capacity. In LICs and some fragile situations (many of which are in UMICs and LMICs), expansion may be constrained by the country's absorptive capacity. Such countries may require IFAD's proactive involvement to ensure smooth implementation arrangements, efficient disbursement processes, simplified projects, sound procurement planning and ability to build on previous interventions without adding complexity.
  - (c) The development of a knowledge and policy agenda. South-South and Triangular Cooperation (SSTC) will be particularly important in UMICs interested in increasing awareness and uptake of knowledge developed in the global South. LICs and LMICs will be the main beneficiaries of this agenda since SSTC has a prominent role in facilitating knowledge flows from UMICs to LICs and LMICs. IFAD's new approach to SSTC will serve as the basis for this work during IFAD11. The combination of national policy engagement, non-lending services and project financing will be expanded under IFAD11, and will mostly benefit LICs and LMICs as a way to enhance the relevance of the policy environment for achieving project objectives.
  - (d) The scaling-up agenda. The most likely way to scale up results in UMICs and LMICs is to mainstream IFAD projects and approaches into governments' own programmes and policies. The main objective of these efforts will be to demonstrate that innovative approaches can work and rely on government systems to replicate them – or establish a policy environment that leads to results at scale. In LICs and some LMICs, a main driver of the scaling-up agenda is IFAD's capacity to leverage new financing from: (i) donors; (ii) the private sector; and (iii) communities themselves, and ensure the sustainability of benefits.
11. Fragile situations. IFAD does not focus on fragile states but fragile situations, which can be national, sub-national or regional, and which affect countries across all income classifications. IFAD's expertise is extremely relevant for interventions in fragile and conflict-affected situations, especially that related to building resilience, prevention and capacity to cope with shocks and risks in the medium- to long-term perspective. The current famine in Africa illustrates the importance of addressing

the root causes of fragility and building rural populations' resilience while ensuring an adequate sequence of short-term humanitarian aid and long-term agricultural development (including through partner agencies).

12. The Fund's new strategy for "most fragile situations" highlights the need to increase resource allocation to these countries. Approximately 32 per cent of IFAD11 core resources are projected to be allocated to most-fragile situations – a 40 percent increase. At the same time, Management recognizes the importance of assessing absorption capacity and continuing the current practice of capping allocations to countries through the performance-based allocation system (PBAS) when needed. Management proposes to continue combining lending and non-lending activities in most-fragile states while carefully sequencing technical assistance with targeted investments.
13. In these situations, IFAD's interventions will be dictated by a better understanding of the following issues:
  - (a) Risk management and resilience. Improving rural livelihoods – and making them more resilient – will enable IFAD to stay engaged and continue implementing assistance in difficult contexts. Informal and customary institutions built on trust and social bonds are especially important in contexts where formal institutions are weak or absent, and rule of law is lacking. Gender equality, women's empowerment and engagement with youth will be prioritized.
  - (b) Addressing the root causes. IFAD has extensive experience in community-level activities that contribute to peacebuilding and state-building by: empowering marginalized rural communities; strengthening governance of natural resource management; fostering inclusive community-based organizations and local government service delivery; and creating employment opportunities for youth and marginalized groups.
  - (c) Building institutions, trust and social cohesion. IFAD recognizes the importance of legitimate, effective and accountable institutions in addressing fragility, starting with institutions serving poor people. The Fund will continue to focus on strengthening community and government institutions, particularly at the local level. These include farmers' organizations, indigenous peoples' organizations, women's associations, water users' associations and other community-level institutions as well as local government agencies.
  - (d) Flexible and responsive resourcing, instruments and approaches. Smaller projects may be most appropriate in fragile situations where larger projects would entail excessive risk or complexity. These operations should include simplified designs and procedures that recognize the challenges of working in situations with high levels of uncertainty.
  - (e) Strategic and complementary partnerships. The crucial importance of partnerships in fragile situations warrants their inclusion as a guiding principle. Partnerships help IFAD to manage risks and enable it to remain engaged in challenging contexts because they provide a means to address the root causes of fragility that lie outside IFAD's areas of comparative advantage.
14. Small island developing states (SIDS). Management recognizes the distinct challenges that SIDS face in achieving food security and employment for smallholder farmers and fishers. These include extreme vulnerability to climate change and persistent exposure to disasters and weather-related hazards – further exacerbated by islands' geographic remoteness and dispersion. The addition of the IFAD vulnerability index to the PBAS formula, and the increase in minimum allocations will ensure that the allocation of IFAD11 resources helps SIDS to address these challenges more effectively.

### III. Tailoring financing

15. Until recently, IFAD has mostly been financed through Member States' replenishment contributions in a three-year cycle. Contributions are then allocated through the PBAS to serve all beneficiary countries on concessional, blend and ordinary terms. This system is the main determinant of the amount allocated to each country and influences IFAD's financial sustainability. A number of factors have placed the system under stress and will require changes, which will begin during IFAD11:
- (a) **Borrowing.** The introduction of a Sovereign Borrowing Framework has opened up new opportunities for diversifying IFAD's sources of financing and expanding its programme of loans. Similarly, the possibility for IFAD to access market borrowing in the future will further diversify its sources of financing and provide a more stable and predictable source of financing for ordinary-term borrowers. The availability of new products such as concessional partner loans will also enhance IFAD's capacity to blend different sources of funds (grants and loans) to serve its clients in a more flexible way without incurring term structure or interest rate risk. This is particularly relevant for blend or highly concessional loans so that funds borrowed by IFAD do not exclusively serve UMICs.
  - (b) **The PoLG as a starting point.** While developing borrowing capacity, the adequate volume and scope should be determined by the desired level of the PoLG. Rather than using borrowing as an ad hoc gap-filling strategy, it will become an integral part of IFAD's funding mechanism. An approach based on leveraging available resources will be introduced to strengthen the links between core contributions and the PoLG, leaving no doubt about whether IFAD's core resources are enough to fund the desired level of PoLG – and as a result the required level of borrowing.
  - (c) **Leveraging in order to fund ordinary loans.** Leveraging will not only enable IFAD to offer more diversified products with different lending terms, but by expanding the overall pie, IFAD would make it possible to use a larger share of the replenishment contributions for highly concessional terms while increasing the use of borrowed resources for loans on ordinary terms. Therefore, this does not mean that the share of IFAD financing to countries classified as highly concessional borrowers will proportionally decrease. A number of options are offered in the Financial Strategy paper.
  - (d) **The link between core contributions and borrowing.** An important element of this approach is maintaining a strong link between core contributions and borrowed funds. This is critical to uphold the integrity of the Fund, which is mandated to use two thirds of its resources for concessional financing to highly concessional borrowers (including all LICs and some LMICs). A successful borrowing strategy alone will not ensure compliance with the Fund's mandate in the absence of a successful replenishment. Member States' contributions will continue to remain the bedrock of IFAD's financial commitment capacity since they will be used as the basis for calculating the desired amount of borrowing (50 per cent has been proposed) to maintain or expand IFAD's PoLG.
  - (e) **Better tailoring for different users.** This resource mobilization strategy will represent a more financially viable and efficient use of resources for IFAD. Highly concessional lending and grants will be fully financed by core contributions from Member States. Ordinary-term loans will be financed increasingly (and eventually exclusively) by borrowed funds. This will allow the Fund to expand its overall PoLG for all types of users, making sure that all categories of beneficiaries are positively affected.



## IV. Can the PBAS respond to diversified needs?

16. The PBAS formula is in the process of being reformed to strike a better balance between needs and performance, and to make it more relevant to the requirements of IFAD's operations. The formula is a useful and transparent tool for helping IFAD reach its desired objective as a function of a number of criteria and parameters that need to be applied by Management:
- (a) PBAS for all. The PBAS can continue to govern the way both core contributions and borrowed money are allocated. As long as IFAD's borrowing arrangements have to be self-funded and are not subject to replenishment subsidies (as specified in IFAD's Borrowing Framework), borrowing will only be directed to ordinary term countries. However, as in the case of concessional partner loans, caveats could be applied if a subsidy is to be provided to allow borrowed funds to be used for highly concessional lending.
  - (b) Adjusting the PBAS with requirements and targets. The PBAS will continue to factor in, upfront, allocation decisions and commitments with regard to core resources, including the requirements that: (i) approximately 45 per cent of its replenishment resources are channelled to sub-Saharan Africa and 50 per cent to Africa as a whole; (ii) the allocations of certain countries are capped; and (iii) two thirds of the money goes to countries borrowing on highly concessional terms. Management proposes that no more than 10 per cent of core resources will be provided to assist UMICs in leveraging their resources for rural transformation. As Management fulfils its ambition to double the programme of work through greater leverage, including market borrowing, this percentage will decrease. Subsequent needs will then be financed through borrowing.
  - (c) Country selection. No borrowing Member State will be dropped from an eligibility point of view but the set of countries that will enter the formula for running the PBAS in every cycle will be subject to clear and transparent criteria.<sup>1</sup> Based on these criteria, Management can decide with borrowers to postpone the inclusion of some countries until the following cycle. This will allow fewer but larger projects in each cycle, generating economies of scale and increasing the development effectiveness of IFAD's operations. All active and eligible countries will continue to receive IFAD support in terms of sustained portfolio supervision, knowledge sharing, policy engagement and non-lending services.
  - (d) Fragility perspective. The introduction of a vulnerability component to the PBAS formula ensures that IFAD's resource allocations are sensitive to fragility. Given the great diversity of fragile situations, country strategies will be used to assess the relevance of IFAD's operations with regard to governance, instability and opportunities for working directly with poor communities to build resilience, social capital and the capacity to cope with shocks.

## V. New products

17. As IFAD11 tailors operational approaches to country circumstances according to evolving needs, it will introduce more diversified products:
- (a) Private-sector finance. Achieving the SDG targets in the agriculture and rural sectors will require a different way of thinking about financing for food, which will inevitably require greater leveraging of the private sector. In

<sup>1</sup> As referenced in the paper "Enhancing IFAD11 business model to deliver impact at scale", these criteria could include: (i) a valid country strategy available early in the PBAS cycle (particularly for countries that have not borrowed from IFAD before); (ii) no previously approved loans from IFAD pending effectiveness for more than 18 months since Executive Board approval; and (iii) all previous operations disbursed at least once in the 12 months prior to the beginning of the PBAS cycle.

addition, generating employment opportunities for rural youth and offering alternatives to migration will require that rural small and medium-sized enterprises (SMEs) grow sustainably. IFAD has also learned from experience that working only through sovereign loans to governments limits its capacity for promoting private-sector involvement and offering new opportunities for rural SMEs to access financing and markets. It is therefore IFAD's intention to establish a new fund for direct investment in smallholders' organizations and SMEs – the Smallholder and Small and Medium-Sized Enterprise Investment Finance Fund (SIF) – and to capitalize on the potential of its existing portfolio to minimize risk and unlock private-sector investments for this under-served rural population and for youth employment.

- (b) Results-based lending. This instrument is coherent with efforts to strengthen results by basing disbursement on the achievement of agreed-upon deliverables and outputs rather than inputs. Results-based lending also simplifies cumbersome procurement and disbursement procedures while ensuring required checks and balances, the costing of the outputs and their monitoring. Initially, this approach will be tested in countries with well-developed financial management, safeguard and M&E systems – most likely middle-income countries.
- (c) Supplementary-funded new initiatives. Through the mobilization of supplementary funds, including from partners that are not Member States (e.g. foundations, the European Union and the private sector), IFAD will be at the leading edge of knowledge, piloting new approaches in combination with new initiatives in its portfolio. In areas such as migration and remittances, agriculture risk management, weather index insurance, farmers' organizations, climate, gender and nutrition mainstreaming, the Fund will be able to offer flexible new tools and approaches based on national demand. The Adaptation for Smallholder Agriculture Programme is being reformed to enable supplementary-funded technical assistance to support operations. In addition, the SIF will initially be capitalized from supplementary funds.