Lessons learned

Lines of credit

Investing in rural people

Inclusive rural financial services

The **Lessons Learned series** is prepared by the IFAD **Policy and Technical Advisory Division** and provides a compilation of past experiences relating to a particular topic and a reflection on evidence-based best practices and failures. "Best practices" refer to processes or methodologies that have been proven to produce good results and are thus recommended examples to be replicated.

These notes are "living" documents and will be updated periodically based on new experiences and feedback. If you have any comments or suggestions, please contact the originators.

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List of acronyms

ARME	associations of rural enterprises (Colombia)
CPMT	country programme management team
FSP	financial service provider
KPI	key performance indicator
LOC	line of credit
MFI	Microfinance institution
PADEMER	Rural Microenterprise Development Programme (Programa de Desarrollo de la Microempresa Rural) (Colombia)
PMU	programme management unit
PPP	public-private partnership
RCC	rural credit cooperatives (China)
SME	small and medium-sized enterprise
TA	technical assistance
VCF	value chain finance

Introduction

Credit markets diverge from the ideal market because information is imperfect and loan contracts are difficult to enforce. Market failure is said to occur when the market is unable to allocate resources efficiently. The complicated features of agriculture inhibit the demand for and supply of credit and insurance, making it especially difficult to create sustainable financial institutions to serve the sector. As such, efforts to increase formal credit supplies have had a spotty record and quick fixes have not worked. Most successes have been a result of careful long-term institutional support.

The old paradigm of subsidized, directed agricultural credit programmes was common in top-down government and donor policies and programmes. However, attempts to resolve supposed market failure often resulted in government failure.[1] In the 1980s, a new financial systems paradigm emerged that shifted the emphasis from dispersing cheap credit to creating sustainable institutions. The terminology changed to treating borrowers and savers as clients rather than beneficiaries, developing products that clients demand and pricing products and services to cover costs and risks.

Donor agencies reduced the use of lines of credit (LOCs) in favour of grants, loans and technical assistance (TA) to help in the design of appropriate products, institutions and policies. Also, during this time, microfinance thrived by using market-oriented approaches. Microfinance institutions (MFIs) have made inroads into agriculture and rural areas but more efforts are needed to design products and methodologies to fit the seasonal cash flow patterns of farm households. Managing the costs and risks of agricultural lending has been challenging. There is need to better understand the demand for and use of agricultural credit to develop effective products, institutions, projects and policies. The rapid growth of microfinance suggests that there may be large unmet demand for agricultural loans. However, farmers' demand for loans may be limited if the interest rates are as high as those set by MFIs to provide small microenterprise loans sustainably.

There are still good reasons to provide professionally managed LOC programmes that can complement savings mobilization and intermediation measures. These reasons include the reluctance of commercial players to venture into rural and remote rural communities. But the commercial players need to start thinking from a different perspective and concentrate greater resources into innovation, especially considering the rapid growth of mobile services, for example, in the East African region.

Traditional branch expansion (brick and mortar) of banking business models will be replaced by Internet and e-money platform services, and high volumes combined with low prices will drive outreach growth. The challenge of the traditional banking sector is to consider facilities such as LOCs and to develop operations and processes that can disburse these funds in a retail service that is cost-effective. Here, Numerous customers will be seen accessing small repetitive loans at affordable interest rates from high-value LOC funds, with attractive margins earned in the process.

This *Lessons Learned* knowledge document is written to provide practical suggestions and guidelines to IFAD's country programme managers (CPMs) and the country programme management teams (CPMTs) to help them design and implement programmes and projects. They are written as addendums to, and in support of, the *Line of Credit How To Do Note*, *Rural Finance Policy* and *IFAD Decision Tools for Rural Finance*, and should be read in conjunction with these documents. Other stakeholders involved in the projects, such as members of the project management units (PMUs), staff from participating rural financial institutions and host government ministry employees have also found these technical notes useful.

The purpose of this guidance is to provide CPMTs with some observations based on lessons learned from IFAD and other donors' projects, as well as from the World Bank Operations Evaluation Department (OED 2006) LOC review that may help in the design of LOCs. *Lessons Learned* provides a compilation of past experiences relating to particular topic and a reflection on evidence-based best practices and failures.

[1] Some of the most comprehensive and accessible publications of the vast literature that analysed the debates and presented the evolution in thinking about agricultural credit includePeacock, Von Pischke, Donald and Adams (1984); ; Yaron, Benjamin and Piprek (1997); and Conning and Udry (2005).

“Best practices” refers to processes or methodologies that have been proven to work well and produce good results and are, thus, recommended as examples to be replicated.

The terminology used in this publication has been carefully selected to be consistent with the philosophy of rural finance methodologies. Use of the terminologies, accompanied by explanation of meanings, is presented in the *How to do lines of credit* note (http://www.ifad.org/knotes).

Photographer: Michael Hamp
Myanmar

Context and challenges

The development of inclusive rural financial systems and the fostering of innovations that increase poor peoples’ access to a wide range of financial services are central to IFAD’s mandate. These goals are especially relevant in the context of a changing global economy that is facing challenges linked to the financial crisis, volatile food and agricultural commodity prices and the perils of climate change.

IFAD focuses on development of and support to diverse, viable financial service providers (FSPs) that increase the rural poor’s long-term access to a wide range of financial services. IFAD’s commitment to promoting pro-poor rural and microfinance is driven by the recognition that effective demand for these services can be met through a number of different instruments. The IFAD*’s Rural Finance Policy* (RFP) (2009) describes in-depth the principles that guide IFAD’s approach to rural finance (see *How to do lines of credit*).

The remaining challenge is to bring sustainable banking services to rural and remote rural communities where savings can be mobilized and credit (funded through LOC initiatives) can be provided in cost-effective ways. Agency banking relationships between MFIs/FSPs and commercial banks need to be encouraged and expanded. Traditional banking business models do not allow for branch expansion into communities that fall below the economic and commercial volume thresholds and, hence, limit improvements in savings mobilization and financial inclusion.

By engineering an outreach banking business model that combines savings mobilization with access to leveraged LOC funds, the existing banking services can be extended to more rural and remote rural communities.

In order to support the MFIs in attracting savings, governments and donors should: (i) provide TA to the MFIs to help them build their capacity to mobilize deposits; (ii) encourage MFIs that mobilize deposits to use borrowing only as a supplement to deposits in order to avoid excessive dependence on public and international lenders, and the displacement of deposits as the primary funding source (and as an important financial service to be provided in its own right); (iii) support the development of a well-designed deposit insurance fund once effective prudential supervision has been established; and (iv) encourage the progressive integration of the MFIs into domestic and foreign capital markets.

Prior alternative considerations to LOCs

Before including a LOC within a project or programme, there are other alternatives that should be considered in order to create sustainable access to financial services for the targeted clientele. When considering alternatives, the overall principle should be to focus on building the capacity of FSPs and not simply providing liquidity.

Promotion of savings mobilization. A savings-driven approach is the ideal starting point for any rural finance project. This creates ownership of the project, encourages a savings culture and reinforces the use of good credit analysis of loan proposals. While this approach will result in a slow build-up in capital available for loans and the need for a better credit culture will be reinforced, it may be the only tool for developing credit availability in remote areas. It is also ideal for capital accumulation when there is a large volume of inward remittances.

Savings-led initiatives such as SaveAct (http://www.saveact.org.za/.for more, see Enterprise Development and Microfinance Vol. 22, No. 2. 2011) (see Box 1) are spreading rapidly in rural areas throughout sub-Saharan Africa. Historically, MFIs have focused on enabling the poor to access credit in order to start and grow their own businesses but, as the financial diary research reported in *Portfolios of the Poor* (Collins, D., J. Morduch, S. Rutherford, and O. Ruthven. 2010), poor people need a wide variety of financial instruments, including savings, to manage their complex financial lives.

Box 1: Savings-led groups operating as SaveAct, South Africa

Savings-led groups are in operation throughout the developing world and they operate in similar ways to the SaveAct model profiled in this case study. Community-managed savings-led approaches to financial services for the poor have a long and successful history, particularly in India where there are over 2 million self-help groups serving 30 million members.

One such approach, village savings and loans associations (VSLAs), has been pioneered by CARE International and has been successfully adapted by other agencies, including Plan, Oxfam, Catholic Relief Services and the Aga Khan Foundation, reaching approximately 2 million very poor people in 22 countries (MasterCard Foundation, Microfinance Opportunities and Genesis Analytics 2011). CARE International developed the VSLA model based on the traditional savings practices in Niger in the 1990s and since then the model has spread to 57 countries (Allen et al. 2012) undergoing refinements and adaptations to local circumstances along the way.

The ability to save money is key (see Box 2) in helping the poor to increase their assets before getting access to credit and minimizes the risk of getting into unproductive debts. According to the Small Enterprise Education and Promotion Network (SEEP), a leading international microfinance network, “demand worldwide for reliable savings services is estimated to be five times greater than the demand for loans” (SEEP 2008).

Box 2: Use of mobile phones – M-PESA, Kenya

M-PESA, which originated in Kenya and launched in 2007, has now been replicated in the United Republic of Tanzania, Afghanistan, South Africa and India. By April 2011, it had more than 14 million users and 27,988 agent outlets (Lehman and Ledgerwood 2013). M-PESA was originally to be used by the MFI Faulu Kenya but during its development, it was quickly recognized that it had much wider potential. Safaricom was also initially interested in introducing M-PESA in order to reduce SIM card churn: by offering M-PESA as an additional service, clients were more likely to hold on to their card numbers longer to ensure that they can participate in the system, especially to receive money. This, therefore, decreased churn and the need to open new pre-paid card numbers for existing users, which decreased costs (by not having to start up new numbers) and ensured continuing income on existing numbers. This also resulted in fewer dormant numbers.

At one level, M-PESA has had a massive impact on financial inclusion in Kenya. The use of semi-formal financial services in the country (including mobile-banking platforms such as M-PESA) increased from 8.1 per cent in 2006 to 17.9 per cent in 2009, while the proportion of the population with access only to informal financial services decreased from 35 per cent to 26.8 per cent. The share of the population excluded from any financial service decreased from 38.3 to 32.7 per cent (FSD Kenya and Central Bank of Kenya 2009). These statistics suggest strong gains in financial access resulting from the introduction of M-PESA.

Encourage equity investments. Although IFAD does not currently use equity as a principal instrument to support rural finance, the use of this instrument should be explored. For example, IFAD can partner with equity investors and help facilitate equity investments in IFAD-supported institutions. Equity not only provides liquidity but it also strengthens the capital structure of the institution, thereby making it more attractive to other potential investors.

Use of LOCs. IFAD has limited experience with LOCs. Consequently, a proposal to include a LOC in an IFAD intervention would need to be justified by the results of a rigorous market assessment and a clear rationale. LOCs may be appropriate in cases where liquidity is available in the financial system but lenders are reluctant to assume exposure to the rural sector. This is briefly discussed in the Frequently Asked Questions (FAQs) section below and is the subject of a How To Do Note on the subject.

Donors and governments expect LOCs to reduce default risks and induce lenders to serve specific target groups or institutions. It is believed that guarantee subsidies accelerate learning, thus allowing lenders to improve their credit analysis and lend their liquid funds rather than investing them in government securities or lending only to highly collateralized borrowers. However, since the methodology used in evaluating LOCs has been weak, questions about additionality and sustainability remain.

LOCs may provide additional comfort for financial institutions interested in testing the feasibility of lending to a new clientele but a guarantee alone is unlikely to induce additional lending if lenders lack such interest. International agencies can perform a valuable service by conducting evaluations to determine whether and under what conditions LOCs produce the expected results and how the details of guarantee designs affect performance. It is also critical to evaluate whether LOCs distort markets and discourage private credit market development. The training and TA components of guarantee schemes could be more effective than the LOCs in stimulating lending to a new clientele. This situation may suggest that “LOC plus” programmes are critical and that guarantees may be just an attractive but inessential extra offer (see Box 3).

Integration into a value chain. Understanding the flow of financial services within and outside the value chain can help identify gaps in the financial sector, offering an opportunity for programming specific rural finance interventions (e.g. support FSPs to design warehouse receipts loan products). Relationships between actors in the value chain may facilitate financial flows either directly from one value chain actor to another or indirectly by making potential clients more attractive to FSPs. This value chain financing could take the form of production outsourcing financing, receivables financing or purchase order financing. Value chain finance (VCF) is the subject of a separate technical niote by IFAD.

VCF is an approach that has a number of advantages. It builds on existing relationships and the realities of the markets in which actors in a chain operate. Well-designed financing arrangements within value chains also help to overcome information gaps and can generate a greater degree of trust between actors. Often, repayment options (for credit) are embedded within non-financial relationships and, therefore, make it relatively easy for lenders to enforce contracts. In some cases, VCF also facilitates the provision of much-needed TA for various actors in the chain.

Box 3: Credit guarantee scheme – PASS Trust, United Republic of Tanzania

Who was involved? Private Agricultural Sector Support Trust (PASS Trust) supported by Danish International Development Agency (DANIDA) and small- and medium-scale farmers and agribusinesses. It provides business development services (BDSs) and a credit guarantee fund (CGF). PASS's facilitation is an important factor in the CGF success as many guarantee schemes are reliant on the banks to appraise the loans. PASS has supported both the banks and the borrowers at every stage through parallel appraisals of businesses and their plans. This led to more rational, better informed credit decisions by the banks and greater understanding by the agroenterprises of how to manage their debts.

What are the challenges and constraints? Lack of collateral and low entrepreneurial capacity of farmers.

What was innovative? The combination of BDS with financial support in the form of credit guarantees.

What was the outcome? Over 35,000 farmers have been supported by PASS and have obtained loans in the amount of TZS 95 billion. A key success factor is that it offers a variety of complementary services to agribusinesses under one roof. It has converted into a sustainable trust rather than a donor-supported project.

Commodity or warehouse financing. This financing should be considered in cases where a project's end clientele are producing a commodity that is in great demand and is highly liquid, such as coffee and tea. A warehouse receipt system can provide farmers with an asset that can be used as collateral to access funds from FSPs. It is important that there be appropriate and available warehouse facilities that are managed locally by an experienced operator. They also require an appropriate legal and regulatory framework to protect the rights of all participants.

The basic rationale for warehouse receipts is that they reduce lenders' risk by serving as a collateralized commodity that can be liquidated in the event of loan default. Commodities are stored in licensed and bonded warehouses that issue receipts certifying the amount and quality stored. The owners of the commodity (such as farmers and traders) provide the receipts to lenders in exchange for loans. With the exception of double or triple cropping, credit obtained after harvest does not directly solve the seasonal need for working capital to plant a new crop.

Leasing and hire purchase financing. In circumstances where longer-term financing is needed for acquiring fixed assets, these types of financing structures should be considered. Both of the mechanisms are asset-based and as such represent a securitized form of financing that could be attractive to other funders. These parties could be directly involved in financing the project or these assets, or may be interested in buying the asset from the project as a third party.

Micro-leasing is a collateralized lending product that can be described as long-term rental to a single client. Its attractiveness as a financial product stems from the separation of ownership and use over the full useful life of an asset. By converting an initial large capital outlay to a stream of smaller payments over time, leasing enables micro and small business to overcome capital impediments. Not having the resources to buy an asset is, therefore, no longer a barrier to acquiring it (see Box 4).

Box 4: Micro-leasing in Bolivia

Who was involved? National Ecumenical Partnership for Development (ANED) with small cotton producers.

What are the challenges and constraints? Lack of productive infrastructure in rural areas and lack of access to capital sources to acquire them was one of the main obstacles for the development of agricultural production and agribusiness in rural Bolivia. The leasing programme initiated by ANED aimed at overcoming this bottleneck. The key factor to explain the success of the scheme was the involvement of the providers of equipment as an integral part of the operation: their presence not only guaranteed that ANED was able to offer better financial conditions to the lessee but also helped to provide training to the lessee in the better use of the equipment. The constraint was lack of access to other financial services and, in particular, to a large amount of capital to invest in infrastructure. The main challenge in Bolivia in micro-leasing is the reduced size of the secondary markets in the country due to its isolated position on the continent, which makes it more expensive to fund "rarely available" equipment.

What was innovative? One innovation was the involvement of the providers of equipment as an integral part of the operation. Another important innovation was the repayments designed to fit with the cash flow of the lessee. Still another important feature of the programme is that it aimed not only to individual producers but also to cooperatives and producer associations, which reduces the total cost of the operation for the lessee. ANED integrated the advance payment as part of the different lease payments so as to prevent small-scale farmers from paying a huge amount of money at the beginning of the contract.

What was the outcome? During the first three years of operation, ANED bought almost 500 items of machinery and equipment for a total value of US$600,000. Most of leasing operations in Bolivia were used to buy either tractors (53 per cent) or irrigation pumps (28 per cent).

Use of apex facilities. In cases when there is a well-functioning apex institution with a track record, this could be considered (see Box 5) a viable option. As with FSPs, apex facilities must be assessed to determine their ability to provide services efficiently and effectively in line with any project's goals. Apex institutions are a pool of funds that is available to lend to FSPs, which in turn will on-lend to low-income people in the project's target area. These apexes generally provide funding to FSPs and additionally may provide TA to strengthen the capacity of both the FSP and its client base. Apex facilities are the subject of a separate knowledge product in process.

Development partners often use apex institutions to deliver funding and technical services in countries where MFIs appear too small or numerous for direct funding relationships. Apexes are attractive because they permit donors to hand over the difficult and time-consuming task of MFI selection to a local institution that is assumed to have the requisite skills.

Lessons learned

Introduction. A LOC must play its catalytic role of strengthening the performance of financial intermediaries (financial market development) and help create conditions that are conducive to the flow of private capital into productive investment (private enterprises and private-sector development, particularly small and medium-sized enterprises (SMEs). It is important to ensure that a LOC determines the extent to which it will contribute beyond the financial institution. However, not all LOCs are expected to improve the financial market development and the enabling environment or are geared towards SMEs. It should also be noted that microfinance might be better suited and result in a better outcome with small business and microjenterprise development.

Box 5: Consultative Group to Assist the Poor's (CGAP) criteria of a good apex institution

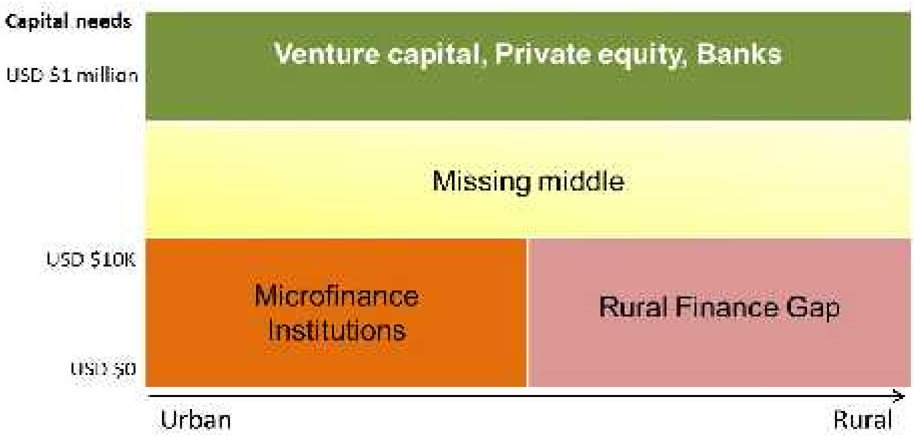
Apex planners almost always overestimate the number of MFIs that can meet sound selection criteria. The number of viable MFIs is a genuine constraint for most apexes. Even when Palle Karma Sahayak Foundation (PKSF), an apex in Bangladesh, used broad eligibility criteria, only 10 per cent of initial applicants qualified for funding. Apexes in Kenya (K-Rep), the Dominican Republic (FondoMicro), Colombia (Fundación Carvajal) and Pakistan (PPAF) have all had more financial resources available than qualified MFIs to fund. Replicating a successful apex model in another context is rarely successful. Among the 28 apexes studied by Fred Levy from Argentina to Yemen, no "one-size-fits-all" model was found.

What are the characteristics of a good apex institution?

1. The apex institution has a clear goal of nurturing the development of sustainable microfinance providers (including banks). Evidence shows that developing permanent, sustainable MFIs – rather than maximizing their MFIs – is the most effective way to expand the number of poor people served.
2. The apex institution is politically independent, with strong governance able to protect it from political intervention, thus ensuring that management can make decisions on technical grounds.
3. The apex institution receives funding based on a realistic assessment of the number of qualified MFIs in the country or region that can absorb apex funding.
4. Apex funding of MFIs is based on clear selection criteria, such as portfolio quality, depth of outreach, management quality and progress towards eventual sustainability. The apex institution must have the authority to discontinue funding to MFIs that fail to meet these criteria.
5. Apex loans are tailored to the cash flow patterns and planning needs of MFIs, not pre-set disbursement plans.
6. The apex institution monitors MFIs on the basis of a few, precisely defined performance targets that are seriously enforced.
7. Apex management is of very high quality, possessing a blend of microfinance expertise, managerial and financial skills, and integrity.

To foster agricultural development, the actors of the agricultural value chains require access to capital. Table 1 summarizes the different tapped and untapped capital needs of the rural population, who mostly derive their income from being engaged in agricultural activities. The large demand and potential for financing the so-called "missing middle" consists of agricultural cooperatives as well as SME agribusiness that use the produce from small-scale rural farmers but face the mismatch of their expectations and financial allocations by formal financial institutions, respectively the capacity of MFIs.

Table 1: The rural finance gap and the missing middle



Source: (Milder 2008)

The missing middle can be trapped between microfinance and venture capital since SMEs and cooperatives require large amounts and commercial banks and private equity funds perceive these businesses as too small, risky and remote to be attractive for investment. The missing middle and the "rural finance gap" are perceived for capital between US$10,000 and US$1 million (Milder 2008). In addition to growth finance, they require business development services.

Photographer: Michael Hamp
Nigeria - Additional Financing to the Community Based Agricultural Rural Development Programme (CBARDP)

Opportunities for using LOCs. The circumstances in which a LOC could be considered will usually have the characteristics described in the following sections.

The market assessment demonstrates a clear lack of liquidity. A rigorous market assessment must identify that there is demand and the types of financial services that are needed. The market assessment needs to take into account the existing structured service providers (other FSPs), as well as the traditional credit mechanisms that have worked satisfactorily for generations, in order to ensure that the project will provide either greater outreach and/or a better range of services. This demand estimate can either be carried out by specialist institutions or can be undertaken by the CPMT. The market assessment will need to take into account the current economic cycle at the time of project implementation so that the supply of funding will be appropriate to demand. Often, clients are enthusiastic about a retail funding facility not because they need to access the LOC but because they hope to obtain loans on cheaper terms or conditions, and/or that the qualifying requirements will be more lax.

There are well-qualified FSP's operating in the project's geographic area. Potential partner FSPs must be identified during the project design stage and must be subjected to a rigorous due diligence exercise. This due diligence includes verifying that the FSP itself is financially sound (e.g. has strong management and governance and a well-performing loan portfolio, is adequately capitalized and has good operational systems), will charge commercial rates on its loans and is not subject to political interference.

Furthermore, it should be verified that the FSPs will use these funds to expand into new markets or develop new loan products, will abide by CGAP's Client Protection Principles for Microfinance (CGAP 2010) and will participate in the MIX Market performance and outreach reporting programme, while reporting regularly to the PMU.

IFAD will not support a Greenfield FSP with a LOC facility. All potential FSPs must have an established track record and have invested some of their own equity or shareholders' funds in financing a loan portfolio before the funding of a LOC facility is considered. This requirement is a "deal breaker" regarding the provision of a LOC facility. If well-qualified FSPs cannot be identified, the project should not proceed.

Technical advice and capacity-building need to be linked with the availability of the fund. IFAD is entrusting FSPs with a significant asset. As such, it is imperative that they have the requisite skill base and reporting systems to successfully manage the funds lent to them. The FSPs' shortcomings will be identified during the due diligence process and the necessary remedial measures will need to be laid out. These remedial measures will be presented as part of a package deal presented to the FSPs.

The LOC must be coordinated with the strategies of other donors and private-sector actors. It is vital that, at the preliminary stage of the project design cycle, there is close coordination with other current and potential funders or lenders who are, or will be, working with IFAD's client base. This will help identify potential areas of partnership and collaboration at an early stage of the project cycle and resolve any potential conflicts. If there are no other lenders/donors operating in the project's region, it will be critical to ascertain why not, since it could be indicative of a poor credit culture, a powerful traditional credit mechanism or an extremely high transaction cost zone of operations.

Other wholesale lenders are keen to enter the rural sector. The goal of including a facility within a project is to encourage other lenders to extend funding to the rural sector or to allow a build-up of savings that will fund individual loans going forward and not to provide funding on a long-term basis. The CPMT will need to have discussions with other potential lenders during the initial design stages to confirm if and when they would be interested in providing funding in rural areas on a long-term basis (see Box 6). If a satisfactory agreement cannot be reached, or a savings mobilization strategy proves insufficient, strategies other than LOC should be considered.

Box 6: IFAD's Rural Microenterprise Development Programme (PADEMER) in Colombia

PADEMER funded credit activities through local associations of rural enterprises (ARMEs) and was successful in encouraging them to establish their own revolving credit facilities. This is an example of how IFAD can change the behaviour of lending institutions.

PADEMER cofinanced 199 projects to support the development of ARMEs, which in turn cofinanced business development plans and the provision of TA for 308 ARMEs. The number of microentrepreneurs who assisted in all phases totalled 20,167. Projects were carried out in 22 departments, covering most of the country.

PADEMER was highly relevant because its objectives and strategy for rural poverty reduction through support for rural microenterprise were effective in meeting the needs of the target population, helping to overcome the agricultural crisis that Colombia experienced in the 1990s. The project has also proven helpful for the government to build rural development policies and is also supporting efforts aimed at eliminating illicit crops. PADEMER has been identified as a "flagship project" by the Ministry of Agriculture and Rural Development.

A clear exit strategy must be developed. A clear exit strategy should be identified at the design stage. Any retail funding facility that is to be included in an IFAD project must be of a short duration, with a maximum maturity of three years and with a clearly defined exit strategy. These exit strategies can include the establishment of a sinking fund, a capital injection by an outside equity investor or a loan takeout by another lender. The CPMT will need to prepare financial projections for a three-year period of the proposed financing facility to show that it can be repaid.

Loans to the FSPs are near or at commercial rates of interest. The loans extended by the LOC must be at or near commercial rates of interest. Subsidized rates will dampen the FSPs' incentive to mobilize deposits and discourage them from accessing other sources of capital. The loan agreements with the FSPs must ensure that the terms, conditions and interests on the LOCs are at market rates and that the loans to end-borrowers financed by these LOCs are also at market rate. This will avoid donor dependency and will signal to the banking sector that the FSPs are a legitimate market for them.

Professional expertise is available at the local level to manage the fund. The facilities must be managed by an independent professional manager who has expertise in this field of activity. They must not be managed by the recipient government or by the project coordinating unit (PCU). The manager of the facility will be responsible for complying with all of the terms and conditions of the management agreement and will report regularly on the performance of the facility to both IFAD and the host government. If local professional management is not available to carry out this task, the facility should not be created (see Box 7).

Box 7: The Achievement of Market-Friendly Initiatives and Results (AMIR) Project in Jordan

AMIR was funded by United States Agency for International Development (USAID) and included a retail financing facility that was managed successfully by Citibank, Jordan. The project aimed to address poverty and increase opportunities in Jordan and to enhance its ability to create robust, sustained economic growth. Building on the successes of the Access to Microfinance and Improved Implementation of Policy Reform, the second phase of the project, known as AMIR II, worked with government and private-sector entities to enhance government efficiency, improve access to credit and accelerate job creation by expanding information and communication technology (ICT).

The USAID-funded AMIR II project partnered with the private sector to develop and implement new policies and improve institutional environments. The project fostered private sector-led growth by emphasizing trade policy, market access and customs reforms. Overall, the project assisted in drafting laws, regulations and sets of instructions to help Jordan better compete in the global economy.

To improve access to credit and investment, the AMIR II project worked with Jordan's capital and financial institutions to build a modern securities market that now attracts domestic and foreign investment in both the debt market and the equity market. Microfinance is also accessible to more people than ever before: over US$81 million has been lent on a sustainable basis to some 85,000 microentrepreneurs, 85 per cent of whom are women. Jordan is now another model for sustainable microfinance in the Middle East.

The participating FSPs should not be over-reliant on the project's LOC. The project's LOC must not be the sole or even the main source of funding for the FSP's rural loan portfolio. Instead, the funding provided by the facility should complement other sources of funding available to the FSP to finance its rural activities. If the FSP insists on 100 per cent external funding for the proposed rural portfolio, this is indicative of a lack of commitment to the success of the project and in these circumstances, IFAD should reconsider working with them (see Box 8).

There is effective monitoring and oversight by the fund manager, the PCU and the CPM. There must be close monitoring and oversight of the use of the facility at all levels of the project. Some recommended key performance indicators (KPIs) are suggested below. These indicators, together with other reports, need to be actively analysed and reviewed, and corrective actions taken, when necessary. This will require that all of the parties have a reasonable understanding of financial analysis.

The participating FSP will on-lend on a sustainable basis. The FSP must establish a sufficient mark-up over the cost of the funds so as to cover their operating costs and receive a reasonable return on the assets created. The FSP must not be seen as an entity to "pass through" subsidized credit to the end recipient.

Box 8: Rural Financial Intermediation Programme (RUFIP), Ethiopia

RUFIP has been successful in attracting lending by the commercial banking sector, both publicly and privately owned, for financing MFIs operating in the programme area. These banks are now funding 29 per cent of the total loan portfolio, with the balance being funded from the MFIs' other resources.

Impact studies conducted by the Association of Ethiopian Microfinance Institutions (AEMFIs) and RUFIP-I, such as the National Impact Assessment Study as well as the Interim Evaluation of RUFIP-I, strongly suggest that the delivery of reliable financial services had a positive impact on household incomes, asset acquisition and diversification of household livelihoods. Women account for nearly 50 per cent of the client base of Ethiopian MFIs and Rural Saving and Credit Cooperatives (RUSACCOs), which have been instrumental in unlocking their untapped potential. The studies also suggest that increased household incomes generated from the effective delivery of financial services enable the rural poor to better cope with external shocks, improve food security and enhance access to primary health care, education and potable water supply facilities, which are critical for sustained poverty reduction.

Loan availability financed by the LOC is part of a package of services offered to the clients of the FSPs. The extension of loans funded by the LOC to end-borrowers must be accompanied by a range of financial services to help tie these clients to the FSP. These other services should include savings services, safekeeping and, possibly, money transfer services (see Box 9).

Box 9: Qingling Mountain Area Poverty Alleviation Project (QMAPAP), China

QMAPAP used a LOC to make funding available through rural credit cooperatives (RCCs). It was estimated that there was an overall loan repayment rate of 92 per cent, although definitions of delinquency varied among RCCs. The programme has increased the availability of credit throughout the project region and clients who joined the RCCs mainly because of the credit availability have continued as members. The programme was also successful in targeting the poor in the rural villages. The project credit fund was channelled through the existing network of RCCs, which were the best option for rural lending at the time of design.

Around 85 per cent of the loan funds were disbursed. Since local RCCs operate independently, the performance of RCCs varied considerably. An estimated 459,300 loans were disbursed by the time of the evaluation compared to the target of 572,000 (80 per cent achievement). The expected number of loans was not attained partly due to late commencement of credit activities. Insufficient training of RCC and project staff regarding credit promotion and management was also a contributory factor.

***Support setting up of public-private partnerships (PPPs)*.** PPPs can be a valuable tool to increase access to finance for the agricultural sector. Due to the specific characteristics and risks related to this sector, public capital can be important in attracting private investors who would otherwise not be willing to take an exposure to agriculture. When structuring investment funds with a developmental objective, there is need to leverage complementary capital from the private investors. In this way, public funds might allow private investors to acquaint themselves with the sector as an exit strategy.

***Careful risk assessment and portfolio diversification*.** Agricultural production faces specific risks, including external and covariant risks, which are beyond the control of the agricultural producer, as well as the investor. These risks impact the amount and quality of yield, profitability and, therefore, return to investors. Although risk diversification is crucial for any investment vehicle, the risk assessment is needed in setting up agricultural investment funds and their portfolio diversification requires particular attention. While investments on a global scale might, for instance, contribute to a risk diversification of agricultural production in different climatic zones to be less exposed to external risk, at the same time, a focus of investments in agriculture in a particular region might be a better approach due to the potentially greater access to in-depth market knowledge on which investment decisions are based.

The role of insurance mechanisms. The role of market-based tools in managing risk, such as weather insurance or derivatives, as well as warehouse and health insurance, has become more accepted. The integration of these mechanisms as a requirement for the investees could be considered when setting up agricultural investment funds to mitigate related risk. These mechanisms can attract investors and facilitate access to capital at lower cost.

Agricultural sector knowledge of decision-making bodies. The set-up and daily operations of an investment fund requires a thorough understanding of the agricultural sector in developing countries. The need for highly specific expertise of fund managers as well as the decision-making bodies, such as boards of directors and investment committees, might be more pronounced for investments in the agricultural sector than in other asset classes and economic sectors.

The development of tailor-made products. The success of a fund depends on its tailor-made approaches. Therefore, adapting financial products and methods to the specific needs of agricultural stakeholders is considered a critical factor also for future investment funds, which can include shared risk mechanisms such as guarantees and investment enhancements. The inherent volatility and the nature of agriculture will, however, remain a challenge for financiers.

The role of impact assessment. LOC investment funds have a development objective and there is a need to ensure that it is reaching out to the target group. There is need to collect and analyse information available on impacts using qualitative and quantitative methods. While some agricultural investment funds have implemented the use of innovative tools, there has been little effort to measure impact. Therefore, the means for measuring the impact of investing should be integrated right from the beginning.

Follow-up and strategic recommendations

Before including a LOC within a project or programme, there are other alternatives that should be considered in order to create sustainable access to financial services for the targeted clientele. When considering alternatives, the overall principle should be to focus on building the capacity of FSPs and not only on providing liquidity. CGAP has developed guidelines on assessing the macro, meso and micro levels (see Box 10).

When carrying out the market assessment, it is important to note that different types of FSPs have different institutional characteristics that may limit their interest or ability to achieve the objective of sustainable financial services for the poor through a LOC.

Banks. Many banks participate in donor-funded LOCs to enhance their public image, focusing on their normal borrowers rather than on new, smaller borrowers. Even when they do extend services to new groups, they may not be motivated to continue the services after the project ends. Banks may need to revise their operating systems and products to serve a lower-income clientele. There might be need for investments in research and development of appropriate methodologies. In this case, TA may be a better incentive than a LOC, especially if liquidity is not a problem for the bank.

Non-bank financial institutions *(NBFI)*. These MFIs have a commitment to provide financial services to low-income people but since many have great difficulty in achieving profitability in rural areas, they operate in urban areas. Many MFIs are organized as NGOs without a shareholding structure that would be able to raise equity from investors, nor are they able to collect and intermediate savings.
Therefore, they are limited to grants, loans and retained earnings. As a result, they often use donor-funded LOCs to start or expand their business. LOCs to NGO MFIs should be accompanied by measures that increase the MFIs' attractiveness to commercial lenders. These may include TA to develop products, delivery mechanisms and systems that improve profitability, installation of strong management information systems, external audit and ratings by independent rating companies. Some MFIs have been established as NBFIs with a shareholding structure or transformed from an NGO structure in order to avoid limitations inherent in the NGO model. Experience has shown that transformation can be a long, difficult and expensive process, and may require TA over an extended period.

Box 10: How to use external support and subsidies without undermining the growth of the private sector

CGAP has created guidelines at the micro, meso and macro levels to address the appropriate use of external support and subsidies without undermining the growth of the private sector (CGAP 2006b). The guidelines include the following recommendations:

Verify that credit is actually needed (the main constraints may lie elsewhere, such as in weak infrastructure, poor production technology, limited market access).

Avoid using microcredit merely as a resource transfer mechanism for high-risk groups when other methods may be more efficient (such as safety net programmes for vulnerable groups).

Provide flexible grant funding to cover research, product refinement and development, and TA for capacity-building.

Support FSPs in progressively intermediating commercial funds and deposits.

Allow FSPs to set their own pricing policies, encourage them to be transparent and avoid compelling them to charge below-market interest rates on loans or rates lower than necessary to cover costs in the medium term.

Price loans to financial institutions at commercial or near-commercial rates to avoid undermining incentives to mobilize deposits or tap other local sources of capital.

Phase out grants and subsidized loans gradually as local and international commercial capital markets and domestic savers become viable sources of capital.

Promote transparency and accountability through regular financial reporting and third-party performance assessments and ratings.

Support research and development on the use of technology for, for example, points of service, transfer and payment mechanisms, and credit bureaus.

Support interest rate liberalization through education and advocacy.

Avoid direct provision of credit services by a government, government-mandated portfolio quotas, directed credit, borrower loan guarantees or operational subsidies. Exceptions may be appropriate for well-run programmes that serve hard-to-reach populations.

Encourage adaptation of policy and legal frameworks that increase competition and improve the quality of services available for poor people.

Build the capacity of key government staff in ministries of finance and central banks.

Financial cooperatives (including credit unions) and their governance are savings-led. External LOCs can damage cooperatives by diminishing members' motivation to save and by creating unhealthy borrower domination in the governance structure. This outcome has been so widespread that LOCs to cooperatives should generally be avoided.

Retail credit delivery by government entities is a challenge. Practical political incentives of government officials run directly counter to the norms of sound practice in credit delivery. Hence, retail credit delivery by government bodies, or by entities subject to government influence, is rarely successful. The successes are cases where the lending body is isolated from political pressure on the amount or recipients of lending.

LOCs have limitations for achieving the objective of sustainable financial services for the poor. Liquidity is often not the constraint that limits poor people's access to loans. The most common constraints are: low interest of financial intermediaries in serving the financial needs of the poor; weak capacity in institutions that are interested in serving poor borrowers; and less credible and/or unbankable business plans by the poor borrowers.

Funding for TA is often essential. Since governments are often reluctant to borrow for TA, it is important to explain to them why TA is needed to achieve long-term sustainability. Limited government funding for TA can also be accompanied by strategic alliances with other donors that have relevant grant instruments.

The skill set of TA providers needs to match the needs of the organization. Firms that provide TA to MFIs or cooperatives may not have the skills to provide TA to banks. Insist that TA providers document the content of the assistance provided so that it can be reviewed during supervision by a qualified rural finance specialist. It is important to note that small LOCs in large projects often do not receive sufficient technical support for successful implementation. If the LOC is a small percentage of total funding, it may be regarded as less important than other aspects of the project and, thus, receive inadequate attention from the design team. But even small LOCs can hinder the development of local financial markets.

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