

International Fund for Agricultural Development (IFAD)

Letter to Management

Executive Summary

A team comprising Heather Clark of UNCDF/UNDP, Hege Gulli of NORAD, and Douglas Pearce and Alexia Latortue of CGAP conducted a Donor Peer Review of IFAD in Rome from 17-21 June, 2002. The review is part of a 21-agency initiative launched by UK Secretary of State Clare Short and CGAP to tackle aid effectiveness by using microfinance as a test case.

The Peer Review focused on the internal procedures, practices and processes of IFAD to identify the success factors and constraints that influence the effectiveness of the agency's microfinance operations. The Rural Finance Advisor provided the team with an orientation to IFAD and organized meetings with around 35 staff members from the five regional divisions, the Technical Advisory Division, Office of Evaluation and Studies, the Finance and Administration Department and UNOPS. The team met with Vice-President Enweze on 20 June and briefed Mr. Klemens van de Sand, several division heads and staff on its initial findings on 21 June.

The Peer Review team found its visit to be timely given the current strategic shift in how IFAD supports rural finance. The team hopes that this letter to management will enrich internal discussions and provide specific ideas of how IFAD can accelerate the implementation of its Rural Finance Policy and move toward better serving the rural poor with financial services.

This letter outlines IFAD's strengths and challenges, and presents a number of specific recommendations for change. A matrix at the end of the letter provides a summary of the key findings and recommendations organized around six strategic areas.

The Peer Review team's recommendations address the lag between the strategic shift (from credit as an input to financial services for the rural poor) and IFAD's institutional culture, processes and systems. The team's suggested actions for change fall into four main categories:

- ***Achieve Agency-wide Vision and Operational Plan for Rural Finance.*** IFAD should attain a clear vision across the agency of what rural finance is and how the new strategic shift can be implemented across the agency.
- ***Manage for Results.*** IFAD should obtain better knowledge of its rural finance portfolio, introduce steps to improve quality, and make decisions based on performance regarding project design, partner selection, and project supervision.
- ***Enhance Technical Capacity and Strengthen the Proactive Role of the Rural Finance Advisor.*** IFAD should enhance its technical capacity internally (CPMs) and across all partners (consultants, implementing partners, cooperating agencies, and PMU staff) who work on IFAD-supported projects.
- ***Facilitate Learning.*** IFAD should promote learning within and across regions, between the field and Rome, and with other donors to encourage innovations in rural finance.

Background

Early in 2002, CGAP and DFID's Secretary of State Clare Short launched an initiative to improve aid effectiveness, using microfinance as a test case. As a first step in this initiative, more than 20 bilateral and multilateral development assistance agencies have volunteered to participate in a series of Donor Peer Reviews. These Peer Reviews are not evaluations or detailed portfolio reviews, but rather focus on each agency's internal procedures, processes, practices and systems to identify success factors and constraints to good practices in microfinance.

The short but intensive reviews will result in concrete recommendations for each agency and should lead to senior management commitment to specific changes that improve the effectiveness of microfinance operations. It is expected that the analysis and recommendations may also apply to other areas of development assistance pursued by each agency.

A Peer Review team including Heather Clark, Director, Special Unit for Microfinance of UNCDF/UNDP, Hege Gulli, Microfinance Advisor of NORAD, and Douglas Pearce and Alexia Latortue, Microfinance Specialists at CGAP visited IFAD in Rome from 17-21 June, 2002. The review team interviewed over 35 people from the five regional divisions, the Technical Advisory Division, Office of Evaluation and Studies, Finance and Administration Department, and UNOPS. In addition, a field visit to Uganda was conducted from 29 April-3 May 2002.

The Peer Review team's findings for IFAD, contained in this letter to management, will be combined with those from other agencies in a synthesis report. The overall results and follow-up actions will be discussed in a meeting hosted by Clare Short in Rabat, Morocco on 9 September, 2002. A final meeting of Ministers and heads of agencies participating in the peer reviews will be organized upon completion of all the reviews in 2003 to share experiences and changes made as a result of the exercise.

This letter outlines IFAD's strengths and challenges with respect to applying good practices in microfinance. It then presents a number of specific recommendations. Finally, a summary matrix presents the key findings and recommendations according to six analytical areas.

Strengths

IFAD stands out among the development assistance community in its exclusive commitment to rural poverty reduction. With 75 percent of the world's 1.2 billion extremely poor people living in rural areas, the Fund has an important contribution to make in helping to meet the Millennium Development Goals (MDGs).

IFAD's strategy for poverty reduction and broad-based growth, as laid out in the *Rural Poverty Report 2001*, hinges on increasing access to a variety of assets for the rural poor. As the *Strategic Framework for IFAD 2002-2006* notes, there is a strong complementarity among the variety of assets the poor need: 1) human and social assets; 2) productive assets and technology; and 3) financial assets and markets. IFAD's approach is highly consistent with the emerging vision of building financial systems for the poor, which entails ensuring permanent access to a

wide range of client-responsive financial services including savings, credit, insurance, payments and remittances for the rural and urban poor. Although not a panacea, evidence shows that the poor use this broad range of financial services to make their own decisions about investing in various types of assets, from education for their children, productive assets of all types, and business opportunities.

Building on this deep commitment to rural poverty reduction, IFAD exhibits the following strengths related to financial services for the poor:

- Staff demonstrate strong allegiance to IFAD’s mission of working with the poor and the poorest in the most remote rural areas. This mission-driven approach presents opportunities for deep outreach and innovation as IFAD works in areas where others will not go and struggles to find solutions to the multi-faceted problems facing its core target group.
- IFAD’s long history of specialization in rural poverty reduction, with about 30 percent of the overall portfolio in rural financial services, has resulted in a wealth of experience in both successful and less successful approaches. Moreover, IFAD’s international staff possess deep commitment to respecting country-level realities, expertise in rural development and an intimate understanding of the project development process.
- The existence of a Technical Advisory Division (PT) that does not manage its own portfolio and is dedicated to supporting regional divisions is an important source of in-house technical expertise. The rural finance advisor (PT/RF)—though just one—has strong expertise.
- Though somewhat complex and not always exploited appropriately, the project development cycle offers potential for program coherence in IFAD’s country interventions, quality assurance early in the inception and formulation stages, and teamwork across divisions. COSOPs can provide a good framework for defining appropriate value-added interventions for IFAD. The PDT, when used as envisioned, allows for the early input of technical expertise and ideas from across the Fund.
- IFAD has the ability to introduce some flexibility in the choice of instruments and the structure of loan agreements. The grant facilities, for example the TAGs, provide CPMs a degree of leeway to seize opportunities to directly support innovative initiatives that require small amounts of funding. New creative ways to introduce performance-based criteria and conditionality clauses in loan agreements present as-of-yet under-exploited opportunities for increased influence and quality control.

Challenges and Creative Tensions

Notwithstanding the strengths outlined above, IFAD faces a number of challenges and creative tensions to maximizing its effectiveness in ensuring the permanent availability of financial services to the rural poor.

Challenges

- *Implementation of strategic shift.* IFAD appears to be in a critical period of transition in how it supports rural finance. This transition is due to both necessity (the failure of state-owned banks) and IFAD's interest in new approaches to serving the rural poor with financial services. This strategic shift from supply-led agricultural credit as an input toward demand-led rural financial services presents fundamental challenges, as IFAD's institutional culture, processes and systems lag behind the shift. Although IFAD's Policy on Rural Finance provides a definition of rural finance, there is no clear common understanding among staff of what rural finance, microfinance, and agricultural finance is at IFAD and their interrelationships. Moreover, the new emphasis on institution building and policy work is not currently matched by changes in instruments and capacity.
- *Considerable approval pressure.* There is considerable approval pressure. CPMs are stretched for time and often prioritize project preparation for Board approval, sometimes to the detriment of technical coherence in design, quality assurance, supervision and monitoring, and learning. With just three approval cycles per year, it appears difficult to stop projects or request serious modifications to project designs that might ensue in delaying the presentation to the Board.
- *Ad-hoc technical input in design phase.* The effectiveness of PT/RF's contribution at the COSOP, PDT and TRC stages depends in large part on whether CPMs actively seek PT/RF's inputs early on and whether rural finance is a sufficiently large project component for the RF advisor to serve as lead advisor. Small rural finance components may be "lost" amidst other project objectives and may be less visible to PT/RF. This ad-hoc involvement of PT/RF in the early design stages has a negative impact on rural finance programming quality, especially since projects and budgets are usually well-defined during formulation. Moreover, the timing of the mandatory TRC process often creates an adversarial environment, where PT may be viewed as a hurdle to clear rather than as a supportive technical partner.
- *Reliance on small group of consultants.* CPMs are mostly generalists and country-specific experts without much sectoral expertise. Many tend to rely on a small group of consultants, for the bulk of design work, on the basis of long-term relationships, rather than seek out new consultants with fresh technical ideas.
- *Limited information on performance.* Basic information on the performance of financial intermediaries is lacking. Cooperating agencies produce volumes of information that is activity or input/output-based rather than performance-based. This monitoring approach presents risks. The timely tracking of financial, efficiency and outreach indicators is vital to get early warning signals about financial intermediaries' health and the satisfaction of clients before it is too late and the institutions fail.
- *Appropriateness of main instrument.* As is the case with other multilateral development agencies, IFAD's main instrument—loans to governments—presents challenges. IFAD's new demand-led approach and support for the development of financial markets and services

requires high levels of specialization and does not lend itself to direct participation by most types of government agencies.

- *Implementation of the Rural Finance policy.* The Rural Finance policy is not yet consistently recognized and applied throughout IFAD. The Decision Tools (DTs) have been recently finalized to operationalize the broad objectives of the policy. The challenge will be to ensure that the DTs are reflected in the reality of IFAD operations in the field.
- *Insufficient learning.* Although some informal networks exist, there is limited systematic cross-fertilization of ideas within and among regional divisions. This limited exchange of ideas inhibits institutional learning in a field—rural finance—that requires innovations to meet the dual objectives of depth of outreach and sustainability. In addition, new project designs do not benefit as much as they could from lessons due to weak feedback loops between the field and Rome. The outsourced supervision to cooperating agencies results in much of the ground-level knowledge staying with implementing partners and consultants.
- *Unclear incentives.* The Peer Review team could not detect any incentive—positive or negative—for IFAD staff to manage a portfolio of quality investments. While staff seem personally motivated to do well, the present system seems to neither reward good work nor sanction poor performance. The apparent lack of incentives is reinforced by a performance evaluation system that some IFAD staff interviewed describe as perfunctory. This institutional culture, coupled with a relatively flat organizational structure that does not provide many career advancement opportunities, may de-motivate hard working staff.

Creative Tensions In addition to the challenges noted above, the review team observed some creative tensions that present opportunities, but may also dissipate effectiveness if not addressed.

- **Regional Specificity vs. Common Minimum Standards.** The premium placed on respect for the specificity of country and regional contexts is sometimes used as a justification for not accepting policy guidance and basic standards of sound financial intermediation that hold true regardless of geography or methodology.
- **Focus on Impact vs. Implementation Support.** The Board's signal to focus on impact does not explicitly address IFAD's unclear mandate in regards to implementation support. To ensure impact, getting, analyzing and using information effectively during project implementation must be a priority. Knowledge of financial intermediaries' performance is a pre-requisite for acquiring meaningful impact data at the client level.
- **Policy Role vs. Field Presence.** Effective policy work requires good knowledge of local stakeholders, experience and accompanying technical skills in upstream work, and continual engagement at high levels. IFAD's move towards upstream policy work raises questions of comparative advantage, given its lack of local presence.
- **Innovation Focus vs. Instruments.** IFAD focuses on innovation, yet its main instrument is not best suited to support this. Convincing governments to take loans for institution-building and including small pilot projects in large credit lines is difficult. This challenge is especially accentuated in the case of non-concessional loans.

Recommendations

The Donor Peer Review team has specific recommendations for IFAD that build on the on-going internal reflection and reform initiatives: the 1996 work of the Project Cycle Re-engineering Working Group; the Rural Finance Policy; the *Divisional Plan: the Technical Advisory Division (PT) 2002 and Beyond*; the *Strategic Framework for IFAD 2002-2006*; *Operationalizing the Strategic Framework of the PD Retreat 2002*; and the draft Decision Tools.

The recommendations are offered in the spirit of strengthening the process to fully implement the strategic shift that IFAD has already begun:

Credit as an Input	Financial Services for the Rural Poor
Agricultural and state-owned banks	→ Pro-poor rural financial institutions
Supply-led agricultural credit	→ Demand-led rural financial services
Large, multi-sector projects	→ Discrete sizeable rural finance components or 100% stand alone projects
Emphasis on design and -loan agreement	→ Better understanding and monitoring of rural financial institutions and implementing partners
One-off credit, time bound to length of Project	→ On-going relationship with financial intermediaries to build permanent capacity through grants and loans
Subsidized interest rates, depleting capital	→ Cost-recovery/commercial interest rates, revolving capital
Delivery managed through project management units (public)	→ Delivery managed by specialized financial intermediaries (private)
Generalists, technical know-how not incorporated in design	→ Specialist, technical input early on in concept and design stages
Accountability for activities: size of target group and number of loans	→ Accountability for performance: clear indicators on efficiency, financial viability and outreach

Specific recommendations, grouped in four categories, for IFAD to build on its strengths and improve its effectiveness in supporting rural financial services for the poor are offered below.

- 1) IFAD should **achieve an agency-wide vision** for its new approach to rural finance and determine how to **operationalize its strategic shift**, building on its comparative advantage. Specific operational recommendations include:
 - *Develop common vocabulary and vision statement.* IFAD should commission PT/RF to draft a concise *Vision Statement* that defines the strategic shift for the agency as a whole and identifies what IFAD will and will not support. The *Vision Statement* should draw from the Rural Finance policy and DTs to develop operational definitions for what microfinance, rural finance, rural microfinance, and agricultural finance mean internally.
 - *Demonstrate leadership's commitment to the shift.* Top management should clearly signal its support for the *Vision Statement* once consensus is achieved and it is finalized. This signal should come from the highest possible level.
 - *Ensure the understanding and application of the DTs.* IFAD should hold in-house trainings and consultations on the content and implications of the DTs. These meetings could occur over a period of time and focus on discrete parts of the DTs.
 - *Focus on comparative advantage in policy work.* Donor agencies can work on policy issues at several levels: macro policy, legislation, regulatory framework, and norms and practices.

Given its size, staff expertise, and lack of field presence, IFAD should primarily engage in developing norms, practices and showcases of what can work in rural finance. IFAD could leverage its grant funds and relationships with other donors to fund innovative rural finance pilots that would be of interest to policy makers.

2) While respecting the time constraints of CPMs and the institutional focus on design, IFAD should institute mechanisms to **manage for results**. Some specific operational recommendations include:

- *Develop questions for rural finance components and projects.* Use the DTs and CGAP's *12 Questions* to establish a list of basic questions that all CPMs, regional division heads, PT advisors, and others should ask of projects with credit/finance components, however small they might be. This up-front filter could help ensure the early involvement of PT/RF and uncover major design flaws. The questions could also be adapted for the Board.
- *Undertake portfolio reviews.* Efforts to improve performance and results should be based on knowledge of the existing portfolio. IFAD should conduct regular rural finance portfolio reviews by region, preferably with external expertise, to understand the portfolio's health. PT/RF should help recruit the external consultants and facilitate the internal follow-up. The reviews should be shared widely through enlarged thematic group meetings and workshops.
- *Establish 3-4 key reporting indicators.* PT/RF should facilitate a consultative process across regions and draw from the DTs to establish simple, "less is more" reporting for rural finance components and projects. This revised reporting could be based on 3-4 key indicators to enable effective and focused monitoring. These indicators could be introduced in phased manner (for example, one region at a time) and included on the first page of all reports. APOs or interns could help identify the rural finance portfolio and determine the ease or difficulty of getting meaningful information from operations. Transparency can have a high cost if the information produced and available for the first time is not positive. For this reason, the introduction of these reporting indicators should be accompanied by clear incentives from management that reward transparent reporting and improvements in trends in performance, not absolute starting points. The success of piloting this type of simple reporting will hinge, in large part, on CPMs being told and believing that they have more to lose by failing to produce information than by presenting poor information. Management should be prepared to help find corrective measures for improving performance in the future, rather than dwell on past performance.
- *Improve partner selection and monitoring.* Tools for partner appraisal and selection should be developed from the DTs. The relationship with cooperating agencies should be managed more proactively with clear, explicit expectations for minimum performance-based reporting. CPMs should more actively monitor partner agencies using agreed upon performance criteria, and should be prepared to cut or halt contracts if milestones are not reached.
- *Support rural finance as a discrete project whenever possible.* Rural finance should no longer be a minority component of multi-sector projects, in order to help ensure specialized technical attention at all project cycle stages. IFAD should accelerate its move toward supporting rural finance only as a discrete project, or as a majority component when necessary.
- *Create a separate budget category for rural finance components.* IFAD should encourage CPMs to use the Flexible Lending Mechanism or otherwise introduce the flexibility to set up

separate budget categories for the rural finance components of projects. This budget line allows for flexibility in budget design (to match institutional capacity needs as they develop during the project) and the ability to end the rural finance component if performance targets are not met.

- *Explore increasing the percentage allocation of grant funds.* Increasing the percentage of grant funding in the overall IFAD budget would provide more flexibility to CPMs. If not possible, make the limited grant funding available only to projects that follow good practice. Sequence grant funding where possible with lending (capacity-building then capital).
- 3) IFAD should look for ways to **enhance technical capacity** internally and across all partners that work on IFAD-supported projects. IFAD should also strengthen the proactive **role of the rural finance advisor in PT**. Some specific operational recommendations include:
- *Offer in-house orientations for Rome-based staff.* PT/RF should develop and periodically organize short orientations on the latest thinking and practices in rural finance for CPMs, division heads and Board members. The training could be offered on two tracks—basic and advanced—and much of the material could be drawn from the DTs.
 - *Facilitate access to technical workshops.* IFAD should invest in more in-depth technical training for CPMs that manage significant rural finance portfolios. Many international courses exist for this purpose (e.g. Boulder, Bankakademie, New Hampshire).
 - *Establish a grant facility for training field-based human resources.* IFAD should create a global grant facility for capacity building of PMU staff, implementing partners and cooperating agencies. Priority should be given to existing partners, although IFAD could also invite other potential partners for the future. Training modules could be developed from the DTs and materials from CGAP’s regional capacity-building hubs.
 - *Retain a core group of roving consultants for increased technical support to the field.* IFAD should consider recruiting a group of very strong consultants, each assigned to a region to provide trouble shooting services, and implementation and monitoring support. They could be hired on a retainer fee basis.
 - *Build a roster of qualified consultants.* IFAD should more systematically encourage the use of the good performing consultants already in its network and expand the use of new consultants, tapping into public databases to identify the best expertise available. PT/RF could also consult with CPMs and external agencies to develop and maintain a consultant roster.
 - *Strengthen the proactive, mainstreaming role of PT/RF across regions.* PT/RF should proactively market its informal, helpdesk function outside the project development cycle to all regions. PT/RF should also help regional divisions develop strategies for obtaining better information on performance in a time-and cost-effective manner. PT/RF could then help CPMs analyze the information, and develop action plans in problem cases.
- 4) IFAD should establish mechanisms to **facilitate learning** within and across regions, between the field and Rome, and with external partners and other donors. Some specific operational recommendations include:

- *Continue to leverage relationships with others.* IFAD can contribute to the global learning agenda on rural finance and work with other donors to develop good practices for rural finance.
- *Write internal success case studies.* IFAD should identify and write-up internal successful models and projects, distribute them widely, and hold short “lessons learned” workshops.
- *Take greater advantage of the Rural Finance thematic group.* The thematic group can *de-facto* serve as an extension of PT/RF in the regional divisions for the purposes of knowledge acquisition and dissemination.
- *Develop an interactive website.* Following the model of Human Health and Nutrition, PT/RF should consider creating an interactive rural finance website to facilitate technical information exchange between HQ and the field. The website should include indexed operational information (including the DTs), and could be linked to other sites such as CGAP’s forthcoming Donor Information Resource Centre (DIRC).
- *Establish a small, grant-based flexible fund to support innovations.* IFAD should support low-cost initiatives that push the frontier of developing financial services for the rural poor. All such pilots should include funds for the learning agenda, to capture, analyze and disseminate lessons learned. A positive step in this direction is the IFAD-CGAP Rural Pro-Poor Innovation Challenge.

AID EFFECTIVENESS AND MICROFINANCE MATRIX – International Fund for Agricultural Development (IFAD)

		Analysis	Recommendations
1.	Strategic Clarity and Organizational Culture	<ul style="list-style-type: none"> • Focus and commitment to rural poverty reduction • Staff demonstrate mission-driven approach to work • Confusion over what rural finance, microfinance, rural microfinance is at IFAD, and how agricultural finance fits into the picture • Strategic shift in how rural finance is supported has begun, but not yet matched by corresponding shift in institutional culture, processes and systems • Rural Finance policy is not yet reflected in operations • Deep respect for regional specificity results in lack of appetite for policy level guidance and standard performance indicators 	<ul style="list-style-type: none"> • Craft <i>Vision Statement</i> that defines how financial assets and markets work for the poor • Affirm commitment to the <i>Vision Statement</i> at the highest possible level • Develop operational definitions for what microfinance, rural finance, rural microfinance and agricultural finance are at IFAD • Ensure the understanding and application of the DTs through in-house training and consultations • Determine comparative advantage for policy work and focus on the appropriate level (i.e. norms and practices)
2.	Technical Expertise & Resources	<ul style="list-style-type: none"> • Expertise of technical staff is high, but with just one person the demand exceeds supply • Influential CPMs are mostly generalists and country specific experts without sectoral expertise • Over-reliance on a small group of consultants identified through an unclear selection process and offering uneven levels of quality 	<ul style="list-style-type: none"> • Offer two tracks—basic and advanced—of orientation and training to CPMs, division heads and Board members • Send CPMs who manage significant RF portfolios to external, in-depth, technical training • Build roster of qualified consultants, identifying good performers already in the IFAD network as well as new sources of expertise • Establish grant for capacity-building of field-based human resources
3.	Organizational Structure and Flows	<ul style="list-style-type: none"> • PT is a purely advisory division to support regions • Ad-hoc technical input in design phase • No field presence • Flat organizational structure with few career advancement opportunities • Limited cross-fertilization within and among regional divisions inhibits learning • Weak feedback loops from field to Rome result in 	<ul style="list-style-type: none"> • Strengthen proactive mainstreaming role of PT/RF • Write internal case studies on successful models and projects, and disseminate widely • Use the Rural Finance thematic group actively for knowledge acquisition and dissemination • Develop an interactive website, following the model of PT/Human Health and Nutrition

		insufficient learning and loss of knowledge of ground-level innovations	<ul style="list-style-type: none"> Establish small, grant-based flexible fund to support innovations
4.	Instruments and Incentives	<ul style="list-style-type: none"> Main instrument—credit lines to government—presents challenges to demand-led approach to developing financial markets and services Grant facilities (e.g. TAGs) provides some flexibility to directly support innovative initiatives Flexible lending mechanism offer the flexibility to introduce performance-based criteria and conditionality clauses in loan agreements Considerable approval pressure Unclear incentives for quality—no reward for good work, no sanction for poor performance 	<ul style="list-style-type: none"> Explore increasing the percentage of grant funding in the overall IFAD budget and/or limiting grant funds for use by good practice projects Establish a small, grants-based fund to support innovations (e.g. IFAD-CGAP Rural Pro-Poor Innovation Challenge) Encourage the more widespread use of the flexible lending mechanism and conditionality clauses in loan agreements to introduce performance-based criteria
5.	Project Cycle	<ul style="list-style-type: none"> Project development cycle, though complex and not always exploited, offers potential for technical inputs and quality assurance Rural finance may be “lost” amongst other project objectives if a component of larger, multi-sector projects Mandatory TRC technical review often creates an adversarial relationship between PT/RF and PMD Unclear mandate and time for implementation support; little capacity building for implementing partners and influence over cooperating agencies Limited information on performance of financial intermediaries Cooperating agencies provide activity-based rather than performance-based monitoring information 	<ul style="list-style-type: none"> PT/RF should offer its informal, helpdesk services outside project development cycle Support rural finance as a discrete project whenever possible Set-up separate budget category for rural finance components of projects Develop and publish basic questions to ask of all projects with finance components Improve partner selection and monitoring Undertake regular regional portfolio reviews Retain a core group of roving consultants for increased technical support to the field Establish 3-4 simple “less is more” reporting indicators for all RF projects
6.	Future Microfinance Operations		<ul style="list-style-type: none"> Document and replicate innovations more systematically within IFAD & contribute to global learning agenda on rural finance good practices Increase co-financing and cooperation with other donors

