PROJECT CLUSTER EVALUATION

on Rural Finance in East and Southern Africa (ESA)

IOE | IFAD Investing in rural people

Independent Office of Evaluation

Executive summary

A. Background

1. This evaluation is the second of its kind, as Project Cluster Evaluations (PCE) are a relatively new evaluation product of IOE that combine the assessment of several projects in the same thematic area and aim to synthesize results through a comparative analysis. The objective is to generate learnings that strengthen existing policies and toolkits and inform the design and implementation of future projects in the thematic area. The topic of rural finance is highly relevant in IFAD's portfolio, considering that it has invested over US$3 billion in rural finance systems over the past four decades. The focus on one region, namely East and Southern Africa (ESA), makes a comparison between different projects more meaningful, as many countries in the region face similar challenges related to expansion of rural finance markets.

2. **Evaluation scope and approach.** The PCE analysed three projects focused on rural finance in the ESA Region, covering all activities implemented under these projects. The three projects were selected by IOE based on criteria such as recent completion, a minimum duration of 6.5 years and a start date which followed the introduction of the IFAD Rural Finance Policy of 2009. Preference was given to projects with interventions at different levels of the financial sector i.e. institutional level (micro), financial infrastructure (meso), and policy and regulatory level (macro). Also, priority was given to projects with a wider variety of partners, ranging from village-based financial organizations to commercial banks. The following three projects were selected for the PCE by IOE and agreed to by ESA: Programme for Rural Outreach of Financial Innovations and Technologies (PROFIT) in Kenya; Rural Finance Expansion Programme (RUFEP) in Zambia; and Rural Financial Intermediation Programme II (RUFIP II) in Ethiopia. The evaluation applied a mixed-methods approach, triangulating evidence from different sources and methods, to answer questions in line with the evaluation framework. Emphasis was placed on comparative analysis among projects to extract common lessons. The evaluation did not assign ratings to projects, in line with the 2022 Evaluation Manual guidance for PCEs.

B. Main findings

3. **Relevance.** All three projects were relevant to the target groups' needs as they addressed weak areas of the countries' rural finance sector, aligning with government priorities. The projects shared the objective of increasing the supply of financial services in rural areas, although they differed in their intervention approach. All projects had an element of strengthening business capacities of financial service providers (FSPs), such as microfinance banks, commercial banks and community-based financial institutions. Only two of the three projects implemented a line of credit, which provided subsidized finance to FSPs. Projects differed in their inclusion of more sophisticated mechanisms such as credit guarantee schemes, which, while being relevant, added to the complexity of design and led to delays in implementation. Regarding targeting, all projects had weaknesses in properly identifying their ultimate beneficiaries and relied on the client base of FSPs, without sufficiently clear mechanisms to ensure inclusion of target groups such as women and youth. This was somewhat mitigated by the projects' use of a wide range of financial service providers.

4. **Effectiveness.** All projects achieved their targets, although with delays; and in the case of PROFIT (Kenya), temporarily marked as a problem project. The main achievements are the increased number of individuals benefiting from access to financial services as a result of stronger capacities of FSPs; and in Kenya and Ethiopia, a greater supply of credit through lines of credit. Reported numbers of beneficiaries reached by the projects are: 441,091 in Kenya; 14,202,645 in Ethiopia; and 643,449 in Zambia. While the choice of FSPs by the projects was conducive to these achievements, the benefits gained by the FSPs were not sufficiently passed on

to clients. FSPs benefited from subsidized credit in Ethiopia and Kenya, and significant capacity development in Zambia. This enabled them to reach more clients, however, it has not resulted in more favourable conditions or services for clients, such as lower interest rates or reduced loan fees.

5. **Efficiency.** The three projects had different intervention approaches and tools to reach similar objectives. Comparing these approaches illustrates that traditional interventions such as lines of credit to FSPs remain relevant given the high demand for credit in rural areas. At the same time, more sophisticated tools such as credit guarantees and matching grants for innovation present opportunities for greater efficiency as they can leverage resources from the private sector. In all projects training of trainers activities faced challenges in their implementation, making them a less desirable approach.

6. **Impact.** Impact data was only available for the projects in Kenya and Ethiopia as RUFEP (Zambia) had not yet conducted an impact assessment. The impact assessments indicate that project impacts included accumulation of assets, improved food security and reduced poverty. For instance asset ownership increased by 54 percent in Kenya and 56 percent in Ethiopia. These increases were enabled by greater farmer incomes as a result of higher agricultural yields, made possible by expanded access to credit. In Kenya, 53 percent of households reported an average increase in agricultural yields of 49 percent, while in Ethiopia increased yields resulted in an eightfold increase in household income on average.

7. **Sustainability.** Sustainability of results is mixed. Sustainability may result from the fact that all three projects supported community-level organizations, which are having a positive effect on savings culture. On the other hand, FSP's reliance on subsidized finance, low capacities and a remaining widespread perception of high risks in serving smallholder farmers will limit the sustainability of project results. While the projects didn't consistently track financial performance indicators of FSPs, thereby making it difficult to assess their financial sustainability, there are promising indications from most FSPs. In Ethiopia, the operational self-sufficiency (OSS) rate of MFIs increased from 1.71 to 2.26, signalling a strengthened financial position. The OSS of rural savings and credit cooperatives (RuSACCOs) declined from 5.51 in 2015 to 3.38 in 2018 but is still a satisfactory rate to ensure sustainability of the institutions. It is, however, of concern that during the observed time period, expenditures increased at a higher rate than revenues. This indicates that technical assistance from the project was not sufficient to improve internal efficiency in the RuSACCO sector and further technical assistance will be required in the future. In Kenya, the savings and credit cooperatives (SACCOs) involved in the project remain in strong financial positions, with return on assets of 1.05 percent and a ratio of operating expenses to financial income of 19 percent. The microfinance banking sector, however, showed significant weaknesses and reported losses from 2015 to 2021, posing overall sustainability risks.

8. **Gender.** The projects lacked a clear strategy to ensure the engagement of marginalized groups, including women and youth, and operated under the optimistic assumption that FSPs would include such groups in their services. Ultimately, there was equal participation of women and men in project services, however there is no evidence this has led to greater gender equality or women empowerment.

C. Conclusions

9. **The absence of in-depth target group segmentation and the lack of clear targeting strategies remain major weaknesses across the projects.** The target groups were too broadly defined and not segmented according to the need for

financial services by different groups in the rural community.[1] In addition, the arrangements between the projects and the FSPs were insufficient to ensure that the target groups will be reached. In Kenya, activities such as the financial graduation were effective in reaching the poorest segments of the population and in helping them develop productive activities. Aside from this, projects appear to have delegated targeting efforts to FSPs by providing guidelines and training on reaching vulnerable and marginalized groups, which, however, is often not aligned with the business needs of FSPs who still require collateral and other forms of guarantees which marginalized groups don't have.

10. **The identification, engagement, capacity development and monitoring of FSPs remain critical for effective implementation and still require efforts by IFAD to be fully realized**. Each project conducted a pre-design assessment of the rural finance landscape in their country to determine the strengths and weaknesses of the potential FSPs. This resulted in a relevant approach to engage them and build their capacity. These assessments included valuable analysis of the countries' macroeconomic factors and regulatory environment, market structure and infrastructure, financial institutions, risk factors, technology and innovation. While these areas of analysis were important at the design phase, the most important aspect of the pre-design assessments was a review of FSP's capacity to reach out to the intended target group, for example by looking at their product range, terms and conditions, branch network and outreach strategy. Despite these assessment, the subsequent monitoring agreements made with FSPs, and the capacity-building activities were insufficient to ensure their reporting on the ultimate beneficiaries and the utilization of financial services, especially loans. Projects' engagement with apex institutions was also appropriate to ensure outreach to FSPs, however various implementation challenges did not allow the technical assistance to FSPs to be fully realized.

11. **High operational cost is still a major reason for insufficient supply of rural financial services; technological advancements and innovative approaches are needed to reduce such cost.** Reducing the cost of reaching potential clients using technology and bridging the "last mile" through cost-effective approaches are key to making rural finance more inclusive. To effectively increase financial inclusion in rural areas, it is necessary to promote the use of alternative delivery channels such as digital technology and agents rather than relying solely on the physical presence of FSPs. This approach can be successful if the necessary infrastructure is in place to support these innovations. It must be noted, however, that in the assessed projects, the use of technology or of innovative models, such as agent banking, have led mainly to an increase in services such as savings and transfers; rural credit still largely relies on physical contact between FSP staff and clients.

12. **Weak FSP institutional capacity remains a core challenge of the sector**. The technical assistance was often delayed or of insufficient quality to substantially expand the capacities of FSPs in a sustainable way. As such, FSPs remain vulnerable to dependence on subsidized finance, external shocks and a potential mission drift as they may shift away from agriculture. The projects were not entirely successful in mitigating these risks.

13. **Continued demand for financial services by the target groups is promising as farmers have proven able to reap the benefits of financial services.**

[1] As an example, credit for agricultural production, processing, and marketing is often lumped together; during field interviews, however, it became apparent that the latter group–agricultural marketers–had little difficulty in accessing loans even from FSPs that were not associated with IFAD projects. Similarly, no distinctions were made on what loan size brackets were most underfunded and what could be done to target those loan brackets through IFAD interventions.

Experiences from all three projects illustrate that the initial assessment of high demand for financial services and high potential growth by farmers was correct, and the increased supply of such services through the projects' diverse approaches has yielded results. Furthermore, the engagement with communities has visibly increased a culture of savings, which is likely to continue benefiting households after the projects' end.

14. **High risk perception of agriculture remains a reason for some FSPs to avoid rural finance.** This occurs despite evidence showing that agricultural lending can be a profitable business, provided FSPs have access to adequate refinancing, possess the skills to assess cash flow and risks of agricultural businesses, and have financial products that are tailored to the needs of rural enterprises—for example with regards to repayment schedules. The three projects missed an opportunity to compile this body of evidence which demonstrates that the viability of agricultural finance is higher than most FSPs perceive. These projects are well positioned to better communicate such findings and contribute to shaping a new narrative around agricultural finance. In this context, it is important to note that the riskiness of agricultural lending is partly overstated through common portfolio quality measurements such as non-performing loans (NPLs). For example, in Kenya an assessment of portfolio quality in 2020 concluded that portfolio NPLs for agricultural lending ranged from 50 to 100 per cent higher than the rest of the portfolio (Mercy Corps, 2021). However, during interviews of the PCE mission team, interviewed FSPs stated that write-offs of agricultural loans occurred at a similar rate to the rest of the portfolio. Farmers who suffered harvest losses often missed payments (thus, leading to higher NPLs) but mostly still repaid during subsequent harvests after rescheduling. Therefore, high NPLs may sometimes simply indicate that loan products are not suited to the cash flows of farmers (e.g. allowing for longer grace periods).

15. **Projects need dedicated gender strategies to ensure participation and empowerment of women**. This implies earmarking financial and human resources to develop and implement gender-sensitive activities and designing monitoring and evaluation (M&E) systems that are able to capture gender-sensitive data, aside from sex-disaggregated data for basic indicators (e.g. number of clients). Despite the final achievements of equal participation of women and men , there wasn't a strategy to ensure this would lead to greater empowerment and equality. The projects worked on the implicit assumption that women would have equal access to financial services, particularly when working with community-based FSPs and use group lending technologies that tend to encourage women's participation. However, there were no dedicated efforts to increase the participation of women, other than setting targets and providing directives to FPS to report on gender disaggregated data. Capacity building of implementing partners and government institutions to create awareness among women of available financial services and improve gender ratings for loan and grant portfolio was lacking or insufficient to make a noticeable impact.

16. **The design of M&E systems was a problem across all observed projects**. There were often wrong expectations of what implementing partners, in particular FSPs, could provide. FSP generally only track information that is important for them to conduct their business, such as disbursement data. Most of the time they do not have the capacity nor resources to track how their loans were effectively used nor what the impact of the loan was. Projects have not sufficiently recognized the limitations of FSPs, and the capacity development activities were not sufficient to ensure FSPs were able to appropriately support the projects' M&E systems. The performance of M&E was therefore mixed in the three projects, with Zambia performing rather better.

D. Lessons

17. **This evaluation shows there is no one-fits-all solution for rural finance as projects had diverse approaches in achieving their results**. The experience in the ESA region shows that different project approaches can be successful if they sufficiently factor in the particularities of each partner country. Depending on the project objectives and the target group definition, working with commercial banks may be as viable of a project approach as working with smaller financial institutions or community-level organizations. Projects working only on the micro-level or those that tackle challenges at different levels of the financial sector may all be successful: it all depends on a sound analysis of the key bottlenecks of rural finance in each country and which activities with which partners are essential to unlock the potential of rural finance.

18. **The involvement of community-based financial institutions, including RuSACCOs continue to play a very important role to reach out to smallholder farmers.** Formal FSPs are still not widely available in rural areas, therefore, continued involvement and strengthening of community-based financial institutions (CBFIs) are key to improved financial inclusion in these areas. All three projects strengthened the relevance of their approach by working through a broad range of FSPs, which proved an effective strategy to ensure a broad outreach and contribute to sustainability of results. Formal FSPs are still not widely available in rural areas, therefore, continued involvement and strengthening of community-based financial institutions (CBFIs) are key to improved financial inclusion in these areas. In addition, it is also important to encourage the connection between formal FSPs and CBFIs to provide formal financial inclusion and larger loan sizes for the members of CBFIs and to facilitate their refinancing.

19. **Line of credit (LOC) to FSPs is still the most popular financing instrument in IFAD's rural finance interventions because it is comparatively easy to implement**. Limited access to refinance for FSPs is undoubtedly one reason for limited flows of investment in rural areas. Therefore, LOC provided by IFAD projects was an appropriate choice of financing instrument.

20. **Credit guarantee can be an effective financial instrument to leverage funds without compromising portfolio quality of underlying agricultural loans.** One common argument against credit guarantee instruments is that FSPs may be tempted to lower their standards for credit appraisal procedures for guaranteed loans. However, the experience in Kenya shows that this is not necessarily the case, particularly when working with highly professional financial institutions such as the commercial bank involved in the scheme.

21. **Comparison of the three projects indicates that a key success factor is a good match between the complexity of the project approach, the project management, and the quality of IFAD supervision.** The complex and often intertwined problems in rural finance require projects that are designed to address challenges at different levels of the market either simultaneously or in a sequenced manner. This, however, requires significant investment in project management capacity, starting with sufficiently and adequately staffed management units and M&E systems.

22. **There is a need to put stronger emphasis on consumer protection, for example, related to transparency on interest rates and applicable fees for financial services.** There is a much stronger emphasis on increasing access to rural finance than on ensuring that clients are sufficiently protected. There are still common practices by rural financial institutions that pose risks to their clients, for example, interest rate and fee structures are often not made clear to farmers. The full cost of loans is often misrepresented because interest rates are sometimes stated in yearly and monthly rates, flat or reducing balance, etc. Furthermore, processing fees and other administrative fees are not included in information materials for

clients, even though these additional costs can be significant. Some products, such as currently very popular mobile phone emergency loans, carry very high interest rates. For example, in Kenya such loans may carry annualized interest rates of over 100 per cent.

23. **In order to attract young people to agriculture, special attention must be given to developing financial products that suit the agricultural ventures and production factors available to youth.** Attracting youth to the agricultural sector is important for the transformation of the rural economy; rural finance can support this process by providing the necessary financial products that suit the business of young agri-entrepreneurs. Traditional farming businesses are often not attractive for the younger generation. Still, there is interest in agriculture and agriculture-related business by young people if, for example, mechanization or innovative agricultural business models that use digitization is involved. Special attention must be given to financial products that suit the needs of young people, factor in their limitations (e.g. lack of land titles) and understanding the business ventures in agriculture that young people pursue.

24. **Financial literacy plays an important role in improving financial inclusion in rural areas and protecting clients.** People who are financially literate are more likely to use financial services and products and feel confident interacting with FSPs. Therefore, it is important to increase financial literacy training in rural areas through existing community structures such as cooperatives and savings groups; and to ensure that rural households can make informed decisions about which financial services they need and know the costs of accessing those services.

E. Recommendations

25. The evaluation makes five recommendations to the IFAD regional team in ESA and country teams in Ethiopia, Kenya and Zambia. The key issues that the recommendations seek to address are: i) benefits obtained by FSPs through a subsidized line of credit from the project are not being sufficiently passed on to FSP clients; ii) the need for FSPs to have clear requirements by the project around targeting, reporting on client outreach, and reporting on their financial performance as a mechanism to inform project management; and iii) the need for greater efforts by IFAD to provide technical guidance on targeting, gender and monitoring.

Recommendation 1: Develop mechanisms at the design stage to ensure that FSPs use the benefits they received to increase customer value for target groups. In many instances, IFAD-supported projects provide financing at favourable rates to FSPs. The benefits of such subsidized financing should be passed to clients, for example, by reducing interest rates or by making terms and conditions more beneficial to the target audience (e.g. loan tenures, grace periods, etc.). In instances where there are serious concerns that offering subsidized credit to target groups may have negative impact on long-term market development, FSPs should be required to provide tangible benefits to the projects for their privilege to access subsidized refinance. Such benefits could be, for example, by ensuring greater outreach efforts to serve remote or marginalized groups.

Recommendation 2: IFAD should require and provide guidance to Project Management Units to conduct thorough assessments of the capacities of FSPs, and to set mutually clear expectations of the implementation, targeting and reporting requirements. Considering the importance of evidence-based project management, it is key that the M&E capacity of any potential project partner, is taken into account during the selection process. This does not mean that only FSPs that already have sufficient M&E capacity should be considered, but also those that show the potential and commitment to develop an M&E system for project monitoring. Capacity development of FSPs needs to be timely and occur before any other support is provided to the FSP, to ensure it has the necessary skills in place to be an effective partner of the project. While investing in social performance

monitoring comes at a cost for FSPs, such an investment should easily be outweighed by the benefits that they receive from participating in IFAD interventions, e.g. by accessing subsidized funds.

Recommendation 3: Require that project design and M&E systems collect financial sector-specific data and a more accurate counting of beneficiaries, to inform project management. It is important that FSPs provide more rural finance-specific data in their reports to IFAD. Currently, supervision and other reports provide very little insight on financial aspects and ratios of FSPs, such as interest rates, default rates, etc. Such information is key to allowing rural finance experts to assess the status of projects and provide recommendations on how to further improve. Also, IFAD should provide technical guidance and require that monitoring systems of rural finance projects are able to differentiate between new clients and recurrent clients of FSPs to assess the actual number of beneficiaries reached. To have a better understanding of a project's effectiveness and on how an IFAD intervention impacts rural financial inclusion, it is key to understand how many households in rural areas were effectively served. The reporting should, therefore, contain information on the number of loans and volumes disbursed (as a measurement of the increase in rural investment) as well as of the number of households served, thus excluding recurrent clients (as a measurement of the contribution to financial inclusion).

26. **Recommendation 4: Provide more substantial technical guidance on gender equality and women's empowerment at project design and implementation stages**. Ongoing and future IFAD rural finance projects and their implementing agencies need to have well-articulated gender strategies; adequate human and financial resources to implement such strategies; and develop realistic targets for women's participation in project activities adequately supported by a gender sensitize monitoring and evaluation system. These need to then be followed up on during the early implementation stages to ensure project management units and implementing partners are aware of their importance.

27. **Recommendation 5: Provide greater technical guidance on targeting strategies that address the needs of disadvantaged groups such as the youth**. Projects must factor in the needs of young people to assess which FSPs are in the best position to serve this target group and what financial products and services are most needed. IFAD and its partners need to allocate sufficient human and financial resources to implement such youth-centric strategies. To ensure that project steering can address the needs of youth, appropriate monitoring and evaluation arrangements must be made.