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Report No: PAD1326

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROJECT APPRAISAL DOCUMENT

ON A

PROPOSED LOAN

IN THE AMOUNT OF US$400 MILLION

TO THE

FINANCIERA NACIONAL DE DESARROLLO AGROPECUARIO,
RURAL, FORESTAL, Y PESQUERO
WITH A GUARANTEE OF THE UNITED MEXICAN STATES

FOR THE

EXPANDING RURAL FINANCE PROJECT

November 2, 2015

Public Disclosure Authorized

Finance & Markets Global Practice
LATIN AMERICA AND CARIBBEAN

CURRENCY EQUIVALENTS

(Exchange Rate Effective as of November 1, 2015)

Currency Unit	=	Mexican Pesos (MXN)
MXN 16.56	=	US$1

FISCAL YEAR

January 1 – December 31

ABBREVIATIONS AND ACRONYMS

CNBV	National Banking and Securities Commission (*Comisión Nacional Bancaria y de Valores)*
CONDUSEF	Commission for the Protection of Users of the Financial System (*Comisión Nacional para la Protección y Defensa de los Usuarios de Servicios Financieros*)
CPS	Country Partnership Strategy
DEC	Development Economics Vice-Presidency
DEPP	The Office of Programs and Products
DFI	Development Finance Institution
EMF	Environmental Management Framework
ERR	Economic Rate of Return
FIRA	National Trust for Rural Development*(Fideicomisos Instituidos en Relación con la Agricultura)*
FND	Rural Financial Development Agency (*Financiera Nacional de Desarrollo Agropecuario, Rural, Forestal y Pesquero*)
GDP	Gross Domestic Product
GP	Global Practice
GNI	Gross National Income
IBRD	The International Bank for Reconstruction and Development
IDB	Inter-American Development Bank
IFI	International Financial Institution
IPPF	Indigenous Peoples Planning Framework
IT	Information Technology
LCR	Latin America and the Caribbean Region
MSME	Micro, Small, and Medium Enterprise
M&E	Monitoring and Evaluation
NAFIN	National Society of Credit Institution Development Bank (*Nacional Financiera*)
NBFI	Non-Bank Financial Institution
NPL	Nonperforming Loan
NPV	Net Present Value
OECD	Organization for Economic Co-operation and Development
PDO	Project Development Objective

PFI	Participating Financial Intermediary
POM	Project Operational Manual
ROA	Return on Assets
ROE	Return on Equity
RFI	Regional Indigenous Fund
SFP	Secretaría de la Función Pública
SHCP	Ministry of Finance (*Secretaría de Hacienda Y Crédito Público*)
SOFIPOS	Popular Financial Companies (*Sociedades Financieras Populares*)
SOFOM	Multiple Purpose Financial Companies (*Sociedades Financieras de Objeto Múltiple*)
ToR	Terms of Reference

Regional Vice President:	Jorge Familiar
Country Director:	Gerardo Corrochano
Senior Global Practice Director:	Gloria Grandolini
Practice Manager:	Alfonso Garcia Mora
Task Team Leader:	Steen Byskov/Rekha Reddy

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GFMDR

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Basic Information

Project ID P153338	EA Category F - Financial Intermediary Assessment	Team Leader(s) Steen Byskov, Rekha Reddy
Lending Instrument Investment Project Financing	Fragile and/or Capacity Constraints [ ]	
	Financial Intermediaries [X]	
	Series of Projects [ ]	
Project Implementation Start Date 29-Jan-2016	Project Implementation End Date 31-Dec-2020	
Expected Effectiveness Date 29-Jan-2016	Expected Closing Date 31-Dec-2020	
Joint IFC No		

Practice Manager	Senior Global Practice Director	Country Director	Regional Vice President
Alfonso Garcia Mora	Gloria M. Grandolini	Gerardo M. Corrochano	Jorge Familiar

Borrower: Financiera Nacional de Desarrollo Agropecuario, Rural, Forestal y Pesquero

Responsible Agency: Financiera Nacional de Desarrollo Agropecuario, Rural, Forestal y Pesquero

Contact:	Raul Galindo	Title:	Director General Adjunto de Finanzas y Operaciones
Telephone No.:	525552301600	Email:	regalindo@fnd.gob.mx

Project Financing Data (in US$, millions)

[X]	Loan	[ ]	IDA Grant	[ ]	Guarantee

[ ] Credit	[ ] Grant	[ ] Other

Total Project Cost:	405.00	Total Bank Financing:	400.00
Financing Gap:	0.00		

Financing Source	Amount
Borrower	5.00
International Bank for Reconstruction and Development	400.00
Total	405.00

Expected Disbursements (in US$, millions)

Fiscal Year	2016	2017	2018	2019	2020	2021	0000	0000	0000	0000
Annual	5.00	140.00	135.00	80.00	28.00	12.00	0.00	0.00	0.00	0.00
Cumulative	5.00	145.00	280.00	360.00	388.00	400.00	0.00	0.00	0.00	0.00

Institutional Data

Practice Area (Lead)

Finance & Markets

Contributing Practice Areas

Agriculture

Cross Cutting Topics

[ ] Climate Change

[ ] Fragile, Conflict & Violence

[x] Gender

[ ] Jobs

[ ] Public Private Partnership

Sectors / Climate Change

Sector (Maximum 5 and total % must equal 100)

Major Sector	Sector	%	Adaptation Co-benefits %	Mitigation Co-benefits %
Agriculture, fishing, and forestry	General agriculture, fishing and forestry sector	20		
Finance	SME Finance	40		
Finance	Other non-bank financial intermediaries	40		
Total		100		

☑ I certify that there is no Adaptation and Mitigation Climate Change Co-benefits information applicable to this project.

Themes		
Theme (Maximum 5 and total % must equal 100)		
Major theme	Theme	%
Financial and private sector development	Other Financial Sector Development	80
Rural development	Other rural development	20
Total		100

Proposed Development Objective(s)
The project's development objective is to expand the availability of finance to the rural economy.

Components	
Component Name	**Cost (US$, millions)**
1. Expanding Credit for Rural MSMEs	375.00
2. Strengthening Institutional Capacity for Sustainable Rural Finance	30.00

Systematic Operations Risk- Rating Tool (SORT)	
Risk Category	**Rating**
1. Political and Governance	Moderate
2. Macroeconomic	Moderate
3. Sector Strategies and Policies	Moderate
4. Technical Design of Project or Program	Moderate
5. Institutional Capacity for Implementation and Sustainability	Moderate
6. Fiduciary	Moderate
7. Environment and Social	Low
8. Stakeholders	Moderate
OVERALL	Moderate

Compliance		
Policy		
Does the project depart from the CAS in content or in other significant respects?	Yes [ ]	No [X]
Does the project require any waivers of Bank policies?	Yes [ ]	No [X]
Have these been approved by Bank management?	Yes [ ]	No [ ]
Is approval for any policy waiver sought from the Board?	Yes [ ]	No [X]
Does the project meet the Regional criteria for readiness for implementation?	Yes [X]	No [ ]

Safeguard Policies Triggered by the Project	**Yes**	**No**
Environmental Assessment OP/BP 4.01	**X**	

Natural Habitats OP/BP 4.04	**X**	
Forests OP/BP 4.36	**X**	
Pest Management OP 4.09	**X**	
Physical Cultural Resources OP/BP 4.11		**X**
Indigenous Peoples OP/BP 4.10	**X**	
Involuntary Resettlement OP/BP 4.12		**X**
Safety of Dams OP/BP 4.37		**X**
Projects on International Waterways OP/BP 7.50		**X**
Projects in Disputed Areas OP/BP 7.60		**X**

Legal Covenants

Name	Recurrent	Due Date	Frequency
Section I.C.1.(d) (Line of Credit)	x		

Description of Covenant

For purposes of carrying out Part 1(b) of the Project, provide a Sub-Loan to an Eligible Beneficiary under a FND Sub-Loan Agreement signed between the Borrower and the Eligible Beneficiary, under terms and conditions acceptable to the Bank and set forth in the Operational Manual.

Conditions

Source Of Fund	Name	Type
IBRD	Loan Agreement, Section 4.01.	Effectiveness

Description of Condition

At least one Subsidiary Financing Agreement has been executed on behalf of the Borrower and an Eligible PFI.

Team Composition

Bank Staff

Name	Role	Title	Specialization	Unit
Steen Byskov	Team Leader (ADM Responsible)	Sr Financial Economist		GFMDR
Rekha Reddy	Team Leader	Senior Economist		GFMDR
Gabriel Penaloza	Procurement Specialist	Procurement Specialist		GGODR
Daniel Chalupowicz	Financial Management Specialist	Financial Management Specialist		GGODR
Anita Tarce	Team Member	Program Assistant		GFMDR
Daniel Ortiz del Salto	Team Member	Consultant		GTCDR

Dora Patricia Andrade	Safeguards Specialist	Consultant		GENDR
Elena Segura Labadia	Team Member	Senior Counsel		LEGLE
Gabriela Grinsteins	Team member	Associate Counsel		LEGLE
Eva M. Gutierrez	Team Member	Program Leader		LCC1C
Francisco Rodriguez	Team Member	Senior Procurement Specialist		GGODR
Henry Forero Ramirez	Team Member	Senior Public Sector Specialist		GGODR
Jose Isaac Rutman	Team Member	Consultant		GFMDR
Luis de la Plaza Bringas	Team Member	Lead Financial Officer/Debt Capital Markets & CBP		FABBK
Martin Henry Lenihan	Safeguards Specialist	Senior Social Development Specialist		GSURR
Pierre Olivier Colleye	Team Member	Senior Microfinance Specialist		GFADR
Puja Guha	Team Member	Consultant		GFMDR
Sunita Varada	Team Member	Financial Sector Specialist		GFMDR
Victor Manuel Ordonez Conde	Team Member	Senior Finance Officer		WFALN
Christian Rodriguez	Team Member	Consultant		GFMDR
Miriam Bruhn	Team Member	Senior Economist		DECFP
Xiomara A. Morel	Team Member	Sr. Financial Management Specialist		GGODR
Alejandra Ramon y Martinez De Alva	Team Member	Team Assistant		LCC1C

Extended Team

Name	**Title**	**Office Phone**	**Location**

Locations

Country	**First Administrative Division**	**Location**	**Planned**	**Actual**	**Comments**

Consultants (Will be disclosed in the Monthly Operational Summary)

Consultants Required?	Consulting services to be determined

I. STRATEGIC CONTEXT

A. Country Context

1. **Sound economic policies in Mexico over the past two decades have contributed to the attainment of stable macroeconomic conditions and resilience during the global financial crisis.** Mexico is an upper-middle-income country with 2014 per capita gross national income (GNI, Atlas Method) of US$9,980. It is a member of the Organization for Economic Co-operation and Development (OECD) and G-20 with an open economy and trade agreements with more than 40 countries. Its economy rebounded quickly from the 2008–09 global financial crisis, reaching an average growth rate of 4.4 percent between 2010 and 2012. Along with the global economy, the gross domestic product (GDP) growth weakened in 2013 and 2014 to 1.4 percent and 2.1 percent, respectively. The GDP is projected to increase to 2.9 percent in 2015 and 3.3 percent in 2016 as confidence recovers and the benefits of recent structural reforms materialize.

2. **However, like many Latin American countries, Mexico faces a productivity growth challenge.** Over the past decade, the economy grew at 2.4 percent annually, well below the regional average of 4 percent. Low productivity growth depressed income growth and Mexico's per capita income has remained at about 30 percent of that of the United States. By comparison, East Asia Tigers' per capita income tripled over the past three decades and is currently about 60 percent of that of the United States. Economic literature offers many explanations for low productivity growth, all of which are relevant in Mexico: inequality, regulatory barriers for doing business, uncompetitive markets for utilities, weak innovation, limited market competition, labor market rigidities, scarcity of skilled labor, and an underdeveloped financial system.

3. **Shared prosperity—the growth in income among the bottom 40 percent of the population—has also been relatively limited.** Between 2004 and 2012, the average income of the bottom 40 percent grew by 1.2 percent annually. A comparison across 17 Latin American countries shows that Mexico ranks near the bottom (16 out of 17) in income growth among the bottom 40 percent of the population during the period[1]. The government has embarked on a reform agenda toward 'democratization of productivity' through microeconomic reforms, which recognizes that productivity growth among low-income groups will ensure shared prosperity.

4. **Poverty rates are much higher in rural than urban areas of Mexico.** States vary widely in wealth and urban centers are dynamic while rural areas remain isolated. Poor rural infrastructure has inhibited significant advances in agricultural production. In 2012, extreme income poverty[2] at 30.9 percent in rural areas was more than twice the 12.9 percent in urban areas. Asset poverty[3] (moderate poverty by national poverty lines, 2012) showed 64 percent rural poor relative to 46 percent urban poor.

[1] World Bank (2014), "Social Gains in the Balance. A fiscal policy challenge for Latin America and the Caribbean".
[2] Extreme poverty refers to CONEVAL's (National Council for the Evaluation of Social Development Policy) food poverty line based adequate income for a basic food basket.
[3] Asset poor are households with insufficient income to cover capabilities realization expenditures, housing, and transportation.

5. **Despite a stable macroeconomic framework and a series of market-enhancing reforms, the financial market fails to provide adequate access to key segments in Mexico.** A vibrant financial sector that identifies and funds viable business opportunities is an important microeconomic foundation for shared prosperity by supporting increased incomes while helping manage risks. Credit in general and (rural) agricultural credit[4] in particular is underdeveloped in Mexico, and the lack of credit is associated with limited rural economic activity.

B. Sectoral and Institutional Context

6. **Mexico's financial sector is small, rural credit is underdeveloped, and little credit reaches small enterprises.** Credit to the private sector in Mexico amounted to 23 percent of GDP in 2014 and thus less than half the averages for the Latin America and Caribbean Region (LCR, 47 percent) and the upper-middle-income countries (49 percent). As measured by the 2014 FINDEX, just 6 percent of adults in rural areas borrowed from a financial institution last year, the same level as in 2010 and well below the 11 percent LCR average. Bank branches are present in 42.7 percent of rural municipalities, in comparison to 99.5 percent of urban municipalities. National data (by the National Banking and Securities Commission, *Comisión Nacional Bancaria y de Valores*, CNBV) indicate that only 20–25 percent of all micro, small, and medium enterprises (MSMEs) use bank credit. Annex 7 offers key data on the Mexican financial sector.

7. **The lack of rural enterprise credit is associated with limited rural economic activity.** Credit constraints have been found to be pervasive in rural Mexico, limiting the investments and growth of rural enterprises[5]. Preliminary findings from a 2014 QFPD/World Bank survey of 1,000 farmers in Tlaxcala found that farmers are not using key inputs such as fertilizers that would improve their productivity, the primary reason cited being lack of finance. Mexico's National Development Plan (2013–18) emphasizes a productive, profitable, and competitive primary sector.

8. **The Mexican financial system has a few large banks focused on larger clients and a dispersed group of smaller financial institutions serving smaller enterprises and lower-income households.** Five banks account for 56 percent of the total assets of supervised financial institutions. Meanwhile, 314 supervised non-bank financial institutions[6] (NBFIs) constitute less than 2.7 percent of the assets. Many of these institutions lack economies of scale and some are constrained by lack of funding sources. However, they play an important role in providing access to clients, particularly in more remote areas where banks' operational costs may be high.

9. **Financial sector policy reforms have supported a sound legal framework for lending, increased availability of credit information, and enhanced competition with open**

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[4] Agriculture's share of GDP is 3.5 percent and its share of employment is 13 percent. The agricultural sector plays an important social role given the importance of agriculture income in the total income of the rural poor, but labor productivity and output growth are low.

[5] Love and Sanchez (2009), "Credit Constraints and Investment Behavior in Mexico's Rural Economy", World Bank Policy Research Working Paper No. 5014.

[6] Not including bank-owned multiple purpose financial companies (*Sociedades Financieras de Objeto Multiple* [SOFOMES]) whose accounts are consolidated with those of their parent banks.

entry into the financial sector. The Strength of Legal Rights Index[7] of the 2015 Doing Business report places Mexico well above the LCR and OECD averages. The Getting Credit indicator[8] of the 2015 Doing Business data ranked Mexico 12 out of the 185 economies assessed. To improve the use of collateral, Mexico has introduced an integrated framework for secured transactions that extends to movable assets. Credit information, though weakened by informality, has been developed. To promote inclusion, a class of non-deposit taking financial institutions (SOFOMES, *Sociedades Financieras de Objeto Múltiple*) have been permitted to operate without supervision by the CNBV. Foreign banks, including Citi, HSBC, Santander, and BBVA, operate in Mexico. Although state development finance institutions (DFIs) remain part of the financial system, they contribute a smaller share to financial sector activity than in most other large G-20 countries. The recent financial sector reform law continues the reform process with attempts to improve the Mexican bankruptcy system by clarifying creditor and debtor rights.

10. **For several years the government has prioritized the expansion of access to finance with a more recent emphasis on credit for productive purposes and leveraging DFIs to that end.** Two coordination bodies, the Committee on Financial Education and the National Council on Financial Inclusion, were established by the government in 2011, and the president announced key pillars for a national financial inclusion strategy in 2014. Internationally, Mexico has taken a leadership role in financial inclusion as chair of the G-20 in 2012. The 2014 Financial Reform Law promoted lending by private intermediaries as well as by DFIs. Mexico has six development banks, six government trusts, and four development finance agencies to support key sectors such as rural economy. The DFIs address access to finance gaps through the provision of financial services (both loans and deposits), finance, partial credit guarantees, and technical assistance to NBFIs. The proposed borrower for this operation, the Rural Financial Development Agency (*Financiera Nacional de Desarrollo Agropecuario, Rural, Forestal y Pesquero*, FND), is one of these agencies.

11. **FND[9] supports access to finance for the rural economy both directly and by financing and strengthening small credit institutions.** FND aims to support rural financial access to encourage private sector activity, including in agriculture, fisheries, forestry, and rural commerce. FND was known until 2014 as *Financiera Rural*. Its establishment was supported by the World Bank when Banrural was liquidated in 2002. Banrural was an agricultural development bank that provided subsidized credit for agriculture. It accumulated large losses from inefficiencies, low collection efforts, and high administrative costs.

12. **FND has US$2.7 billion in assets and is strongly capitalized.** As of end-2014, loans were US$2.1 billion and liquid assets were US$581 million. The equity base was large at US$2 billion, equaling 76 percent of assets in 2014. Unlike some other Mexican DFIs, FND is restricted from collecting deposits and issuing bonds and is therefore planning to expand its activities by borrowing from international financial institutions (IFIs). Considering the segment served by FND, asset quality is reasonably good with 4.1 percent nonperforming loans (NPLs) and it maintains a positive real return on capital in line with its mandate.

[7] The index measures how collateral and bankruptcy laws protect the rights of borrowers and lenders.
[8] The index measures the coverage, scope, and accessibility of credit information.
[9] See annex 6 for further discussion about FND and the PFIs, including on financial performance.

13. **Financing and developing participating financial intermediaries (PFIs) is an important and growing part of FND's approach to developing access to credit in rural areas.** FND envisions portfolio growth of 62 percent by 2018 relative to end-2014. Lending through PFIs and thus leveraging the distribution networks already built by other financial service providers helps not only increase FND's reach as the PFIs can economically serve smaller borrowers but also to support the sustainable long-term development of private sector supply of rural finance.

14. **The PFIs include a range of institution types and sizes (table 1), and their financial performance is generally good.** At end-2014, FND's 442 PFIs had assets of US$4.4 billion and loans of US$3 million, of which US$1 million was funded by FND. Of the 442 PFIs, 386 were unsupervised by financial regulators and either registered as SOFOMES or as producer associations, which FND refers to as *dispersoras*. Most supervised PFIs are credit unions and cooperatives, but a small number of banks and warehouse finance entities also borrow from FND.[10] Just 12 of the 442 PFIs take deposits. Thus, they rely extensively on FND or other financial institutions for funding. Financial performance varies widely, but the majority appears sound. Among reporting PFIs in 2014, capital exceeded 10 percent of assets for all but 10 of 380, NPLs were below 5 percent for all but 33, and earnings were negative for 38 PFIs. Annex 6 provides further analysis of PFIs.

Table 1. FND PFIs

Dec 2014	**Institutions**	**Share of FND Portfolio**	**Borrowers Per Institution**	**Average Loan Amount**
	Number	Percent	Average	US$
Supervised Institutions				
Deposit Warehouse	1	1	–	–
Cooperative	12	2	3,092	622
Credit Union	43	20	62	52,243
Unsupervised Institutions				
Producer Associations	202	25	84	9,474
SOFOM	184	51	1035	1,972
Total	442	100	559	2,875

Source: FND.

15. **In addition to providing financing, FND helps strengthen the capacity of PFIs.** FND's accreditation for PFIs primarily aims to manage FND's credit risk, but it also serves to strengthen the PFIs. FND requires healthy financials, effective risk management and internal processes, adequate governance, and regulatory compliance. As PFIs adapt to qualify, they upgrade the arrangements needed to access commercial funding or to obtain supervised financial institution licenses. In conjunction with the Secretary of Agriculture, Livestock, Fisheries and Rural Development (*Secretaría de Agricultura, Ganadería, Desarrollo Rural, Pesca y Alimentación*), FND supports capacity building of PFIs through a network of accredited providers, to strengthen business planning, operations, information technology (IT) systems, and risk management.

[10] At end-2014, banks were not yet among the PFIs but now they are.

16. **FND administers subsidies for agricultural and rural credit that can be accessed by borrowers from a variety of institutions.** Subsidies include *garantias liquidas,* which are funds provided by the government to compensate for loan losses of certain portfolios to allow lower credit risk premiums charged by lenders, as well as direct subsidies to borrowers. The subsidies can be accessed when borrowing directly from FND, from a financial institution that is a client of FND, or the National Trust for Rural Development (FIRA). The few lenders active in rural areas can access these subsidies and thus, a level playing field is generally maintained. Lenders can freely determine interest rates when using FND[11] or FIRA products.

17. **The government of Mexico and FND have requested this project to support FND's expansion of credit to the rural economy.** FND is currently, by law, allowed to borrow only from domestic public institutions and IFIs. The IFI involvement will help expand activities based on good lending practices and leveraging global lessons. The successful implementation of FND's strategy to expand its outreach requires an efficient operational interaction with PFIs, an effective assessment and monitoring of PFIs, and effective capacity building to support PFI capacity.

C. Higher Level Objectives to which the Project Contributes

18. **The proposed operation is fully aligned with the Country Partnership Strategy for Mexico for FY2014–19, which in turn supports Mexico's National Development Plan (2013-2018).** The operation has been requested by the Ministry of Finance (*Secretaría de Hacienda y Crédito Público*, SHCP) and FND and has been designed to support their stated development goals. It is expected to contribute to the pillars of Mexico's National Development Plan related to making Mexico's growth more inclusive and supporting prosperity. The project also supports the core thematic area of the Country Partnership Strategy related to unleashing productivity, which includes financial sector development and a more competitive business environment.

19. **The operation supports the twin goals of the World Bank Group to eradicate extreme poverty and increase shared prosperity by providing access to finance for underserved rural MSMEs, thereby supporting their growth.** Research has shown a positive causal relationship between financial development and economic growth (particularly working through the credit to firms channel) and furthermore a positive association with declines in income inequality.[12] Higher levels of financial development cause a faster decline in the share of the population living below the poverty line,[13] and income inequality tends to fall more rapidly with financial development.[14] During 2014, approximately 28 percent of FND's final borrowers came from areas defined as high or very high levels of marginalization.[15] Over 40 percent

[11] An exception is a program with an interest rate cap for small producers, including women and indigenous populations.
[12] See "Who gets the credit? And does it matter? Households vs. firms lending across countries", Beck et al., 2012, The B.E. Journal of Macroeconomics.
[13] Empirical evidence shows that a 10 percentage point increase in the ratio of private credit to GDP reduces the share of population living below the poverty line by 2.5–3 percentage points.
[14] "Finance, Inequality, and the Poor", Beck et al., Journal of Economic Growth. 2007.
[15] The Mexican Government classifies municipalities as having very high, high, medium, low, and very low levels of marginalization. The classification is based on indicators related to education, housing, income levels, and geographic density.

originated from municipalities with a medium level of marginalization. Finally, the project supports the Bank Group's 'Universal Financial Access by 2020 Agenda' for which Mexico is one of the 25 focus countries.

20. **The Bank brings a combination of long-term funding and knowledge of financial intermediary lending and rural finance.** The long-term finance will enable FND to offer stable finance for small intermediaries, in turn, helping them develop credit for rural MSMEs. Moreover, the Bank team brings experience of financial intermediary lending and rural finance. The team also draws on the expertise of the Development Economic group and the Agriculture Global Practice of the Bank to exploit global lessons on agricultural finance. Finally, the team will distill project lessons and communicate them to Mexican and global stakeholders.

II. PROJECT DEVELOPMENT OBJECTIVE (PDO)

A. PDO

21. The PDO is to expand the availability of finance to the rural economy.

B. Project Beneficiaries

22. **FND, PFIs, and MSMEs borrowing from the PFIs are the main project beneficiaries.** The project helps FND expand its activities and loan portfolio, reduce its operating costs relative to its portfolio size, and to strengthen its IT systems. The loan will support lending for productive activities as opposed to consumption credit and the funding will help PFIs reach more clients and grow their activities in rural areas. The capacity of PFIs will be developed and they will receive equipment to expand capacity to offer sustainable finance in rural areas. Rural[16] MSMEs will benefit from improved access to finance and expanded economic activity.

C. PDO Level Results Indicators

23. **The key results indicators are** (a) number of loans disbursed under the project, (b) volume of total loans disbursed under the project, and (c) average NPL ratio for PFIs receiving project funds (percentage). Additional intermediate outcome indicators are elaborated in annex 1.

III. PROJECT DESCRIPTION

A. Project Components

24. **The project will have two components supporting the development of rural finance:**

25. **Component 1: Expanding Credit for Rural MSMEs: (**US$375 million- IBRD: US$375 million). A credit line of US$365 million will be disbursed through PFIs (Component 1A). US$10 million is allocated to pilot new MSME financial solutions either through PFIs or through direct lending by FND (Component 1B).

[16] 'Rural' herein refers to the Mexican government's definition as municipalities with fewer than 50,000 inhabitants.

> **Component 2: Strengthening Institutional Capacity for Sustainable Rural Finance** (US$30 million- IBRD: US$25 million). This component will support the modernization of FND's core banking system to improve rural finance delivery for FND (Component 2A). Counterpart financing (US$5 million) will be used to fund institutional strengthening activities for rural financial institutions (Component 2B).

Component 1: Expanding Credit for Rural MSMEs (US$375 million-IBRD: US$375 million)

Subcomponent 1A: Credit Line through PFIs to MSMEs (US$365 million)

26. **The credit line will be intermediated by the FND through PFIs serving rural MSMEs.** FND, the borrower and implementing agency for the project, will on-lend to eligible PFIs. The PFIs will in turn on-lend to eligible private rural MSMEs. FND will assume the credit risk of the PFIs that fail to repay and the PFIs will assume the credit risk of the MSMEs.

27. **PFIs will be carefully selected by FND based on their financial health, institutional capacity to on-lend, governance, and operational processes.** Potential PFIs include credit unions, cooperatives (Savings and Loan Cooperatives [*Sociedades Cooperativas de Ahorro y Crédito Popular*]), deposit warehouses *(Almacenas Generales de Deposito)*, SOFOMES, agricultural producer associations (*dispersoras*), and banks serving the rural economy. The accreditation process for a PFI to borrow from FND takes up to a year, partly reflecting the thoroughness of the process and partly that some prospective intermediaries must upgrade their practices to become eligible. The accreditation review includes general questions about the type of institutions and its objectives as well as a detailed review of products, balance sheets, organizational structure and governance, quality of financial reporting, systems, and manuals for operation and risk management. FND undertakes on-site and off-site monitoring and supervision of PFIs at regular intervals. Determination of PFI eligibility to receive Bank funding will include additional eligibility criteria pertaining to credit quality, solvency, exposure with FND, and related lending for initial eligibility and ongoing disbursement criteria based on financial performance.

28. **In addition to expanding lending to the existing PFIs, FND is seeking to expand its reach by introducing new PFIs.** Simulations suggest an envelope of about US$1.9 billion of possible additional prudent borrowing by the existing PFIs.[17] The project will include a combination of existing and new PFIs.

29. **The MSMEs will include both legally constituted firms and individual borrowers.** A maximum loan amount will help target loans to the MSMEs and ensure that the project is well-dispersed across beneficiaries. The project will seek to include PFIs that make efforts to reach women and indigenous populations. Both working capital and investment finance will be eligible, with the former likely to dominate, considering the small size and sophistication of rural MSMEs.

[17] See annex 6 for further details on the assumptions and estimation.

Subcomponent 1B: Supporting FND Pilots for Rural Finance (US$10 million)

30. **FND will seek to expand the range of solutions to better serve rural borrowers.** FND and its PFIs typically offer a narrow range of financial products (primarily working capital and simple fixed assets loans). Increasing access to rural finance will require the broadening of financial products that take into account specific sector characteristics. The Bank and FND will agree on a set of solution designs and evaluations.

31. **The credit line under this subcomponent will be offered under conditions similar to those under Subcomponent 1A.** Subcomponent 1B will be specifically earmarked for testing new financial products. FND may provide financial services directly to the MSMEs, through the PFIs, or a combination of the two. A key objective will be to test, evaluate, or promote new financial products with potential to be scaled up.

32. **The specific solutions will be identified both during project preparation and implementation.** The selection of the specific solutions will be determined through consultation with FND, its current PFIs, and key players in the financial sector. These solutions will address constraints typical to rural finance, such as production cycles, risks inherent to agriculture, high transaction costs, or lack of collateral. Examples of modalities that this credit line could finance include price hedge products for agricultural commodities, leasing products, moveable assets finance, factoring, warehouse receipts, value chain financing, or other sustainable initiatives to improve financial inclusion. Lessons from these pilots will be documented and disseminated.

Component 2: Strengthening Institutional Capacity for Sustainable Rural Finance (US$30 million-IBRD: US$25 million)

Subcomponent 2A: Modernization of Banking Systems (US$25 million)

33. **FND will evaluate options and implement improvements to its core banking platform and related systems.** IT modernization is a priority action in FND’s recent strategic plan and it is particularly important in the context of FND’s planned balance sheet expansion. Enhanced internal processes and information and communication technologies systems will support the improved delivery of financial services, better performance monitoring, and stronger risk management capabilities of FND. The component will include the funding of equipment and software for an upgraded core banking setup as well as the consultancies necessary for diagnostics, technical design, and implementation support. The component can also help fund an expansion of the geographic coverage of FND in cost-effective ways, for example, through alliances with key strategic partners with complementary distribution networks. The upgraded system will support a better user experience, with the goal of facilitating online banking and access to new products.

Subcomponent 2B: Strengthening Rural Financial Institutions (US$5 million, utilizing counterpart financing)

34. **FND will provide capacity building to PFIs to support the development of a sound rural financial sector.** The objectives are both to help manage FND’s risks and to develop strong rural financial institutions. FND will use funds from the SHCP to offer capacity building

and equipment to PFIs. FND will use an existing network of accredited specialists experienced in supporting low-income and rural-oriented financial institutions.

35. **The institutional strengthening assistance will address, for example, credit risk management, corporate governance, and IT systems.** The component will provide capacity building to the PFIs that receive lines of credit from FND and potential PFIs to help them meet eligibility criteria. PFIs serving priority populations, such as indigenous funds, will be prioritized.

B. Project Financing

36. **The total project cost is US$405 million, of which US$5 million is counterpart funding.** The project's allocations to the two components are summarized in this table.

Project Cost and Financing

Project components	Project cost Million US$	IBRD funding Million US$	% IBRD Financing
Component 1. Line of credit	374.0	374.1	100%
Component 2. Institutional capacity	30.0	24.9	83%
Total Project Costs	**404.0**	**399.0**	
Front-End Fees	1.0	1.0	100%
Total Financing Required	405.0	400.0	

C. Lessons Learned and Reflected in the Project Design

37. **The project incorporates lessons from recent, ongoing, and completed Bank Group and donor projects, international best practices in MSME finance, and the World Bank OP 10.00 Guidelines on Financial Intermediary Financing.** It also incorporates good practices identified in the Independent Evaluation Group's 2006 evaluation of World Bank Lending for Lines of Credit. In particular, the following practices are reflected:

(a) **The performance of credit lines improves significantly when PFIs are sound.** This will be achieved through the careful selection process and monitoring by FND. The team has reviewed both FND's appraisal system and its monitoring system for PFIs and deemed it sound though some suggestions for improvement were offered, and revisions to monitoring and follow-up systems are under way. Annex 2 elaborates on PFIs' eligibility. Finally, the capacity building under Subcomponent 2B will help upgrade PFI processes when needed.

(b) **A suitable pipeline of projects identified during preparation supports implementation success.** Demand from both final borrowers and from PFIs is necessary not only for implementation success but also for impact. The targeted final borrowers are currently substantially underserved by financial institutions as discussed above. Simulations suggest that existing PFIs may comfortably be able to borrow an additional US$1.9 billion. In addition, FND is expected to identify more PFIs.

(c) **Leveraging private financial institutions helps reach more final borrowers in a cost-effective way.** Apart from the small portion of the credit line (less than 5 percent) to pilot innovative financial solutions, the credit line will be intermediated through private sector PFIs in line with FND's strategic plan.

(d) **Information sharing among credit institutions is important to prevent multiple borrowings and to manage credit risk.** Mexican private credit bureaus are highly rated under the Doing Business Getting Credit indicator and the 2014 financial reform further strengthened information sharing. With recent regulatory changes, most of the PFIs that FND works with will be required to verify information with and provide information to credit bureaus, with the exception of very small loans. The one exception is agricultural producer associations, which are not required to use a credit bureau.

(e) **Some flexibility in activities contributes to project success.** The Independent Evaluation Group has noted that some degree of flexibility in project activities (for example the piloting and scaling-up of innovative approaches) can support improved project outcomes. With Subcomponent 1B, the project leaves space to pilot new solutions to address rural finance needs.

IV. IMPLEMENTATION

A. Institutional and Implementation Arrangements

38. **FND is the borrower and the implementing agency for the proposed project.** The Bank will enter into a Loan Agreement with FND and a Guarantee Agreement with the United Mexican States (the member country) through the SHCP. For implementation of Component 1, the borrower (FND) will enter into Subsidiary Financing Agreements with eligible PFIs to on-lend to rural MSMEs through loan agreements. For Subcomponent 1B, FND may also lend directly to the MSMEs for pilot initiatives.

39. **FND was selected based on its expertise in second-tier lending to rural borrowers and its strong financial position.** FND is one of Mexico's 13 DFIs and plays a key role in channeling resources to the rural economy. FND's direct and second-tier (through PFIs) lending portfolio is well-diversified, and its current and projected financial soundness indicators are robust (see annex 6). Its accreditation for opening lines of credit with PFIs includes all the required key elements. Finally, FND has ongoing experience working with another IFI as it is implementing lending projects with the Inter-American Development Bank (IDB).

40. **The Office of Programs and Products (*Dirección Ejecutiva de Programas y Productos,* DEPP) within FND is coordinating the design and implementation of the project and will be the Bank's main counterpart.** Its responsibilities include: (a) implementation of the project as described above; (b) ensuring compliance of fiduciary and safeguard requirements; and (c) monitoring and evaluating the project based on agreed indicators. A technical team with representatives across FND will also support project implementation. A core team will include an experienced project coordinator, a fiduciary specialist, and a social and environmental specialist. FND will ensure staffing to perform these functions effectively throughout implementation.

41. **FND has prepared a Project Operational Manual (POM) consistent with the provisions of the Loan Agreement.** The POM adopts FND's relevant existing policies and

procedures and provides details on the implementation arrangements, including the eligibility criteria for PFIs and MSMEs, and procedures and controls for fiduciary and safeguards arrangements. Annex 3 provides additional detail.

B. Results Monitoring and Evaluation

42. **FND will evaluate progress based on agreed indicators (see annex 1).** The agreed monitoring and evaluation (M&E) framework leverages PFI reporting and existing systems. As a DFI, FND already has considerable monitoring capacity, which has been strengthened by recent IDB loans (approved in 2012, 2014 and 2015) to the institution. Targeted ad hoc evaluations can be undertaken to assess innovative initiatives under Subcomponent 1B and an impact evaluation to assess the impacts of institutional strengthening activities will be undertaken with the Development Economics group of the Bank. Finally, administrative data on the PFIs will be used to monitor their performance over time.

C. Sustainability

43. **The sustainability of the project beyond the life of the loan will depend on the ability of the PFIs to access alternative sources of finance.** After relying on FND, the PFIs are most likely to turn to commercial lenders. A rigorous accreditation procedure by FND and technical assistance provided to the PFIs will improve their governance, risk management, and operational processes, allowing them to better present themselves to commercial lenders. The track record of repaying FND and reporting on their financials will also help the PFIs demonstrate their repayment capacity. A more advanced alternative for PFIs that do not take deposits will be to become deposit taking, which will require a change of license and supervision. FND's accreditation procedures are similar to supervisory requirements and will thus help the PFIs on that path. Finally, the securitization and selling of loans can possibly provide a funding mechanism for the PFIs.

44. **Sustainability of FND's activities beyond the life of the loan will depend on continued access to budgetary resource, IFI lending, and capital markets access.** The need for maintaining and expanding the activities of FND should be regularly assessed against the rural access to finance gap. Even as the existing PFIs gain access to commercial funding, the need for strengthening additional ones may persist. At its creation, the legal framework allowed FND to fund its operations only with its own equity. Following the global financial crisis, it was authorized to borrow from DFIs. Whereas the Bank supported the legal borrowing restrictions when FND was established, a well-managed FND will be able to serve its objective better with additional funding options. Accessing capital market funding can provide for future funding of FND. If FND facilitated securitization of PFI loan portfolios, the need for funding can be reduced. Each option comes with different risks that will need to be effectively managed, in addition to the legal amendments required to FND's Organic Law.

V. KEY RISKS

A. Overall Risk Rating and Explanation of Key Risks

45. **The overall project risk rating is Moderate, reflecting the financial strength and experience of FND in operating in the rural finance segment.** The main risk to successfully

achieving the PDO is the failure of the PFIs to sustainably develop their credit business. This risk may materialize if the PFIs grow too aggressively with inadequate risk management or if the PFIs do not find sufficient viable rural economic activities. A general risk to intermediaries serving the agricultural sector is the vulnerability to weather events that affect production, price volatility, and threats to animal and plant health. FND requires appropriate insurance when it is available in the market. The capacity building offered under Subcomponent 2B to rural financial institutions will support their operational processes and credit underwriting.

46. **FND will carefully select and monitor PFIs to manage credit risk.** FND's PFI selection process is comprehensive. The process is elaborated in FND's Manual of Credit Policies and includes, among others, ownership and governance, financial health, risk management, and internal processes. Monitoring is conducted off-site on a quarterly basis and on-site on a semiannual basis, including visits to PFI clients. When needed, FND provides a detailed time-bound action plan to ameliorate identified weaknesses.

47. **FND is working to improve its PFI risk management, but challenges remain.** FND has developed an early warning monitoring system and supported increased credit bureau usage by the PFIs to improve credit risk management. However, the status of the PFI IT systems are currently not subject to supervision, and although FND's first-tier and second-tier lending have different profiles and risks, the same personnel are in charge of loan origination, analysis, and monitoring.

48. **Uncoordinated competition among DFIs expanding their second-tier lending could reduce PFI demand for funds.** Several DFIs have been given mandates to expand credit. FIRA also provides second-tier finance in rural areas. However, there is segmentation, with 78 percent of FIRAs lending being through banks, whereas 76 percent of FND's second-tier lending is through unsupervised institutions. Moreover, the supply of financial services in rural areas is so limited that ample opportunities for expansion remain.

49. **FND faces operational challenges in expanding its activities.** Operational efficiency and the IT systems underpinning it must be able to accommodate increasing activities. This applies both to direct lending and PFI lending. Although the latter is operationally lighter than direct lending, there are many small intermediaries that pose an operational challenge.

50. **The upgrading of FND's IT system and associated alignment of business processes carry important implementation risks.** The system, once in place, will help FND better manage its risks and monitor its performance. However, IT projects in large institutions are complex to manage, prone to cost and time overruns (typically taking longer than the average loan cycle to implement), and require proper internal planning and monitoring as well as specific technical skills. The team has reviewed the IT master plan for FND that provides evidence of preparation and engaged an expert IT consultant as a team member to assess the human resources, governance structure for IT, and existing systems to support a sound approach and maintain realistic expectations. As part of project preparation, the Bank team provided recommendations to FND such as (a) assigning a senior IT director for the project; (b) creating a project management office; and (c) conducting a detailed costing exercise for the project, that FND is working to implement.

51. **Increased violence in the rural areas of Mexico can reduce the impact of the project.** In recent years, violence associated with organized crime and narcotics has increased in urban peripheral and rural areas. This violence can discourage the PFIs from lending in affected areas and undermine the viability of MSME projects. At the same time, the economic opportunities created by finance can be a solution to reduce crime and violence, justifying the risk.

VI. APPRAISAL SUMMARY

A. Economic and Financial Analysis

52. **For Subcomponent 1A, the expected Net Present Value (NPV) for MSMEs is estimated at US$92 million.** The Economic Rate of Return (ERR) is expected to be 21.7 percent. The analysis estimates the benefit based on the difference in cash flows between the borrowing scenario versus the without borrowing scenario. It is based on the Food and Agriculture Organization's agricultural data and field research that estimates the impact of similar programs on rural MSME value-added and productivity growth and changes in wages. The analysis is detailed in annex 5.

53. **For the remaining subcomponents, evidence from literature is offered, given the experimental and/or indirect nature of the benefits.** Capacity strengthening at FND and the PFIs as well as the demonstration effect from pilots under Subcomponent 1B can improve the supply and quality of rural financial services. The relationship between access to finance reform and firm performance is well-supported in literature[18]. The literature supports capacity-building programs to financial institutions to increase the number and customization of products offered to MSMEs. The potential poverty impact is particularly large for relatively unbanked populations.[19]

54. **The supply of financial services in rural Mexico is extremely low.** Mexico has very low credit depth in general, and with significant disparities between rural and urban areas, the supply in the former is meagre. The little credit by banks to rural areas has been concentrated on large agribusinesses. The project aims to expand the availability of rural finance to the rural economy while supporting sustainable rural financial intermediaries.

B. Technical

55. **The project's technical design draws on analysis from FND, government of Mexico reports, and the Bank's knowledge products and lending projects.** Key principles underlying project design include (a) transparent eligibility criteria for PFIs developed based on available domestic (CNBV and Microfinance Information Exchange Market data) and international data to benchmark sector performance; (b) adherence to market principles for interest rates to final borrowers; (c) establishment and monitoring of clear indicators tracking project performance (annex 1); and (d) examination of FND's financial strength and its processes for accreditation of PFIs to receive funds under the project.

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[18] See, for example, Demirguc-Kunt and Klapper 2012.
[19] See, for example, Burgess and Pande 2005.

C. Financial Management

56. **The project will use country systems, which in general provide an adequate internal control environment with sound financial and operational systems and well-defined procedures used by the entities within the federal government.** FND will apply its operational manuals and procedures, which are well-developed and comply with supervisory requirements of the CNBV, the country's financial sector supervisory authority. The team will conduct regular financial management (FM) supervisions and provide periodic training aimed at building capacity, as needed. The project will be annually audited according to terms of reference (ToR) acceptable to the Bank. The ability to apply retroactive expenditures has been established. FND may solicit withdrawals up to 20 percent of the loan amount (US$80 million) for payments for eligible expenditures under the Project, made up to twelve months prior to the signing of the loan agreement.

D. Procurement

57. **Procurement management will draw from the strengths and lessons learned by FND from an ongoing operation with IDB and FND's experience in the rural finance sector.** FND will be responsible for the bidding processes of Component 2, including the preparation of the bidding documents, ToR, and signature of contracts. Procurement under Component 1, including selection of consultants, will be based on established private sector or commercial practices in accordance with section 3.13 of the Procurement Guidelines, Procurement in Loans to Financial Intermediary Institutions and Entities as described in the POM. FND provides funds to PFIs to on-lend to private MSMEs for small-value subloans on commercial lending terms. Procurement by clients is expected to be undertaken in a prudent manner because loans must be repaid with interest.

E. Social (including Safeguards)

58. **Overall the project is expected to deliver important benefits to vulnerable groups that have been traditionally excluded (ex: women and indigenous people) from the financial sector in rural areas**. The potential negative social impacts, such as resettlement, are minimal due to the loan sizes offered, and the application of an environmental and social screening process.

59. **Indigenous Peoples.** The Operational Policy for Indigenous Peoples (OP 4.10) was triggered as the project area covers all of rural Mexico and indigenous peoples constitute close to 15 percent of the country's population. FND's strategy for engaging with indigenous communities is to build the capacity of the regional indigenous funds (RFIs), established by the National Commission for the Development of Indigenous Peoples as community-based mechanisms for the delivery of federal subsidies to indigenous producer groups. FND works with a subset of the RFIs to help them transition into PFIs. RFIs can receive capacity-building activities under Subcomponent 2B. The program document describing the strategy serves as the basis for the project's Indigenous Peoples Planning Framework (IPPF), which was prepared and disclosed on FND's website and the World Bank Insfoshop in July 2015, and was discussed with relevant indigenous peoples' organizations following disclosure. During these meetings the IPPF was supported by the participants, as a means to strengthen RFIs for local economic

development, and to support the provision of credit to traditionally excluded populations. The IPPF was approved and disclosed in Infoshop by the World Bank in August 2015.

60. **Involuntary Resettlement.** The Operational Policy on Involuntary Resettlement is not triggered because the project will support PFIs to provide relatively modest loans to rural enterprises implemented on private land. Any activities on land where involuntary resettlement takes place is included in the exclusion list for the Environmental and Social Management System.

61. **Citizen feedback.** The project presents a number of entry points for citizen engagement. These include FND's web-based client feedback form, the utilization of public information from Mexico's Commission for the Protection of Users of the Financial System (*Comisión Nacional para la Protección y Defensa de los Usuarios de Servicios Financieros* [CONDUSEF]) in collecting and addressing complaints from PFI clients, and the role of RFIs in empowering marginal communities with resources and decision-making powers.

62. **Gender.** FND 2014 data on credit line beneficiaries who were sole proprietors confirmed that the majority were women. This is partly due to a number of female-oriented policies implemented by FND, which will continue during the life of the program. A gender-disaggregated indicator on the number of credit line beneficiaries will be monitored.

F. Environment (including Safeguards)

63. **The project is classified as Environmental Risk Category F (Financial Intermediary Assessment) and four environmental safeguard policies are triggered.** Environmental risks are considered low as FND has experience in implementing environmental and social policies including with the IDB. Policies triggered include Environmental Assessment (OP 4.01), Natural Habitats (OP/BP 4.04), Pest Management (OP 4.09), and Forests (OP 4.36). The subprojects are not pre-identified, but the majority will be small loans to MSMEs. In 2014, 95 percent of PFI loans were less than US$10,000 and 78 percent were related to commercial and services activities. In terms of environmental issues, significant negative impacts are not expected due to the size of the loans offered, and the application of an environmental and social screening process.

64. **An Environmental Management Framework (EMF) has been developed by FND to support the PFIs in the identification of environmental requirements.** The EMF applies eligibility criteria, including risk level, credit amounts, and the nature of activities to be financed. Activities are classified into three categories: Category 1 - Exclusion list; Category 2 - Eligible activities that do not require environmental permits, licenses, or authorizations; and Category 3 - Eligible activities that require some type of environmental permit, license, or authorization and best practices application. No activities that are high risk and/or likely to have significant adverse environmental impacts (World Bank Category A) will be funded. The EMF was approved by the World Bank and disclosed in-country in July 2015, and consultations were held with PFIs and other stakeholders who affirmed their support for the framework defined. The EMF was disclosed in the Infoshop in August 2015.

65. **An environmental analysis of potentially eligible activities has identified the most common activities (agricultural, livestock, forestry, and fishery sectors), their environmental impacts and mitigation measures, and/or good environmental, health, and safety practices for use by the beneficiaries.** Recommendations for thematic best practices have been developed as a part of the EMF and will be distributed to relevant beneficiaries through brochures. The POM outlines EMF implementation, including the distribution of the brochures and EMF monitoring. Subprojects will be monitored ex post through random audits in the first year, the project midterm review, and upon project completion. Cumulative impacts are not foreseen given the wide range of sub-project locations, their relatively small size, and the nature of the relatively small investments (mostly working capital) in MSMEs.

G. World Bank Grievance Redress

66. **Communities and individuals who believe that they are adversely affected by a Bank-supported project may submit complaints to existing project-level grievance redress mechanisms or the Bank's Grievance Redress Service (GRS).** The GRS ensures that complaints received are promptly reviewed to address project-related concerns. Project-affected communities and individuals may submit their complaint to the Bank's independent Inspection Panel, which determines whether harm occurred, or could occur, as a result of Bank non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the Bank's attention and Bank management has been given an opportunity to respond. For information on how to submit complaints to the Bank's corporate GRS, please visit http://www.worldbank.org/GRS. For information on how to submit complaints to the Bank's Inspection Panel, please visit www.inspectionpanel.org.

ANNEX 1: RESULTS FRAMEWORK AND MONITORING

Mexico: Expanding Rural Finance (P153338)

PDO statement: The PDO is to expand the availability of finance to the rural economy.

Results are at the project level.

PDO Indicators									
				Cumulative Target Values					
Indicator Name	**Core**	**Unit of Measure**	**Baseline**	**YR 1**	**YR 2**	**YR 3**	**YR 4**	**End Target**	**Frequency**
Number of loans disbursed under the project (cumulative)		Number	0	14,400	40,000	66,000	71,000	74,800	Biannual
Volume of total loans disbursed under the project (cumulative)		US$, millions	0	72	200	330	355	374	Biannual
Average NPL ratio for PFIs receiving project funds		Percent	Not applicable	<6	<6	<6	<6	<6	Biannual
Intermediate Results Indicators									
Volume of bank support - lines of credit, microfinance	Yes	Number	0	29	100	165	178	187	Biannual
Volume of bank support - lines of credit, SME[20]	Yes	Number	0	43	100	165	177	187	Biannual
Number of final beneficiaries with loans financed with project funds (cumulative)		Number	0	8,000	22,222	36,667	39,444	41,555	Biannual
Subindicator 1: Number of final microfinance beneficiaries financed with project funds (cumulative)		Number	0	4,800	13,333	22,000	23,666	24,945	Biannual

[20] Beneficiary MSMEs are defined to include both individuals and firms according to the Mexican context. The small and medium enterprises (SMEs) here are defined as the difference between all MSMEs in the project and those classified as microfinance to comply with the Bank's core indicators.

Subindicator 2: Share of loan recipients from marginal municipalities financed by the project		Percent	0	15	15	15	15	15	Biannual
Subindicator 3: Female beneficiaries as a share of total beneficiaries financed by the project		Percent	0	60	60	60	60	60	Biannual
Average NPL rate for FND lending to PFIs under the project-funded credit line		Percent	0	<5	<5	<5	<5	<5	Biannual
Percentage of FND branch offices using the new core banking system		Percent	0	0	0	10	50	70	Biannual
Number of PFIs that receive capacity building from FND		Number	145	145	290	435	580	725	Biannual
Submission of operational tracking data		Yes/No	No	Yes	Yes	Yes	Yes	Yes	Biannual
Number of PFIs registered to receive client feedback on CONDUSEF's website		Number	107	130	150	180	200	200	Biannual

Indicator Descriptions

PDO Indicators			
Indicator Name	**Description**	**Data Source/ Methodology**	**Responsibility for Data Collection**
Number of loans disbursed under the project	Number of loans disbursed under the project for Subcomponents 1A and 1B to the rural economy. This is the sum of two core indicators disaggregated below that measure the number of microfinance and MSME loans disbursed. Beneficiary MSMEs include both individuals and firms.	FND	FND
Volume of total loans disbursed	This indicator is a cumulative measure of the total volume of funding	FND	FND

under the project	disbursed by PFIs to MSMEs under the credit line in Subcomponent 1A and 1B. This is the sum of two core indicators disaggregated below that measure the microfinance credit volume and MSME credit volume.		
Average NPL ratio for PFIs receiving project funds	NPL ratio = loans overdue for between 30 and 90 days / gross loans reflecting portfolio at risk of lending of PFIs to final beneficiaries	FND	FND
Intermediate Indicators			
Volume of bank support - lines of credit, microfinance	Core indicator: A line of credit is classified 'microfinance' if the supporting subloans (a) have an average outstanding balance (gross loan portfolio / number of active borrowers) <300% of the latest per capita GNI or (b) are less than US$1,000. Either circumstance triggers classification as microfinance. Lines of credit and other funding for retail microfinance subloans by PFIs or community-managed loan funds. Report the cumulative amounts disbursed as of most recent date available. If a split by microfinance and MSME is not available or possible, use 50% for each as proxy.	FND	FND
Volume of bank support - lines of credit, MSME	Core indicator: A line of credit is 'MSME finance' if the supporting subloans have an average outstanding balance > microfinance cut-off noted below, but no more than US$300,000. A line of credit is classified 'microfinance' if supporting subloans (a) have an average outstanding balance (gross loan portfolio ÷ number of active borrowers) <300% of the latest per capita GNI, OR (b) less than US$1,000. Either circumstance triggers classification as microfinance. Lines of credit and other funding for retail MSME subloans by PFIs or community-managed loan funds. Report the cumulative amounts disbursed as of most recent date available. If a split by microfinance and MSME is not available or possible, use 50% for each as proxy.	FND	FND
Number of final beneficiaries with loans financed with project funds	This indicator is a cumulative measure of the total number of unique MSME beneficiaries provided under the credit line in Component 1a and 1b.	FND	FND
Number of final microfinance beneficiaries with loans financed with project funds	This indicator is a cumulative measure of the total number of unique microfinance beneficiaries provided under the credit line in Subcomponent 1A and 1B. A line of credit is classified 'microfinance' if supporting subloans (a) have an average outstanding balance (gross loan portfolio ÷ number of active borrowers) <300% of the latest per capita GNI or (b) are less than US$1,000.	FND	FND

Share of loan recipients from marginal municipalities financed by the project	The National Council on Population classifies municipalities according to their level of marginalization (social and economic disadvantage), based on the 2010 census. This indicator will track the percentage of final borrowers (unique beneficiaries, first loan, and first disbursement from project funds) from municipalities with high and very high levels of marginalization.	FND	FND
Female beneficiaries as a share of total beneficiaries financed by the project	Percentage of female unique beneficiaries (counted only once)	FND	FND
Average NPL rate for FND lending to PFIs under the project-funded credit line	NPL rate = loans overdue for more than 90 days / gross loans reflecting lending from FND to PFIs (average)	FND	FND
Percentage of FND branch offices using the new core banking system	Percentage of FND branch offices that have installed the new banking system and are at least in the testing phase of using it	FND	FND
Number of PFIs that receive capacity building from FND	Number of PFIs financed through Subcomponent 2B. This includes both PFIs receiving funds through the credit line and PFIs that are not yet eligible for or not yet participating in the credit line.	FND	FND
Submission of operational tracking data	FND presents information on additional tracking indicators as indicated in the Operational Manual.	FND	FND
Number of PFIs registered to receive client feedback on CONDUSEF's website	Citizens' feedback indicator: Data available on CONDUSEF's website. This includes all PFIs working with FND, not just those financed by the project.	CONDUSEF	CONDUSEF

Additional indicators to be measured are described in annex 3.

ANNEX 2: DETAILED PROJECT DESCRIPTION

Mexico: Expanding Rural Finance

1. **The project is a five-year financial intermediary loan in the amount of US$400 million, consisting of an IBRD credit line to FND.** A credit line will be provided to be intermediated by FND through eligible PFIs serving rural borrowers, following OP 10.00 principles (see annex 6 for assessment). FND, the borrower and implementing agency for this project, will in turn on-lend/finance PFIs. FND will select PFIs pursuant to criteria agreed between FND and the Bank. The selected PFIs will in turn subfinance private MSMEs in the rural economy.

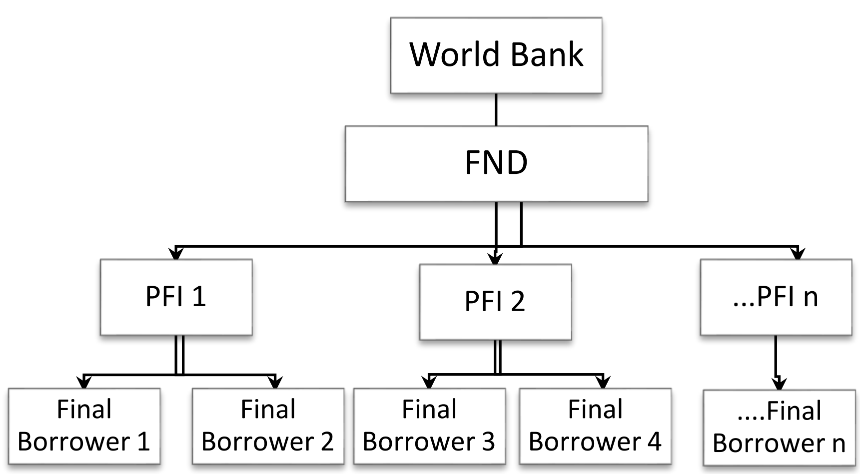
2. **The PDO is to expand the availability of finance to the rural economy.** The higher-level objective is to support growth and employment creation through unlocking opportunities for firm growth that the financing would provide. The project will have two components supporting the development of productive finance.

Component 1: Expanding Credit for Rural MSMEs

Subcomponent 1A: Credit line through PFIs to MSMEs (US$365 million)

3. **Subcomponent 1A has three key stakeholders**: FND, PFIs, and final borrowers, including rural producers and MSMEs. The structure for the line of credit for this subcomponent includes (a) the Bank extending a credit line to FND; (b) FND extending loans to PFIs; and (c) PFIs extending subloans to final borrowers. FND will administer the credit line according to the provisions of the Loan Agreement and the POM, agreed with the Bank.

Figure 2.1. Structure for the Credit Line Flow of Funds for Subcomponent 1A



4. **As part of its responsibilities for implementing subcomponent 1A**, FND will (a) define eligibility criteria for PFIs; (b) define the characteristics of the loans to be provided from FND to PFIs; (c) define eligibility criteria for final borrowers; (d) define the characteristics of

subloans eligible to receive Bank funds; (e) define and implement a communication strategy; and (f) define and implement a M&E strategy. This has been agreed with the Bank and formulated in the POM.

5. **FND will offer lines of credit to PFIs, through a diverse set of rural financial institutions.** These financial institutions, described in Box 1, includes niche banks, credit unions, popular financial companies (*Sociedades Financieras Populares*, SOFIPOS), cooperatives, unsupervised regulated financial institutions (Sociedades SOFOMES), and unregulated producer organizations with the ability to reach rural producers where regulated institutions do not. The PFIs on-lend to MSMEs, enabling them to expand their activities. In addition to supporting the general objective of improving access to credit in rural areas, the component will help FND achieve its strategic objective of increasing its proportion of credit disbursed through intermediaries.

Box 1. Types of Institutions with which FND Works

Supervised institutions:

- **Banks:** Including both full banks and niche banks.
- **SOFIPOS:** Public limited liability companies offering both lending and deposit services.
- **Cooperative societies of savings and credit (*Cajas*):** Both lend and take deposits and they are only supervised if their assets exceed about US$1 million. Currently, FND only works with supervised cooperatives.
- **Credit unions:** Member-based companies able to offer credit only to their members and can operate only in the industry group to which their members belong.
- ***Almacenas generales de deposito* (warehouse deposit financing):** Serve to both store agricultural products and also lend to those using the warehousing facilities with stored products as collateral.

Unsupervised institutions:

- **SOFOMES:** Public limited liability companies offering lending services to the population. Only SOFOMES with ownership links to banks are supervised and FND has not traditionally worked with these.
- **Producer associations/*dispersoras*:** Legally constituted multipurpose associations that disburse credit to primary producers.

6. **Selection of PFIs will be based on clearly defined eligibility criteria with the primary focus on financial strength and reach to the target audience.** The accreditation currently takes up to a year, partly reflecting the thoroughness of the process and partly that many prospective intermediaries must upgrade their practices to be eligible. The accreditation review includes general questions about the type of institutions and its objectives as well as a detailed review of products, balance sheets, organizational structure, quality of financial reporting, systems, and manuals for operation and risk management. The team has reviewed FND's accreditation procedures, which include the key elements of standard due diligence process, and FND's supervision and monitoring activities. Determination of PFI eligibility to receive Bank funding will include transparent performance indicators such as credit quality, solvency, exposure to FND, related lending, loan concentration and other aspects related to institutional capacity and sound lending practices such as use of credit bureaus, as specified in the POM.

7. **Simulations conducted with 2014 data suggest that lending through PFIs will be achieved, partly by working with more PFIs and partly by increasing lending to existing PFIs.** Their 2014 equity base is US$951 million and FND's lending to these institutions is

currently US$698.4 million. The majority of the current FND PFIs have prudent exposure to FND of less than 25 percent of their assets, but increasing exposure to existing PFIs should be done cautiously. FND has conducted simulations with the support of the Bank to estimate an envelope of possible prudent lending to existing PFIs, to understand the number of PFIs meeting proposed eligibility criteria and the nature of their activities. For example, there will be an envelope of about US$1.9 billion by expanding lending only to PFIs with NPL ratios below 5 percent, FND lending not exceeding three times the equity of the PFI, and the leverage of the PFI as measured by a capital-to-assets ratio not below 15 percent.

8. **Interest rates to final borrowers will be market based to ensure sustainability and avoid creating interest rate distortions in the market.** FND will on-lend funds to the PFIs at interest rates that take into account minimum FND cost of funding, operating costs, and an appropriate credit risk margin, subsidized in some cases by liquid guarantees available from FND or other public funds. The PFIs will independently set their interest rates, which are expected to cover at least the cost of funding, operational costs, and an appropriate credit risk premium based on the credit assessment of the borrower.

9. **All final beneficiaries of FND loans are engaged in the rural economy**. For second-tier lending in 2014, by volume, the agricultural sector was the most prevalent. However, by number of loans, commercial activity was most common. The loans from PFIs to enterprises will be made for productive purposes to both legal and physical persons. Both working capital and investment finance will be eligible and the former is likely to dominate considering the size and sophistication of rural borrowers. Women are the majority of FND borrowers through PFIs due to their high level of participation in rural microcredit.

10. **Key steps and processes for lending through PFIs were mapped by FND and described in detail in the POM.** The mapping includes the selection process for credits, a review of documentation requirements and systems involved at each step, and supervision and audit processes for credits. Lending will take place for credits provided through the credit generation facility and the credit discounting window, both of which can be funded through the credit line. Annex 6 elaborates on the financial performance of FND and the PFIs and details the credit process as it relates to OP 10.00.

Component 1B: Supporting FND Pilots for Rural Finance (US$10 million)

11. **This component provides a credit line for FND to pilot financial products and services that are not prevalent in the rural economy.** FND and its PFIs typically offer a narrow range of financial products to their clients/members. About 79 percent of the FND portfolio through PFIs finances working capital and another 5 percent finances fixed assets. The growth of the portfolio will partly depend on these financial service actors being able to expand their product line to meet the demand from enterprises of the rural economy.

12. **The financial products to be developed and tested will be finalized during implementation and in consultation with PFIs.** They will typically try to address constraints typical to rural finance, such as production cycles, risks inherent to agriculture, high transaction costs, or lack of collateral. The list of products that this credit line will finance may include leasing, moveable assets finance, factoring, warehouse receipts, contract farming, or other types

of value chain financing. The World Bank team will collaborate with FND to design these interventions and document lessons from these experiences.

13. **FND may lend directly to MSMEs, lend through PFIs, or a combination of the two**. A key objective will be to test and/or promote new financial products that have the potential of being scaled up. When channeled through PFIs, this subcomponent will also be coordinated with Subcomponent 2B, which will provide capacity building to rural financial institutions (see below).

14. **Pilots will be developed according to the following sequence.** First, FND will develop in detail the proposals of the products to be piloted. The Bank will review the proposals and share with FND similar solutions for overcoming barriers to finance that have been implemented around the world, where applicable. FND will evaluate the alternatives and adjust, if needed, the design of the pilot ideas, ensuring the approach is fully consistent with FND's objectives and its agencies implementation capacity. Details of the pilot will be clearly defined and will include the type of targeted beneficiaries, sectors to be supported, geographical area where the pilot will be implemented, activities to be financed, estimated budget, and time frame, among others. An M&E strategy to measure the progress and results of the pilot will be developed.

Component 2: Strengthening Institutional Capacity for Sustainable Rural Finance (US$30 million)

Component 2A: Modernization of Banking Systems (US$25 million)

15. **FND will analyze options for enhancing its core banking platform and related systems.** IT modernization is a priority action in its 2014 strategic plan and it is particularly important in the context of FND's planned balance sheet expansion. As part of diagnostics supported by this project, FND will explore options ranging from implementing new software applications that complement its current banking setup to potentially replacing the bank's entire core banking platform. Appropriate diagnostics will help ensure that the scope, timeline, and budget for such enhancements are within the expected loan cycle and have appropriate levels of risk.

16. **The enhanced internal processes and information and communication technologies systems will support the improved delivery of financial services, greater efficiency, and risk management capabilities of FND.** The component will include the funding of equipment and software for an upgraded core banking setup as well as the consultancies necessary for diagnostics, technical design, and implementation support. The component may also help fund an expansion of the geographic coverage of FND in cost-effective ways, for example through alliances with key strategic partners with complementary distribution networks. The upgraded system also contemplates a better user experience, allowing for online banking and facilitated access to new products.

17. **FND's current information systems have weaknesses that limit efficiency and risk management.** FND's current banking information system was developed in the 1990s. Since then, technology changes have made core banking systems more flexible, user-friendly, and scalable. FND's core banking system currently presents different challenges, including

duplication of data capture at different stages of the credit process, as modules for credit evaluation, credit monitoring, and nonpayment are not integrated into a single system. This also impedes a comprehensive analysis of risks. In conjunction with identification of system needs, FND is also undergoing a reengineering of credit processes that need to be incorporated into a new software application.

18. **Diagnostic work and development of business, functional, and technical specifications are key preparatory steps for evaluating alternatives to improve FND's core banking system.** FND will be responsible for (a) developing the internal business, functional, and technical requirements for an enhanced core banking system; (b) evaluating different options for enhancing the existing banking system, including looking at options such as new software applications that complement its current banking setup to potentially replacing the bank's complete core banking platform; (c) conducting a detailed costing exercise that outlines the costs for software licenses, hardware, customizations, consultancies, and other implementations costs; (d) putting together a proper roadmap for enhancing or replacing the core banking system, including estimated budget and time frame for selection and implementation; (e) conducting the procurement process for the required new application; (f) signing the contract with selected firm; and (g) managing all aspects of the implementation process, such as overall project management, architecture design and integration approach, customizations, testing, data migration, and launching of the system.

19. **FND will need to build its internal capacity to manage large IT projects.** FND needs to fill key vacancies in the IT area (director of IT Department) and to create a project management office to coordinate and monitor the activities for the core banking system upgrade. Additionally, external assistance will likely be needed to support diagnostics; the elaboration of the business, functional, and technical specifications for the system; and the implementation. Experienced IT professionals who have been involved with major system change in government institutions suggest that a steering committee of external experts be established to guide this project**.**

Component 2B: Strengthening Rural Financial Institutions (US$5 million, utilizing counterpart financing)

20. **The expansion of rural financial services in Mexico will rely on new institutions entering the market and existing institutions strengthening their operations.** Currently, FND receives support from the SHCP to provide capacity building and equipment to a limited number of PFIs through a network of accredited specialists with extensive experience in supporting financial institutions focused on lower-income populations. The funds currently provide assistance to different types of rural financial institutions—*dispersoras*, credit unions, SOFOMES, and cooperatives. In 2014, almost half the capacity building was provided to SOFOMES. Capacity building is provided in various forms, including support to open branches in remote areas, diagnostics of credit approval processes, and trainings and scholarships to increase the skills and capacity of PFI staff. Funds are allocated on a first-come, first-served basis.

21. **Funds from this subcomponent will be used to provide capacity building to rural financial institutions.** The funds from this subcomponent will be used both to provide capacity

building to PFIs receiving lines of credit from FND and also to assist potential PFIs to meet FND eligibility criteria with the goal of helping strong formal financial intermediaries in evolving from the unsupervised segment. Funds are provided in a nondiscriminatory fashion, although funds serving priority populations, such as the indigenous, receive a preference for capacity building provided through this subcomponent. Capacity building provided through this subcomponent will cover a variety of topics, including credit risk management, management training, and IT systems selection. Some PFIs also receive equipment (for example, copiers and desks) through the project to support the start-up of branches and/or expansion of their operational capacity to offer sustainable access to finance in rural areas.

22. **Government entities and other multilaterals are providing complementary support to PFIs and their beneficiary MSMEs.** Rural DFI FIRA provides institutional strengthening support to rural financial institutions. Mexico's Secretary of Agriculture, Livestock, Fisheries and Rural Development (*Secretaría de Agricultura, Ganadería, Desarrollo Rural, Pesca y Alimentación*) provides a range of support to agricultural beneficiaries, such as on-farm investment and expenditures. The Secretary of Economy, through the National Microenterprise Finance Program, provides capacity building to PFIs. Payments based on on-farm investment and subsidies to crop insurance are provided through the National Agricultural Insurance Company (*Agro-Aseguradora Mexicana*). In one of its loans to FND, the IDB is providing support for technological interventions for agricultural producers to increase their productivity.

ANNEX 3: IMPLEMENTATION ARRANGEMENTS

Project Institutional and Implementation Arrangements

A. Overall Arrangements

1. **FND will be the borrower and responsible for the implementation of the Expanding Rural Finance project. The Bank will enter into a Loan Agreement with FND and a Guarantee Agreement with Mexico represented by the SHCP.** For implementation of Component 1, the borrower (FND) will enter into a Subsidiary Financing Agreement with eligible PFIs to on-lend to rural MSMEs through loan agreements. For Subcomponent 1B, FND may also lend directly through loan agreements with MSMEs for pilot initiatives. The DEPP within FND participated in the design of this project and will be the Bank's main counterpart.

2. **The implementing agency is part of the system of DFIs playing the key role of channeling resources to the rural economy directly and through PFIs.** FND's lending portfolio for direct and PFIs lending is well-diversified and its current and projected financial soundness indicators are robust. Its accreditation procedures for accepting PFIs include the key elements of standard due diligence process.

3. **Throughout the project implementation, FND will maintain a core team within the DEPP**. This team will consist of an experienced project coordinator, a fiduciary specialist, and social and environmental specialists, responsible for, among other things, (a) preparing and updating a detailed POM and (b) managing, implementing, and supervising the project according the provisions of the Loan Agreement and the POM. FND has experience working with other international organizations,[21] and FND's predecessor, Banrural, was restructured as part of a Bank operation.[22]

4. **A technical committee with fixed representatives from different areas of FND will be created to support the implementation of this project.** FND will nominate technical staff from key departments, including (a) Credit; (b) Programs and Policies; (c) Operations; (d) Legal; (e) Data Management; (f) Promotion; and (g) IT.

5. **FND has prepared a POM that is in form and content satisfactory to the Bank and consistent with the provisions of the Loan Agreement.** The POM adopts some relevant policies and procedures already in place in FND's existing operational manuals and includes details on the implementation arrangements, including the eligibility criteria for PFIs,[23] and its procedures include specific controls to ensure that the project's funds are managed under sound FM practices. Changes in the POM cannot be made without prior approval of the Bank.

[21] Currently, FND is administering a US$400 million conditional credit line investment IDB project.
[22] They were responsible for managing the MX Rural Finance Development Structural Adjustment Loan (P074655) approved on June 12, 2003, for an amount of US$505 million.
[23] Eligibility criteria may include credit quality, solvency, FND leverage, and other aspects such as operational efficiency and use of credit bureaus. In addition, financial performance indicators for PFIs such as leverage ratio, profitability measured by the ROE and ROA and portfolio quality indicators (e.g. NPL ratio) will be monitored by FND and reported to the Bank at the midterm evaluation and for Implementation Supervision Reports.

6. **The Bank's funds will flow to FND.** First, funds will be allocated as part of the national budget, which is approved annually by congress, and then, the funds will be integrated with FND's own financial resources. A dedicated and experienced unit in charge of consolidating the financial information within FND will be accountable for financial reporting.

B. Financial Management and Disbursement

7. **A Financial Management (FM) Assessment of the proposed Project's FM arrangements has been performed in accordance with OP/BP 10.00 and in line with Bank specific guidelines[24].**

8. **Summary.** The residual FM risk, i.e. the inherent risk as mitigated by existing controls, is Moderate. From the operational perspective the project poses some implementation challenges. However, DEPP has an experienced unit in charge of executing projects financed through Multilateral International Institutions, with acceptable implementation arrangements in place.

- **Flow of funds.** The project's funds are first allocated as part of the budget which is approved annually by the Congress and in addition, Bank funds will be integrated with FND's own financial resources.

- **Flow of information.** FND has a dedicated and experienced unit in charge of consolidating the financial information after conducting a number of checks and balances procedures.

The FM risk is mitigated through various measures divided in 3 main layers of control:

- **Country level mitigating measures.** The overall strong country public FM arrangements will be applied to this project as it will be integrated into the national budget which operates under a comprehensive and well established legal framework. The Bank will advance funds for eligible expenditures recorded under earmarked budgetary lines.

- **Project level mitigating factors.** There are well defined operating rules governing the project, which include strict eligibility criteria for selecting beneficiaries, clear rules for transferring the money, documenting the project's expenditures, and for the project oversight.

- **Entity level mitigating measures.** FND through DEPP has experience working with the Bank. Although the FM Unit is well staffed with an adequate segregation of functions, the unit may need to be supported with additional staff for managing the incremental work load from this project. Apart from this, the Unit conducts a number of periodic reconciliatory procedures to reasonably ensure the accuracy of financial information.

9. **Main mitigating measures include the development of a POM, which has already been prepared in form and content satisfactory to the Bank, which adopt relevant policies**

[24] Financial Management Manual for World Bank-Financed Investment Operations; document issued by Operations Policy and Country Services OPCFM on March 1, 2010.

and procedures already in place at FND's operational manuals. Procedures will include specific controls for ensuring that the Project's funds are managed under sound financial management practices. In addition, the annual Project audit will provide assurance that the funds were used for the intended purposes.

10. **The PFIs receiving sub-loans through FND will be targeted through eligibility criteria for PFIs and a maximum sub-loan amount.** PFI criteria will rely on the FND accreditation procedure and will likely include indicators pertaining to solvency, asset quality, and leverage. Enterprise eligibility will be based on the documented underwriting process of the PFI assessing willingness and capacity to repay, as well as fiduciary, safeguards, and reputational risk considerations.

11. **The mitigating control factors described in this Annex include:**

(i) Strong country Public FM arrangements;
(ii) The Project's budget will be included in the Public Federal Administration and embedded in the standard budgetary procedures of FND, including formulation, monitoring and control;
(iii) Budget will be controlled and monitored through an Annual Operations Plan (POA, by its Spanish acronym);
(iv) Loan withdrawals and project account activity will be included in FND central accounting systems and incorporated in Project financial statements and audits;
(v) The internal audit function is carried out by the FND's Internal Auditor which reports to an independent Audit Committee. It is also subject within the scope of audit of the Supreme Audit Institution. CNBV also supervises regularly FND;
(vi) Internal Auditor is also responsible for following up on all findings identified by external auditors;
(vii) The PFIs will be responsible for transferring the sub-loans and keeping files of all the supporting documentation of the project's expenditures, including evidence to transfer to project beneficiaries;
(viii) A number of operational controls have been established in the operating rules of the project, at various level of the project's operation, including the planning in the use of the resources, and the authorization of payments related to credits to beneficiaries;
(ix) Project Financial Statements will be subject to external audits on an annual basis, performed by auditors acceptable to the Bank;
(x) FND will prepare and submit to the Bank calendar semester (biannual) unaudited Interim Financial Reports (IFRs).

12. FND will act as its own financial agent for this operation.

Budgeting

13. **FND has its own financial resources, which conform FND funds; these resources supports its credit operation and expenses of the organization.** Additionally, under the sectorial Special Concurrent Program for Sustainable Rural Development, within the Expenditure Budget of the Federation, the Chamber of Deputies, provides resources for the

operation of programs subject to Operating Rules that contribute to the credit operation. These resources are contributions to the organization equity and part of it, in order to meet the operation of the programs mentioned.

14. The loan resources will form part of the resources that sustain the credit operation of the organization.

Accounting

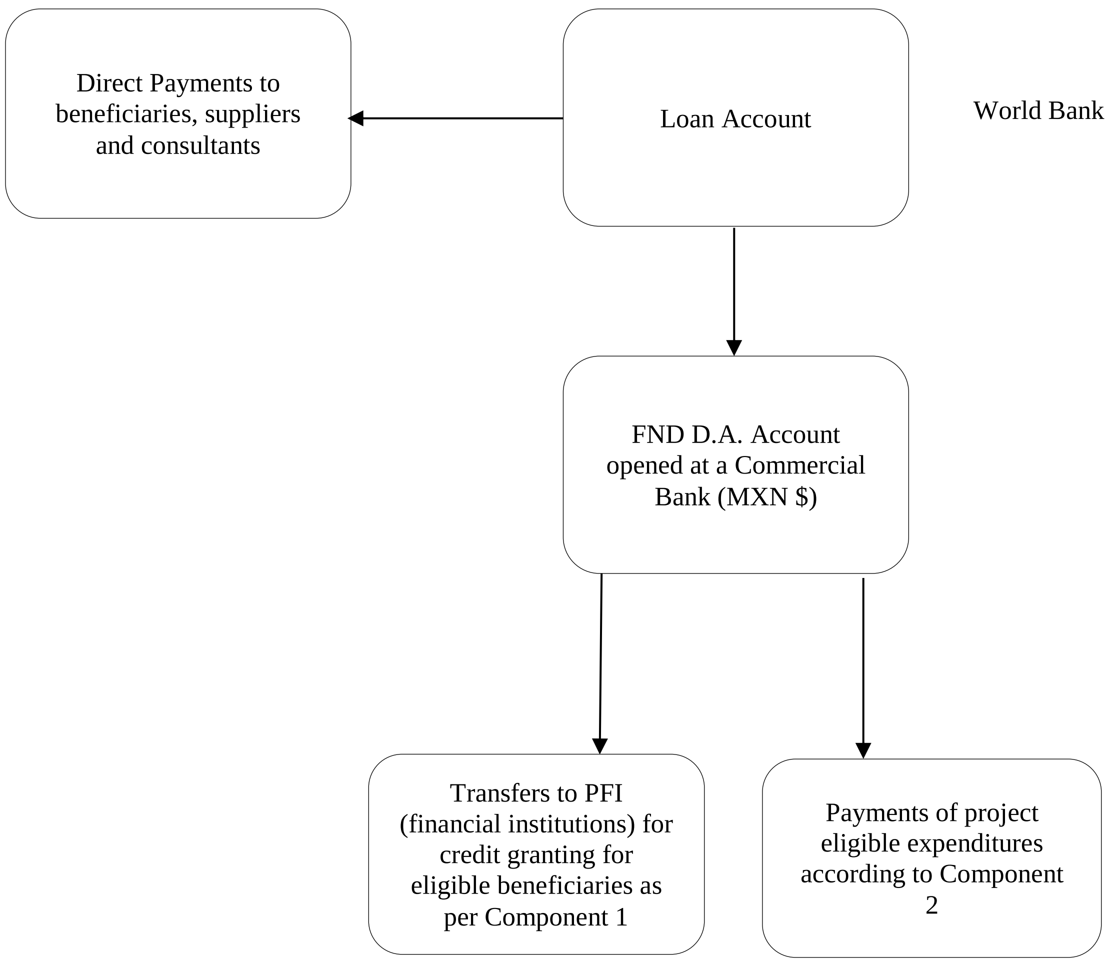
15. **FND accounting is governed by Financial Reporting Standards issued by the Mexican Institute of Public Accountants and The General Provisions Pertaining of Prudential Character, accounting and information for the requirement applicable to the FND, issued by the CNBV.** There is a chart of accounts that will be customized to maintain the accounting records of the project.

Internal Control and Internal Auditing.

16. **The current internal audit practice reports to the FND Independent Audit Committee and will have oversight functions over the Bank financed operations as well.** The Audit Committee also approves the Internal Audit annual work programs, oversees its operation, and receives its audit reports. Good systems are in place for timely follow-up to internal audit observations and implementation of recommendations.

17. **Flow of funds.** The general flow of funds arrangements is described in the following chart and explained below.

Loan Funds



18. **There will be a designated bank account (DA) to receive funds from the Bank**. The choice of the bank will be based on the known quality of service and experience with the various institutions; currently, the banks FND has banking agreements are: Interacciones, Bancomer Santander, and Banorte. The DA account will be opened in MXN. A due diligence for acceptability of the Commercial Bank to receive funds financed by the WB, has been confirmed with the Loan Operations unit of the World Bank.

19. **Funds from the DA account will be used to pay for all of Component 1 project activities and activities under Component 2.** Main disbursement mechanism for this project will be advancing funds through the DA account. There might be reimbursement of funds as well, for some purchases under Component 2.

Disbursement arrangements. The loan disbursement arrangements[25] are hereby summarized:

Table 1
Disbursements Arrangements

Disbursement method	The following disbursement methods may be used under the loan: • Reimbursement • Advances • Direct Payments
Advance method	In case that the Advance method is used, the following will apply: • The currency requested for the DA is MXN $ and all the expenses of this Project are expected to be made in MXN. • The Bank will disburse against an application of funds, in which FND will request the loan resources according to the Project's cash flow needs for the following two quarterly period.
Supporting documentation	SOEs[26], invoices and receipts, including copies of agreements between PFI and beneficiaries, with evidence of transfers to same beneficiaries. Unused advances will be reconciled against the outstanding balance of the DA. The DA bank account statement will be included as well. • A projection of the resources needed for the following two quarterly period. • The exchange rate used for conversion purposes.
Limits	Different aspects such as the minimum value of applications for direct payments, ceiling of the DA, and thresholds to deliver application of funds versus records, will be determined and agreed with FND and confirmed with Loan Operations.
Type of DA	Segregated
Currency of the DA	MXN $
Retroactive expenditures	▪ Eligible payments must meet the following conditions: ▪ Made by the borrower one year before the date of the Loan Agreement. ▪ That do not exceed 20 percent of the loan amount (US$80 million). ▪ Subject to the same systems, controls and eligibility as expenditures made during the loan period.

Financial Reporting.

20. **FND uses an in-house developed system (*sistema de contabilidad integral*) for preparing the Project's accounting records**. This is a commercial software with adequate capabilities to recognize different levels of accounts and issue financial reports. FND will use its accounting system, as described earlier, to prepare calendar semester unaudited Interim Financial Reports (IFRs) and the annual audited project financial statements. These will be prepared on a cash basis using the standard formats agreed with the SFP for the Mexico portfolio.

[25] For details, please see the Disbursement Handbook for World Bank Clients.
[26] All SOE supporting documentation will be available for review by the external auditors and Bank staff at all times during Project implementation, until at least the later of: (i) one year after the Bank has received the audited Financial Statements covering the period during which the last withdrawal from the Loan Account was made; and (ii) two years after the Closing Date. The Borrower shall enable the Bank's representatives to examine such records.

Report	Due date
Semester unaudited Project IFRs	Within 45 days after the end of each calendar semester reported.
Annual audit report on FND annual financial statements.	Within six months after the end of each calendar year of loan disbursements (or other period agreed with the Bank).
Annual audit report on Project financial statements and eligibility of expenditures	Within six months after the end of each calendar year of loan disbursements (or other period agreed with the Bank).

External audit.

21. **The Bank will request FND Annual Financial Statements Audit Report as well, for each calendar year, during the implementation of the Project.** In addition, annual audits on Project financial statements and eligibility of expenditures will be performed in accordance with Bank policy, as reflected in the audit terms of reference and memorandum of understanding agreed between the Bank and SFP. An independent audit firm selected by SFP and acceptable to the Bank will conduct the project audits. The Terms of Reference for the annual financial audit will require independent auditors to report on the actual use of funds, ensuring that loan proceeds have been used for the intended purposes.

22. The same audit firm that is appointed by SFP to audit the FND Annual Financial Statements may perform the Project financial statements audit as well.

Written Procedures.

23. **Project operation is governed primarily by its Operational Rules, to which a number of procedures and guidelines are linked.** Given available documentation, only those FM procedures that are specific to the Bank will be compiled or referenced to a Project FM Manual. A version of the POM, has already been prepared in form and content satisfactory to the Bank, and adopts relevant policies and procedures already in place at FND's operational manuals. Procedures include specific controls for ensuring that the Project's funds are managed under sound financial management practices.

24. **Risk assessment.** On the basis of the Bank's Project FM assessment, the overall FM residual risk is considered moderate.

C. Procurement

25. **Procurement management under the proposed project draws from the strengths and lessons learned by FND, the implementing agency, from an earlier association with multilaterals such as the IDB and its experience in the rural finance sector.** FND will be responsible for the bidding processes (including the preparation of the bidding documents, ToR, and the signature of the contracts) of Component 2. Procurement activities under Component 1 will be conducted in accordance with section 3.13 of the Procurement Guidelines, Procurement in Loans to Financial Intermediary Institutions and Entities. The credit facility is being provided to PFIs through FND for on-lending to MSMEs for small-value subloans on commercial lending terms.

26. **Under this component, procurement by clients is expected to be undertaken in a prudent manner because this will amount to using the proceeds of a loan on which the beneficiary will also pay interest.** Hence, it is intended that procurement procedures will be based on established private sector or commercial practices, which are acceptable to the Bank (under the provisions of paragraph 3.13 of the Procurement Guidelines). Reliance will be placed on the significant accountability mechanisms that exist through checks undertaken by the PFI's operational staff as part of the credit underwriting process and their internal audit/control team members through external audits and checks, including random checks undertaken on a sample basis by FND on a biannual basis for each PFI. Procurement under subloans, including selection of consultants, will be undertaken in accordance with well-established private sector or commercial practices acceptable to the Bank, as described in the POM.

27. **Procurement general provisions.** Procurement for the TA component of the program will be carried out in accordance with the Bank's 'Guidelines: Procurement of Goods, Works and Non-consulting Services under IBRD Loans and IDA Credits & Grants by World Bank Borrowers', dated January 2011 and reviewed in July 2014; 'Guidelines: Selection and Employment of Consultants Under IBRD Loans and IDA Credits & Grants by World Bank Borrowers', dated January 2011 and reviewed in July 2014; and the provisions stipulated in the Loan Agreement. For each contract to be financed by the project, the different procurement methods or consultant selection methods, estimated costs, prior review requirements, and time frame are agreed between the borrower and the Bank in the Procurement Plan. The Procurement Plan will be updated at least annually or as required to reflect the actual project implementation needs and improvements in institutional capacity. The coordinator in the DEPP will be in charge of the coordination of procurement activities and updating the Procurement Plan in the *Sistema de Ejecución de Planes de Adquisiciones*, which is the publicly accessible procurement plans executions system.

28. **Selection of consultants.** Consultant services under the project will include technical support for the expansion of geographic coverage of FND, M&E of strategic programs and products, and capacity building for FND staff. The enhancement of the banking platform, which is part of the project, will be financed by the loan, including the services and consultancies that FND will require to support its design and implementation of this project. These will be procured following the Bank's policies and using harmonized documents.

- Short lists of consultants for services estimated to cost less than US$1 million equivalent per contract may be composed entirely of national consultants in accordance with the provisions of paragraph 2.7 of the Consultant Guidelines. Universities, government research institutions, public training institutions, and NGOs in some specialized fields of expertise can participate in the provision of consulting services according to Bank procurement guidelines and polices.
- *Firms*. Most contracts for firms carried out by FND are expected to be selected using Quality- and Cost-based Selection Method. Consultant assignments of specific types, as agreed previously with the Bank in the Procurement Plan, may be selected with the use of the following selection methods: (a) Quality-based Selection; (ii) Selection under a Fixed Budget, especially for works supervision contracts; (c) Least Cost Selection; (d) Selection Based on Consultants' Qualifications, for contracts estimated to cost below US$300,000

equivalent; and, exceptionally, (e) Single Source Selection, under the circumstances explained in paragraph 3.9 of the Consultant Guidelines.

- *Individuals*. Individual consultants will be hired to provide technical advisory and project support services and selected in accordance with Section V of the Consultant Guidelines. All sole source selection of consultants will be subject to prior review. Other specific procedures for the selection of consultants are described in the POM.

29. **Goods and non-consulting services.** Procurement of goods and non-consultant services will be done using harmonized standard bidding documents for all International Competitive Bidding and National Competitive Bidding. Small contracts for sundry goods will be generally procured through Shopping (including price quotations from local suppliers).

30. **Operating costs.** Operating costs include sundry items such as office supplies, maintenances, communication, transport, and other expenses related to the project management and also per diem for officials participating in workshops related to the objectives of the project. Small procurement may be undertaken for operational needs using simplified methods acceptable to the Bank as detailed in the POM.

31. **Others.** The Bank has agreed with the client the conditions in which the proceeds of the loan are transferred to the financial intermediaries and the final beneficiaries (ensuring that this is done with transparency and equity).

32. **Assessment of the executing entity to implement procurement.** FND has no recent experience implementing Bank procurement policies and procedures although it has experience with other multilaterals that have similar procurement procedures as it has implemented projects, including lines of credit, with the IDB; this previous experience will benefit the project. Staff experienced with the Bank's procurement policies and procedures will be hired and retained to support the implementation of the project.

33. **Overall risk assessment.** An assessment of the capacity of the implementing agency to implement procurement actions for the project has been carried out by procurement-accredited staff in November 2014 and February 2015. The assessment reviewed the organizational structure for implementing the project and the interaction between the project's staff responsible for procurement. The key issues and risks concerning procurement for implementation of the project have been identified and discussed with the clients to mitigate them. The procurement risk for fiduciary is considered moderate during implementation.

34. **Procurement Plan.** A Procurement Plan for the first 18 months of the program has been prepared by the executing agencies and provides the basis for the procurement methods. The activities and corresponding amounts of this Procurement Plan will be confirmed and perfected once program implementation initiates. This plan will be available on the Bank's external website, and in the *Sistema de Ejecución de Planes de Adquisiciones (SEPA)*, or another system utilized by the Bank. The Procurement Plan will be updated in agreement with the Bank, annually or as required, to reflect actual implementation needs and improvements in institutional capacity.

Social and Environmental Safeguards

35. **Indigenous Peoples (OP4.10). Given that the project area covers the entirety of Mexico and that indigenous peoples constitute close to 15 percent of the country's population, the Bank's Operational Policy for Indigenous Peoples applies.** It is not anticipated that the operation will negatively impact indigenous communities in any way, due to the modest size of the loans to be provided. The World Bank's Operational Policy on Indigenous Peoples is triggered, to ensure the delivery of culturally appropriate benefits to indigenous communities. The current strategy of FND to engage with indigenous communities is to build the capacity of the RFIs, which have been established by the National Commission for the Development of Indigenous Peoples as institutional mechanisms for bringing indigenous producer groups together and to deliver federal subsidies for the productive activities of these groups. Overall, 300 entities were established in regions of the country where indigenous peoples were concentrated.

36. **FND's strategy has been to work with a subset of indigenous producer groups to support their transition into PFIs**. This involves accompanying the delegates of these organizations to put in place the necessary institutional arrangements, technical expertise, and business and operational plans to receive a credit line from FND that can then be disbursed to member organizations and producer groups for productive activities. So far, FND has successfully built the capacity of 17 RFIs to serve as PFIs and has plans to grow this number during the life of the project.

37. **The business and operational plans necessary for receiving a line of credit are subject to the approval of the general assembly of each fund, and participation in FND's program is based on demand from those general assemblies.** As such, the implementation of the FND program adheres to the Bank policy requirement for free, prior, and informed consultations. Capacity-building activities planned under Subcomponent 2B prioritize support to the strengthening of RFIs (through capacity building on risk management, corporate governance, and IT systems and/or equipment to furnish offices). For this project, the Bank has reviewed an amended version of FND's program document for indigenous peoples, which serves as an Indigenous Peoples Planning Framework. This document was disclosed in July 2015 and consulted with relevant indigenous people's organizations. The document was accepted by the World Bank and disclosed in the Infoshop in August 2015.

38. **Involuntary Resettlement (OP 4.12). Because the project will support PFIs to provide relatively modest loans to rural enterprises that are implemented on private land, the Operational Policy on Involuntary Resettlement does not apply**. For loans requested for crop planting, the borrower needs to demonstrate that they have legal rights to use the land on which the activity will take place. Furthermore, the exclusion list included as part of the updated Environmental and Social Management System will include any activities that will require the involuntary displacement of other users of the land where the activity will take place.

39. **Citizen Feedback. The project presents a number of entry points for demonstrating citizen engagement**. First, FND itself has a number of client feedback mechanisms, including a web-based client feedback form, which are managed by its social communication's unit. Second, the majority of the PFIs are covered by CONDUSEF, which collects complaints from PFI clients

and regularly publishes summaries of the actions taken to address these complaints. Finally, the efforts being made to grow the number of RFIs that can serve as PFIs are a good example of empowering marginal communities with resource and decision-making powers.

40. **Gender and Social Inclusion.** During project preparation, FND analyzed the data on the gender of the owners of rural enterprises (sole proprietorship) that benefitted from credit lines disbursed by PFIs. The 2014 data confirmed that loan beneficiaries were predominantly women (72 percent). This is partly due to the prevalence of rural microcredit in the FND portfolio and a number of female-oriented policies implemented by FND, including a capped interest rate for female beneficiaries of their small producers program. These policies will continue to be implemented during the life of the project, during which it is expected that the number of female beneficiaries will continue to grow. A gender disaggregated indicator on the number of beneficiaries of the credit lines supported by the project has been included in the results framework.

41. **In terms of broader social inclusion, it is also important to note that approximately one in five of the borrowers came from high or very high areas of marginalization.** Over 40 percent originated from municipalities with a medium level of marginalization. It is worth noting that although only 28 percent of the borrowers were from municipalities with high or very high marginalization, in monetary terms they represented 68 percent.

Safeguards

Environmental Safeguards

42. **FND seeks to act in a socially and environmentally responsible way and to participate in a national and global mission of supporting sustainable development.** FND has experience in implementing environmental and social operating policies of international organizations such as the IDB, for which they developed an Environmental and Social Assessment System and an Indigenous Population Management Strategy, to identify, assess, and mitigate negative social and environmental impacts of projects financed by the IDB (over 4 million UDIs; MXN 20 million).

43. **The funding that the Bank proposes has the goal of increasing financial inclusion of MSMEs (rural production units), dispersing credits through PFIs.** This is a demand-driven project and subprojects are presumed to be small-size amounts (an analysis of credit demand in 2014 was performed, showing that 95.3 percent of the total credits disbursed were in projects of less than US$10,000 and 77.7 percent are related to commercial and services activities). The existing Environmental and Social Assessment System is being complemented with an EMF that has specific topics for second-tier loans financed by FND, to support both FND and the PFIs in the identification of environmental requirements for credit, through the application of eligibility criteria according to (a) risk level, (b) level of microcredit amounts, and (c) the frequency of demand, among others.

44. **An EMF has been developed by the FND and approved by the WB, to support the PFIs in the identification of environmental requirements.** The EMF applies eligibility criteria including risk level, credit amounts, and the nature of activities to be financed. Activities are classified into three categories: Category 1 - Exclusion list; Category 2 - Eligible activities that

do not require environmental permits, licenses, or authorizations; and Category 3 - Eligible activities that requires some type of environmental permit, license, or authorization and best practices application. No activities that are high risk or likely to have significant adverse environmental impacts (Bank Category A) will be funded. The EMF **was disclosed** in-country in July 2015, and **consultations were held** with PFIs and other stakeholders who affirmed their support for the framework defined. The EMF was disclosed in the Infoshop in August 2015.

45. **A comprehensive environmental analysis of potentially eligible activities has been performed to establish the most common activities** (**in agricultural, livestock, forestry, and fishery sectors), its environmental impacts and mitigation measures, and/or good environmental, health, and safety practices for use by the beneficiaries.** Specific thematic best practices recommended in the form of brochures (*Cartillas de Recomendaciones de Mejores Prácticas Ambientales*) developed as a part of the EMF will be distributed to beneficiaries when granting credit for the PFIs. The commitment to the EMF implementation by the PFIs and the distribution of the brochures to the PFIs' clients as well the EMF monitoring mechanism will be established in the corresponding credit operating manual. Due to the volume of credits that may be financed as well as the diversity thereof, they will be monitored ex post through random audits the first year, the project midterm review, and after the conclusion.

46. **To strengthen institutional capacity, it will be necessary to include environmental consultants whose qualifications must be acceptable to the Bank.** These consultants will perform the following tasks: (a) ensure that the selected subprojects are properly evaluated for potential environmental impacts; (b) develop booklets (*cartillas*) as needed; (c) provide support or assistance and training to the PFIs to comply with EMF provisions and properly integrate the environmental and social records; and (d) conduct ex post monitoring of field audits**.**

Applicable Safeguards

Table 3.1. Explanation of the Applicable Safeguards

Safeguard Policies	Triggered?	Explanation
OP/BP 4.01 - Environmental Assessment	Yes	This project is classified as a Category F (Intermediary Financial Assessment), and because of the nature of the activities involved it is unlikely to result in significant negative environmental impacts. Any adverse impacts are identifiable, mostly temporary, and easily mitigated with known management techniques. The project and the EMF, prepared by FND, exclude financing of any Category A subprojects and works. No cumulative impacts are foreseen given the wide range of subproject locations, their relatively small size, the very low probability of a large number of small subprojects in a limited geographic area, and the nature of the relatively small investments (mostly working capital in MSMEs to enhance productivity). The EMF includes a procedure for subproject screening by FND or PFI (that is, using the line of credit from FND to the PFI). The EMF also include (a) requirements for subprojects and for PFIs, which will receive credit lines; (b) potential applicable legal environmental, social, and cultural resources protection requirements that may apply to the subprojects; (c) training and

Safeguard Policies	Triggered?	Explanation
		capacity-building activities; and (d) supervision and reporting requirements. The EMF was disclosed and consulted with key stakeholders in July 2015 and published by the World Bank Infoshop in August 2015.
OP/BP 4.04 - Natural Habitats	Yes	While the exact project types are not known, the policy has been triggered on a precautionary basis and the appropriate measures included in the EMF.
OP/BP 4.36 - Forests	Yes	While the exact project types are not known, the policy has been triggered on a precautionary basis and the appropriate measures included in the EMF.
OP 4.09 - Pest Management	Yes	The project will not finance the acquisition of significant quantities of pesticides in any subproject. However subprojects may involve the purchase and use of pesticides and the EMF includes applicable measures.
OP/BP 4.11 - Physical Cultural Resources	No	It is not anticipated that the subprojects will involve significant impact on physical cultural resources. In the unlikely event of an incidental finding, the EMF will consider developing a handbook of good practice for the treatment thereof.
OP/BP 4.10 - Indigenous Peoples	Yes	Given that the project area covers the entirety of Mexico and that indigenous peoples constitute close to 15% of the country's population, OP 4.10 applies. The current strategy of FND for engaging with indigenous communities is to build the capacity of the RFIs, which had been established by the National Commission for the Development of Indigenous Peoples as institutional mechanisms for bringing indigenous producer groups together and for the delivery of federal subsidies for the productive activities of these groups. Overall, 300 such entities were established in different regions of the country where indigenous peoples were concentrated and FND works with a growing subset of RFIs to build their capacity to function as PFIs. Given that this project is working through financial intermediaries, an indigenous peoples planning framework has been prepared, based on FNDs strategy of working with RFIs.
OP/BP 4.12 - Involuntary Resettlement	No	All of the subprojects to be financed under this operation will be carried out on private land owned or leased by the ultimate beneficiaries. To avoid potential impacts on third parties, the environmental management system includes a question on involuntary resettlement that will allow the intermediary financial institutions to exclude activities that may result in resettlement impacts.
OP/BP 4.37 - Safety of Dams	No	The project will not support the construction or rehabilitation of dams, nor will it support other investments, which rely on the services of existing dams.
OP/BP 7.50 - Projects on International Waterways	No	The project excludes any subproject that affects international waterways as defined under this policy and this exclusion is

Safeguard Policies	Triggered?	Explanation
		noted in the EMF.
OP/BP 7.60 - Projects in Disputed Areas	No	The project will not affect disputed areas as defined under this policy.

M&E

47. **Additional indicators.** FND will apply its M&E procedures as described in the POM. In addition to the indicators listed in annex 1, FND will also monitor additional indicators that will not be officially tracked as part of the project.

- Number of RFIs receiving loans with project funding
- Percentage of individuals (as opposed to firms) that receive loans with project financing
- Number of final beneficiaries with loans financed through financial intermediaries (not just with project funds)
- Number of PFIs that receive project-financed loans
- NPLs of institutions, by institutional category
- NPLs of institutions with FND (all PFIs)
- Number of PFIs that receive technical assistance and become accredited to receive loans from FND
- Operational efficiency of FND
- Volume of total loans (in MXN) disbursed under the project (cumulative)
- Number of PFIs that receive project loans and technical assistance from FND

ANNEX 4: IMPLEMENTATION SUPPORT PLAN

MEXICO: EXPANDING RURAL FINANCE

Strategy and Approach for Implementation Support

1. **This implementation support plan describes how the Bank will support the risk mitigation measures and provide the technical advice necessary to help the client achieve the PDO.** This plan also identifies the minimum requirements to meet the Bank's fiduciary obligations. It has been developed based on the nature of the project and its risk profile. Formal implementation support visits and field visits will be carried out semiannually and will focus on the areas detailed below.

2. **There will be strong coordination between the Bank and FND, the borrower and the implementing agency.** The Bank task team will bring a comprehensive set of instruments and expertise to advice on project activities. It will work closely with FND to ensure project success. The team plans two implementation support visits on average per year to Mexico, as well as engagement through ongoing dialogue via video and audio conferences and email.

3. **In addition to implementation support visits and ongoing engagement, the Bank project team will carefully monitor the progress of project implementation and achievement of results via formal and informal reporting channels.** Formal reporting channels include Implementation Status and Results Reports and results monitoring reports supplied by FND (more details under M&E below). Informal channels include interaction with direct beneficiaries of the project, reports from local media, and country economic analyses.

4. **The project team will also take a flexible approach to ensure that it meets client needs as circumstances evolve.** The Bank will continue a close policy dialogue with the implementing agency, SHCP, CNBV, and other stakeholders.

5. **Financial Management.** The Bank will conduct risk-based FM supervision, initially after every six months (as part of implementation support visits) and later, at appropriate intervals based on assessed risk. During project implementation, the Bank will supervise the project's FM arrangements in the following ways: (a) review the project's biannual unaudited IFRs, the internal audit reports, the annual audited financial statements complemented by the operational and performance information report, the auditor's report, and remedial actions recommended in the auditor's management letters; (b) during the Bank's onsite implementation support visits, review project accounting and internal control systems, budgeting and financial planning arrangements, and disbursement management and financial flows, as applicable; and (c) at other times when applicable, participate in discussions with the client, check that payments are made strictly in accordance with contract provisions, and look into any areas requiring attention.

6. **Procurement.** All procurement to be financed under the proposed project will be carried out in accordance with the Bank's 'Guidelines: Procurement under IBRD Loans and IDA Credits', dated January 2011 and reviewed in 2014; 'Guidelines: Selection and Employment of Consultants by World Bank Borrowers, dated January 2011 and reviewed in July 2014; and the provisions stipulated in the Legal Agreement. The project will carry out implementation in

accordance with the 'Guidelines on Preventing and Combating Fraud and Corruption in Projects Financed by IBRD and IDA and Grants', dated October 15, 2006, and revised January 2011 (the Anti-Corruption Guidelines). Procurement and consultant selection under Component 1 will be carried out in accordance with well-established private sector procurement methods or commercial practices acceptable to the Bank as detailed in 'Procurement in Loans to Financial Intermediary Institutions and Entities' and paragraph 3.13 of the above-mentioned Procurement and Consultant Selection Guidelines of January 2011 and reviewed in July 2014. As part of implementation support visits, the Bank will undertake procurement supervision. Implementation support missions will be geared toward ensuring that FND staff and intermediaries fully understand the commercial practices that are acceptable to the Bank and how to apply them and a review of external audit reports.

7. **Safeguards.** During project implementation, the Bank will supervise the project's environmental and social safeguard arrangements in the following ways: (a) conduct field audits of PFIs and project beneficiary activities and (b) assess compliance with the POM. The Bank will also seek updates on support from the IDB, targeted at strengthening FND's environmental and social management capacity.

8. **M&E.** The M&E framework is designed to leverage FND's existing channels for monitoring the performance of PFIs and the characteristics of their lending. With the introduction of a reformed IT system, the monitoring tools may change and the team will support FND as needed. Whereas the content of the existing system is good, the quality of data collected can be improved, including through the planned IT investments. Evaluations will be pursued opportunistically where data lends itself to analysis and the team will work with FND to help demonstrate the results of their activities including innovative solutions under Subcomponent 1B.

Implementation Support Plan

9. The tables below detail the key areas of focus of the implementation support activities for the first 48 months of the project's implementation. These have been determined based on conversations with the client and an understanding of the priority activities to be implemented during the first year of the project. Future updates will be based on the progress of project activities, timing of major new activities, and the expertise required to address any issues that arise, among other things.

Time	Focus	Skills Needed	Resource Estimate	Partner Role
First twelve months	Project/task management	TTLs/financial sector specialists	16 weeks	FND
	Technical support - Subcomponent 1B	Innovative finance	3 weeks	FND
	Technical support - Subcomponent 2A	IT	3 weeks	IT
	Procurement supervision	Procurement specialist	2 weeks	Procurement
	Financial management	Financial management	2 weeks	Financial Management

	supervision	specialist		
	Safeguards	Environmental and social specialists	4 weeks	
Years 2–5	Project/task management	TTLs/financial sector specialists	48 weeks	FND
	Technical support - Subcomponent 1B	Innovative finance	4 weeks	FND
	Technical support – Subcomponent 2A	IT	4 weeks	FND
	Procurement supervision	Procurement specialist	4 weeks	Procurement
	Financial management supervision	Financial management specialist	4 weeks	Financial Management
	Safeguards	Environmental and social specialists	6 weeks	–

Skills Mix Required (over project life - 60 months)

Skills Needed	Number of Staff Weeks	Number of Trips	Comments
TTL/financial sector specialists	64	15	–
Procurement specialist	6	2	Based in Mexico
Financial management specialist	6	2	Based in Mexico
Environmental and social specialists	10	3	Based in Mexico
IT specialist	7	7	–
Innovative finance	7	2	–

ANNEX 5: ECONOMIC AND FINANCIAL ANALYSIS

Mexico: Expanding Rural Finance

1. **This analysis projects the potential economic benefits of the project by estimating the direct impact of improved access to finance through the project funds on the rural economy.** The improved access to finance will support rural production and incomes. This is a partial equilibrium analysis and it does not consider the long-term effects of a better-functioning rural financial sector. Whereas access to better financial services remains the project's objective and the link between financial development, growth, and poverty reduction is well-established in literature, the improved access to finance itself does not lend itself to meaningful economic analysis. Instead, the improved quantity and quality of financial services will be measured in the results framework, whereas this analysis focuses on the users of finance.

2. **The project will comprise two mutually reinforcing components**: (a) line of credit for rural finance and (b) strengthening institutional capacity to provide sustainable finance. In Subcomponent 1A, the project will provide a line of credit through PFIs to MSMEs. In Subcomponent 1B, FND may lend directly, lend through PFIs, or use a combination of the two as part of a pilot program. In Component 2, the project will provide capacity-building support to FND and PFIs.

3. **The economic analysis of Subcomponent 1A is built as a financial analysis with the estimated difference in cash flows to sub-borrowers (smallholders and MSMEs, including new jobs created) accounted for as cash flows to the project.** The costs and benefits expected to accrue from these investments, the net present value (NPV), and the economic rate of return (ERR) for these subcomponents have been estimated. These valuations are constructed through scenario-based analyses with sensitivity testing.

4. **The economic analysis of Component 2 (strengthening institutional capacity to provide sustainable finance) presents a special challenge due to the indirect relationship between the IT modernization activities supported under the project and the stream of benefits that these are expected to trigger.** In the absence of commonly accepted methodologies for the economic analysis of these types of investments, these investments are based on cost-effectiveness and more general analytical work on the effects of institution building and strengthening and improved access to finance. As such, a qualitative analysis has been made for Component 2, based on literature discussing the impact of supporting access to finance.

5. **The total investment under Component 1 is estimated to result in an NPV of US$108 million at the discount rate of 15 percent[27] and an ERR of 20 percent[28] with the base case scenario.** Different assumptions and detailed data from multiple sources are used for the analysis of specific components. Correspondingly, each subcomponent includes its own sensitivity analyses, which follow.

[27] The discount rate is based on the risk-adjusted opportunity cost of capital for Bank financing in Mexico.
[28] Valuation calculations are given over a fifteen-year period.

6. **The estimated NPV and ERR reflect the value for money of the investments under these components.** These investments are expected to generate increases in income for beneficiaries that exceed the NPV of the project investment. The opportunity cost of Bank funds is estimated at 10–12 percent, but the risk-adjusted opportunity cost of investments in rural communities in Mexico is estimated at 15 percent. Since the ERR exceeds this percentage, the value of the project activities outweighs the opportunity cost of using these funds for other investments in this or a similar country.

Subcomponent 1A: Credit line through PFIs to MSMEs

7. **Subcomponent 1A will provide a line of credit to MSMEs through PFIs, either financial intermediaries or producer organizations.** The PFIs will on-lend to MSMEs to enable them to expand their activities. The project is investing a total of US$365 million in this subcomponent disbursed over the five years of the project.

8. **In the economic analysis of this component, the ERR is expected to be 21.7 percent. The NPV is expected to be about US$91.7 million, with a discount rate of 15 percent.** The positive valuation indicates that the returns on investment exceed the returns that could otherwise be earned by investing in another project in any similar country.

9. **Assumptions:**

(a) The technical data on revenues, costs, and average wage are taken from the Food and Agriculture Organization’s data, data gathered during the identification and pre-appraisal missions, along with benchmarking provided by comparator country estimates. In many cases, these numbers were adjusted to arrive at more conservative estimates.

(b) The total number of beneficiaries is estimated at 70,000 based on the subcomponent budget and an average loan size of US$5,000.

(c) The analysis is built upon an expected increase in the growth rate of revenue after the business receives the loan from a PFI. In the base case scenario, the analysis assumes a revenue growth addition of 4 percent for MSMEs, in line with recent literature documenting the returns to microfinance (de Mel and Mackenzie 2009). These assumptions have been tested according to the sensitivity analysis below.

Table 5.1. Economic Analysis of Subcomponent 1A

NPV (15% Discount Rate)	**US$91,764,536**
ERR	**21.7%**

Table 5.2. Assumptions - Subcomponent 1A

Interest rate due to the Bank by FND	5.0%
Interest rate charged to PFIs by FND	6.5%
Year 1 fees by PFIs to FND	1%
Growth rate of fees	0%
NPL ratio	3%
Year 1 average loan size (pesos)	77,500
Year 1 number of loans (disbursement/average loan size)	14,800
Growth rate in average loan size	0%
Growth rate in number of loans	0%

Table 5.3. MSME Beneficiaries

Average number of employees	3
Average revenue (pesos)	310,000
Percentage costs	80%
Average value added (revenue * (1 - %cost)) (pesos)	62,000
Annual growth (without loan)	2%
Annual additional growth increase with loan (Years 1–5)	4%
Number of years growth increases due to loan	5
Percentage of farms showing revenue additionality	80%
Percentage tax base	20%
Tax rate	29%
Average salary per employee (annual) (pesos)	54,250
Annual growth in wages	4%
Jobs created per peso increase in revenue	0.000011

10. The sensitivity analysis shows that Subcomponent 1A with only 3 percent reduction in additional revenue will reduce the ERR to 13 percent. In contrast, an additional revenue growth to 5 percent means that the component's ERR will increase to 30 percent with all other factors constant. The results of the sensitivity analysis are provided in box 5.1.

Box 5.1. Sensitivity Analysis with Different Scenarios

1. Reduction in additional revenue growth to 3 percent
   → Reduces ERR to 13 percent
2. Increase in additional revenue growth to 5 percent
   → Increases ERR to 30 percent
3. Increase in the NPL ratio from 3.2 percent to 5 percent
   → Reduces ERR to 20 percent
4. Reduction in the NPL ratio from 3.2 percent to 1 percent
   → Increases ERR to 24.1 percent
5. Increase in interest rate charged by PFIs to MSMEs from the assumed 10.50 percent to 12.50 percent
   → Reduces ERR to 20 percent
6. Reduction in interest rate charged by PFIs to MSMEs from the assumed 10.50 percent to 8.50 percent
   → Increases ERR to 24 percent

Subcomponent 1B: FND Pilots for Rural Finance

11. For Subcomponent 1B, the experimental nature of the benefits makes quantification impractical. Strengthening the capacity of FND and the PFIs and the demonstrated effect and lessons from pilots under Subcomponent 1B have the potential to improve the supply and quality of rural financial services.

Component 2: Strengthening Institutional Capacity for Sustainable Rural Finance

12. **This component will focus on strengthening FND's banking systems and building the capacity of the PFIs that it lends to**. These enhanced IT systems will support improved efficiency and risk management capabilities for FND. Activities to strengthen PFIs will include capacity building in, among other things, business planning, IT systems, credit underwriting, and administration and risk management processes to support MSMEs in the rural economy.

13. **The relationship between the 'access-to-finance' reform and the performance of firms is well-supported in literature.** Greater business opportunities and better access to finance are generally related to a more robust private sector.[29] Additionally, at the individual and microenterprise level, the probability of making an investment tends to increase with greater access to credit and collateral. The number of financial instruments available to both lenders and borrowers also contributes to a higher probability of personal and business investment[30].

14. **Thus, literature supports technical assistance programs with financial institutions to increase the number of financial products offered to MSMEs along with products that are more tailored to meet the needs of MSMEs.** This benefit is particularly large for relatively unbanked populations, where improvements in access to finance and financial development have

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[29] Demirguc-Kunt, Asli, and Leora Klapper. 2012. "Financial Inclusion in Africa: An Overview," Policy Research Working Paper 6088, World Bank, Washington, DC.

[30] Besley, Timothy (2005), "Property Rights and Investment Incentives: Theory and Evidence from Ghana", Journal of Political Economy, Vol. 103, No. 5 (Oct., 1995), pp. 903-937.

larger poverty impacts[31]. As such, access to finance reforms and improvements such as those proposed under the project are likely to benefit Mexican MSMEs in rural communities, particularly within the current under-banked population.

15. **The data also show a positive and significant relationship between economic and financial development and entrepreneurship.** The logarithm of GDP per capita and domestic credit to the private sector (as a percentage of GDP) are both positively and significantly correlated with entry rates and business density. This suggests that greater business opportunities and better access to finance are related to a more robust private sector[32], lending further credence to the access to finance investments supported by the project.

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[31] Burgess, Robin, and Rohini Pande. 2005. "Do Rural Banks Matter? Evidence from the Indian Social Banking Experiment." American Economic Review, 95(3): 780-795.

[32] 20. Acs, Zoltan J. & Desai, Sameeksha & Klapper, Leora F, 2008. "What does "entrepreneurship" data really show? a comparison of the global entrepreneurship monitor and World Bank group datasets," Policy Research Working Paper Series 4667, The World Bank.

ANNEX 6: FINANCIAL ANALYSIS - FND AND INTERMEDIARIES

Mexico: Expanding Rural Finance

1. **The governance and the financial and operational strength of FND and the PFIs are important for the success of the project and the Bank's OP 10.00 provides guidance on these topics**. The policy requires (a) adequate profitability, capital, and portfolio quality assessed using audited financial statements acceptable to IBRD; (b) acceptable level of loan collections; (c) appropriate capacity, including staffing, for carrying out subproject appraisal (including environmental assessment) and for supervising subproject implementation; (d) capacity to mobilize domestic resources; (e) adequate managerial autonomy and commercially oriented governance; and (f) appropriate prudential policies, administrative structure, and business procedures. The financial analysis presented is primarily based on independently audited FND financial statements (2013 and 2014) presented to the *Secretaría de la Función Pública*, in accordance with International Financial Reporting Standards and accounting rules set by the CNBV.

Overview of FND

2. **FND's predecessor, *Financiera Rural,* was created with the technical support of the Bank as part of the liquidation of Banrural in 2002.** Banrural was an agricultural development bank that for several decades had provided subsidized credit for agriculture, accumulating large losses caused by inadequate credit risk policies, low collection efforts, and high administrative costs. The transformation to a development finance agency model was made with the goal of encouraging financial access for underserved sectors through market-friendly instruments that encourage private sector activity. The transformation was considered highly satisfactory by the Bank's Independent Evaluation Group.[33]

3. **With its focus on rural credit for productive purposes, FND plays a key role in the ecosystem of Mexican DFIs.** Mexico's six development banks focus on strategic areas such as export finance (National Exterior Commerce Bank [*Banco Nacional de Comercio Exterior, Banca de Desarrollo*]); infrastructure (National Works and Public Services Bank [*Banco Nacional de Obras y Servicios Publico*]); and housing finance (*Sociedad Hipotecaria Federal*). Other DFIs playing important roles in the rural sector are FIRA, which offers first- and second-tier finance for rural financial intermediaries; Mexico Savings and Rural Finance Bank (*El Banco del Ahorro Nacional y Servicios Financieros, Sociedad Nacional de Crédito*), which promotes savings and credit institutions with a focus on deposit mobilization through its network; and the National Society of Credit Institution Development Bank (*Nacional Financiera*), which offers second-tier finance as well as partial credit guarantees for MSMEs.

4. **Article 2 of FND's Organic Law establishes that it can provide loans to PFIs to support the development of agriculture, fisheries, forestry, and other activities of the rural economy in a sustainable manner**. Article 4 of the Organic Law establishes a wide range of

[33] Project Performance Assessment Report, the United Mexican States, Rural Finance Development Structural Adjustment Loan, IBRD-73670, January 29, 2014.

PFIs with which FND can work. Article 33 establishes that the FND Board determines the total amounts of credits to PFIs as well as the required levels of approval for lending to PFIs.

5. **FND is one of the most common sources of agricultural credit.** The 2007 agricultural census showed that FND was the most common source of agricultural credit, serving 17 percent of rural production units with financial services in Mexico. Commercial banks and credit unions are the second and third most common sources, serving 9 percent and 8.8 percent of agricultural units, respectively. FND's lending market share in the primary sector of the economy (predominantly agriculture) has increased from 3.9 percent in 2003 to 15.3 percent in 2013. FND lends both directly, through about 100 branches, and through small PFIs. In 2014, FND provided 430,000 loans as a second-tier institution and allocated approximately MXN 19.5 billion (US$1.2 billion).

FND Business Model

6. **FND is engaged in both wholesale lending through more than 400 PFIs as well as direct lending to rural enterprises**. FND lends directly through about 100 branches throughout the country. Wholesale funding is provided through intermediaries such as credit unions, SOFOMES, cooperatives, and producer organizations (*dispersoras*) when acting as a PFI. Financing and developing intermediaries is an important part of FND's approach to developing access to credit in rural areas.

7. **By number of loans, most are provided through PFIs, but by value it is only one-third.** In **2014**, direct lending accounted for 67 percent of the bank's loan book, while the 33 percent that was channeled through PFIs' second-tier lending is important in terms of outreach (number of loans) because FND can leverage small rural institutions (442 in 2014) to reach rural borrowers. The unsupervised entities account for 77 percent of FND's outstanding PFI loans. Just 12 of the 442 PFIs take deposits and, therefore, rely extensively on FND or other financial institutions for funding. At end-2014, FND's PFIs had assets of US$4.4 billion and during 2014, the PFIs disbursed loans worth US$996 million funded by FND.

8. **All of FND's borrowers are engaged in the rural economy, with the majority dedicated to agricultural or commerce activities.** For those loans channeled through PFIs, the highest volume of loans were allocated in the agriculture sector (54 percent) and the greatest number of loans went to finance commercial activity (70 percent). Over 99 percent of the borrowers were sole proprietors. Approximately one in five of the borrowers came from high or very high areas of marginalization.

9. **FND offers three key products for PFIs**. The most important types of credit lines are *Crédito Simple* (working capital, fixed assets, simple); *Cuenta Corriente* (microcredit, working capital, pledge loans, equipment); *Cuenta Corriente Global* (assigned to preferential PFI clients with a strong risk rating where the client does not specify ex ante the type of credits to be generated or discounted).

10. **PFIs borrow at interest rates reflecting FND's cost of funds, cost of administration and operation, and an appropriate risk margin**. Annual interest rates to PFIs range from 6.5 percent to 13 percent depending on the purpose of the line of credit; the type of collateral offered

(property, movable collateral, liquid guarantee, and so on); support provided by other governmental entities; and FND's risk assessment of the PFI.

Financial Performance of FND

11. **FND has US$2.7 billion in assets and a very strong balance sheet structure.** As shown in table 6.1, at end-2014, loans were US$2.1 billion and liquid assets were US$581 million. The equity base is large at US$2 billion, equaling 76 percent of assets in 2014. FND is restricted from collecting deposits and issuing bonds and is therefore planning to expand its balance sheet by borrowing from IFIs.

12. **FND has maintained a positive real return in line with its mandate.** As shown in table 6.2, the ROE is low by financial institution standards, but it reflects FND's low leverage and policy mandate to focus on lending in areas that are relatively more difficult to serve. The ROA is high for a financial institution, but it largely reflects the very high share of equity and, thus, modest need to incur interest expenses. Following the financial reform law, which provides a more aggressive focus on expanding financial access, FND no longer has a legal obligation to preserve the real value of its capital (which requires an ROE in excess of inflation), but FND management has committed to continuing doing so.

Table 6.1. FND Balance Sheet, 2014 (US$, Millions)

Assets		**Liabilities**	
Cash	411	Short-term debt	5
Investments	170	Long-term debt	641
Loans, net	2,114	Other	25
Gross performing direct loans	*1,427*	**Total liabilities**	**670**
Gross performing PFI loans	*707*		
Gross direct NPLs	*55*	**Capital**	
Gross PFI NPLs	*35*	Contributed capital	1,625
Provisions	*-110*	Retained earnings	445
Other assets	45	**Total capital**	**2,070**
Total assets	**2,740**	**Liabilities and capital**	**2,740**

Source: FND.

Table 6.2: FND Performance Indicators

Percent	Dec 2012	Dec 2013	Dec 2014
NPLs	4.4	3.6	4.1
Provisions to NPLs	85	106	122
Operating efficiency	4.2	4.0	3.5
Return on equity (ROE)	3.9	3.4	3.5
Return on assets (ROA)	3.9	3.3	3.0
Net interest margin	7.9	7.3	6.7
Capital/assets	99	95	76

Source: FND.

13. **The liquidity position is robust, with borrowing amounting to only a quarter of the balance sheet.** FND cannot accept deposits or issue commercial paper or bonds. It funds its operations through equity, loans from banks, and from Mexican DFIs and IFIs. Of the US$670 million in liabilities, 96 percent is long term. As FND has expanded its operations recently, the capital-to-asset ratio has decreased from 99 percent in 2012 to 76 percent in 2014 and a declining trend is expected. FND will need new funding to achieve its strategic objective of balance sheet growth

14. **Loan quality is acceptable considering FND is operating in the rural finance space.** A total NPL ratio of 4.1 percent reflects a ratio of 3.9 percent for direct lending and 4.9 for lending to PFIs. The latter warrants monitoring because it is the ratio pertinent to the project and risk in PFIs should be lower than for direct lending.

FND Managerial Autonomy and Governance

15. **FND is fully owned by the Mexican government.** It is supervised by the CNBV and follows prudential guidelines as specified in the regulations that govern its operations. Its board of directors is composed of fifteen members, including members from the SHCP, the Agriculture Ministry, the Agrarian and Urban Development Ministry, the Central Bank of Mexico, and the National Agricultural Insurance Company (*Agro-Aseguradora Mexicana*). Members have relevant professional profiles evidencing knowledge of the banking and rural sectors including, various positions within the aforementioned ministries and private sector institutions. FND's director general has nearly two decades of experience supporting development in the Mexican rural economy, through positions in the government and private sector rural finance.

16. **The government and FND have established a strategic plan that sets key goals related to FND's strategic direction.** This includes an increase in the volume of second-tier lending and an expansion of the number of PFIs. Being a government development finance agency, the government can request FND to support priority industries. However, on the qualitative criteria specified in OP 10.00, information from FND was found to be reliable and the overall quality of FND's management to be acceptable.

17. **FND has a positive record on governance and anti-corruption issues.** Since its first loan with the IDB in 2012, no complaints have been issued against FND and the IDB approved an additional larger loans in 2014 and 2015. Mexico has no open cases with the Bank's Integrity Vice Presidency. FND has an internal audit function, undergoes external audits, and has an audit committee. FND's internal control function works to ensure that assistance provided by FND is disbursed and applied in an appropriate manner.

FND Credit Appraisal and Risk Management

18. **FND has the legal framework and tools to effectively implement and manage the credit risk of PFIs.** To assess FND's processes, the team has reviewed the legal framework, the credit risk manual, the credit appraisal and monitoring tools, and discussed the legal enforcement procedures. The credit appraisal tools are comprehensive and organized in a well-structured Excel-based tool. To support the appraisal of PFIs, FND has third-party evaluators specialized in

rural finance to conduct a credit evaluation for submission to FND's credit committees, thereby providing an additional check.

19. **FND has detailed policies and procedures for credit appraisal and monitoring established in its Manual of Credit Policies**. The bank has a Board Credit Risk Committee, two levels of a Corporate Credit Committee, and a regional level subcommittee each of which have their specified mandates and approve credits up to reasonable thresholds (see table 6.3). The maximum amount that each final borrower of the PFI can receive (including common risks of related parties) is limited by the participation in the credit line and the accounting capital of the PFI (see table 6.4).

Table 6.3. FND Credit Approval Level for Lending to PFIs

Type of Approval/Type of Intermediary	Regulated PFI	Non-regulated PFI (producer associations)
FND Board	5% to 7% of accounting capital of FND	2% to 3% of accounting capital of FND
Credit Committee (Corporate)	–	Greater than 25 million UDIs[34] and less than 2% of accounting capital of FND
Credit Committee -Minor (Corporate)	Greater than 7 million UDIs and less than 5% of accounting capital of FND	Between 5 and 25 million UDIs
Subcommittee of Credits (Regional level)	Up to 7 million UDIs	Up to 5 million UDIs

Source: FND.

Table 6.4. Maximum Loan Amounts for PFI Lending to Final Borrowers

	% of the Total Credit Line	% of Accounting Capital of the PFI
Individuals	5	3
Firms	10	6

Source: FND.

20. **PFIs must meet several requirements to borrow from FND.** These include (a) legal (contents of its *Acta Constitutiva*); (b) credit history (not to have defaulted in the past); (c) capital (net accounting capital of minimum 250,000 UDIs); (d) organizational differences depending on category of PFI (to have an annual business plan/operational plan, experience in financing issues, policies defined for different stages of credit, credit manuals and credit underwriting policies similar to that of FND, and to be responsible for administration of credits provided to final borrowers); (e) formalization and registration of operation (individual registers of credit operations, audited financial statements); (f) distinction between active portfolio and portfolio at risk, more than 90 days of arrears, under acceptable limits (or presenting a plan to reduce this level if it is higher than the stated percentages); (g) provision of required reports (quarterly and annually); and (h) supervision by FND and other institutions who fund FND, related to destination and use of funds, integration of files, and management of assets.

[34] UDI *(Unidad de Inversión)* is a consumer price index unit used in Mexico. Its value is published by the Central Bank of Mexico. As of December 2014, the UDI represented MXN 5.27 and US$0.35.

21. **The evaluation process for PFI accreditation consists of multiple steps lasting up to a year.** They include a preevaluation done by a credit officer of FND; an initial evaluation (reviewing aspects of organizational structure, risks, administration and finance, strategy and operations, and financial performance) conducted by an independent firm contracted by FND; a credit analysis that captures the credit request reviewed by credit analysts; and the legal area of FND. Finally, the relevant credit committee (depending on the amount of credit involved) considers the request.

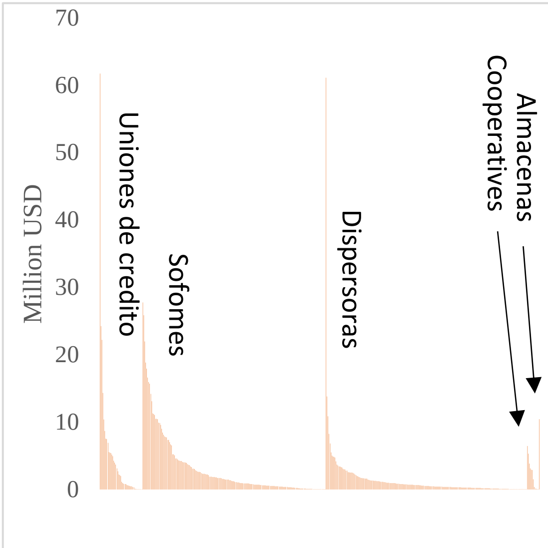
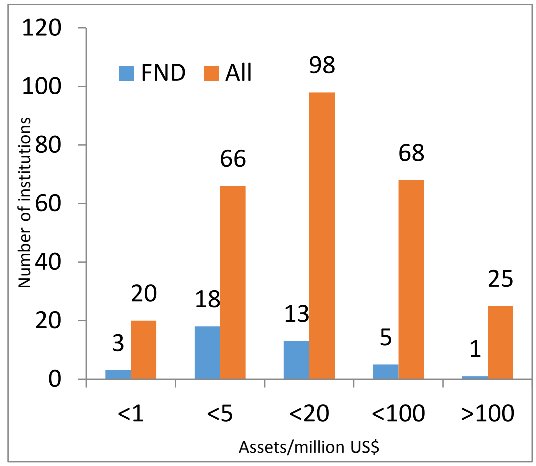
22. **FND engages in regular supervisory activities of its PFIs and has the faculties to penalize PFIs for noncompliance with policies.** FND visits each PFI twice a year and issues an action plan for more minor weaknesses in operation and follows up on required actions during each supervision visit. FND has in its contracts with PFIs the ability to stop disbursement, for reasons such as nonrepayment, nonreporting of documentation, failure to supervise the loan portfolio, failure to comply with social or environmental policies or other legal requirements, and so on. In some cases, it can demand immediate repayment and pursue legal proceedings where relevant.

23. **PFIs can obtain FND funding of up to 10 times their capital based on their assessed level of risk both at appraisal and during the monitoring phase.** An approved new PFI without a risk rating can borrow up to 2.5 times its capital. For the PFIs' on-lending, at most 80 percent can be financed from FND. In no case, can the credits to the PFIs exceed 3 percent (producer associations) or 7 percent (other PFIs) of the accounting capital of FND.

PFIs and their Financial Performance

24. **FND's PFIs include a large number of mostly smaller NBFIs (figure 6.1)**. Fifty percent of current PFIs have assets under US$4 million and just 26 larger ones have assets over US$30 million. Since many cannot take deposits they rely extensively on FND or other financial institutions for funding. Larger institutions have better access to commercial funding as well as to funding from FIRA.

25. **All regulated PFIs, whether supervised or not, are subject to financial consumer protection and anti-money-laundering authorities.** Regulated credit institutions including unsupervised SOFOMES must be registered with the CONDUSEF, which handles consumer complaints, including from MSMEs. They are also subject to CNBV supervision of anti-money-laundering arrangements. The producer associations are not registered as credit institutions and are subject to the laws and regulations of the general consumer protection agency and under anti-money-laundering oversight by the tax authorities.

Figure 6.1. Distribution of FND's Current Lending to PFIs	**Figure 6.2. Distribution of Supervised NBFIs* by their Asset Size**
 *Source:* Analysis of 2014 FND data	 *Source:* Analysis of 2014 FND and CNBV data *Note:* *NBFIs included here are the credit unions, cooperatives, and SOFIPOS, which are the only supervised institutions relevant for FND.

26. **Among supervised NBFIs, FND works with the smaller ones (figure 6.2), but among unsupervised institutions, FND probably works with the larger and stronger ones.** Most of FND's supervised PFIs have assets of less than US$5 million, whereas most Mexican NBFIs have assets of more than US$5 million. Balance sheet data on unsupervised institutions is not systematically collected or publicly available, but CONDUSEF data indicate there are about 2,000 active SOFOMES. Among the ones operating in rural areas and not only serving households, FND tends to work with the bigger ones.

27. **The majority of PFIs have solid financials (table 6.5, figures 6.3 to 6.6) based on available data, but there are weak institutions as well.** Table 6.5 summarizes the balance sheets of existing PFIs by type, provides financial performance indicators, and presents some data on their loan portfolio. Performance varies by institutional category, with cooperatives and credit unions having relatively low levels of delinquency while SOFOMES have the highest probably reflecting that most microfinance institutions are SOFOMES. Figures 6.3 to 6.6 illustrate the dispersion of financial performance of PFIs. It should be noted that reporting is incomplete for some small PFIs with weak capacity who are not reporting financials on an ongoing basis.

- **Solvency (figure 6.3).** The capital asset ratio in 2014 averaged 24 percent and was above 10 percent for 370 out of the 380 PFIs for which data was available. The majority of PFIs do not report risk-weighted assets, but assuming only loans were risk weighted, the capital adequacy ratio[35] will be 35 percent.

[35] Capital to risk-weighted assets, assuming only loans are risk weighted and they are assigned a 100 percent risk weight.

- **Asset quality (figure 6.4).** Reported NPLs at an average of 3.1 percent are low for the majority of PFIs. A minority of PFIs report very high NPLs (18 PFIs have NPLs in excess of 10 percent) highlighting the need for effective monitoring and follow-up.
- **Profitability (figure 6.5).** The sector generally shows strong earnings, with ROA in excess of 5 percent for 287 of the 379 reporting PFIs. There is, however, a small weaker group that lost money in 2014.
- **Liquidity (figure 6.6).** The liquidity position is strong for the majority of PFIs, particularly considering that only 12 are deposit taking institutions and thus do not have material short-term liabilities. A small group of 12 PFIs had liquid assets below 10 percent of total assets.

Figure 6.3. Capital/Assets, PFI Distribution

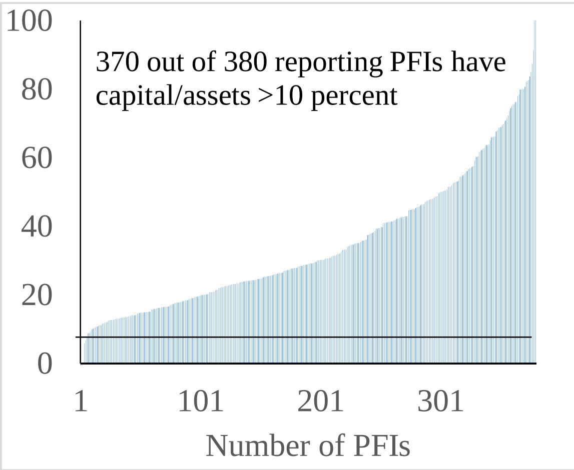


Figure 6.4. NPL Ratio, PFI Distribution

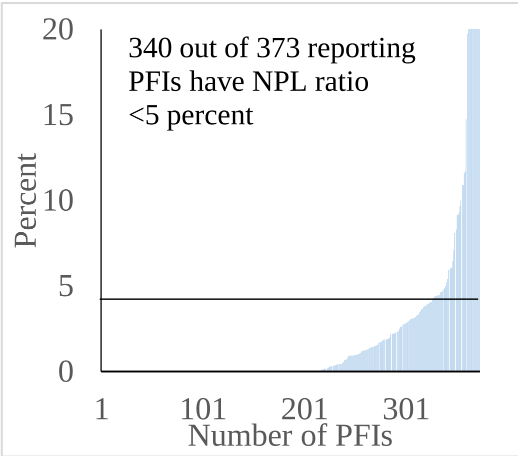


Figure 6.5. ROA, PFI Distribution

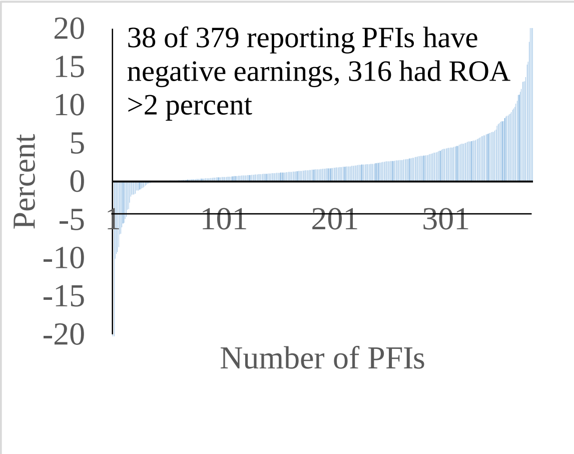
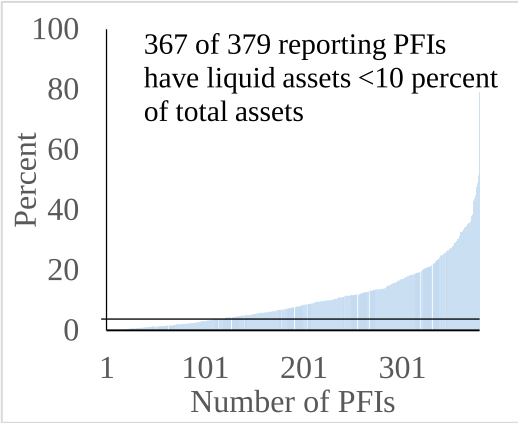


Figure 6.6. Liquid Assets/Total Assets, PFI Distribution



Source: Analysis of 2014 FND data

28. **PFI visits by the team confirmed overall financial performance, management, and governance commensurate with the nature of the PFIs' operations.** During preparation, the team visited PFIs representing different regulatory categories (credit unions, SOFOMES, producer associations) and lending methodologies (for example, microcredit and agricultural lending). PFIs analyzed were considered representative of the kinds of institutions expected to participate in the project. A sample of beneficiary MSMEs and agricultural producers were

visited as well. Available documentation for the PFIs and final borrowers was reviewed and the Bank team met with staff at different levels of the PFI and members of its board of directors. The visits confirmed that the variety of institution size and product complexity was matched by the sophistication of their operational processes.

Table 6.5. FND PFIs Financial Indicators

	Supervised Institutions			Unsupervised Institutions		
	Deposit Warehouses	Cooperatives	Credit Unions	Producer Associations	SOFOMES	Total
Aggregate balance sheet				*US$, millions*		
Assets						
Liquid assets	27	21	30	167	232	477
Net loans	255	220	235	1,056	1,310	3,077
Other	7	26	47	496	310	887
Total assets	**289**	**268**	**312**	**1,718**	**1,852**	**4,440**
Liabilities						
Short-term bank loans	175	91	122	853	786	2,028
Other short term	2	5	52	218	252	530
Long-term bank loans	64	133	17	174	357	744
Other long term	0	0	3	31	17	51
Total liabilities	**241**	**229**	**194**	**1,276**	**1,412**	**3,353**
Capital						
Total capital	**48**	**39**	**118**	**443**	**440**	**1,087**
Performance ratios				*Percent*		
NPLs	2.4	1.1	2.0	1.8	4.8	3.1
Provisions/NPLs	146.0	135.0	122.0	118.0	79.0	94.0
Capital/assets	17	14.0	38.0	26.0	24.0	24.0
ROE	12.5	0.6	14.7	7.7	3.6	6.7
ROA	2.1	0.1	5.5	2.0	0.9	1.6
Net interest margin /1	4.5	3.8	21.5	9.4	9.5	9.5
Operating costs/assets	1.8	4.0	12.3	5.6	8.3	6.9
Memo items				*US$, millions*		
FND lending	9	24	198	254	511	996
				Percent		
FND/assets	3	9	63	15	28	22
				US$		
Average loan amount /2		622	52,243	9,474	1,972	2,875
				Number		
Loans/unique borrowers /2		1.7	2.2	1.4	1.8	1.7

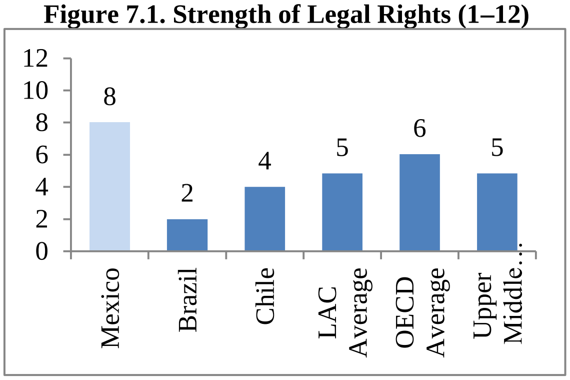
Source: FND, December 2014.
Note: /1 measured by interest income/interest earning assets - interest expenses/liabilities.
/2 For FND-financed loans only.

ANNEX 7: MEXICO FINANCIAL SECTOR SUMMARY DATA

Panel 1: Despite having pursued market-oriented reforms in support of healthy financial sector development pertaining to credit infrastructure, allowing foreign bank entry, and maintaining a modest state bank presence, Mexico trails its peers in credit depth and MSME access to credit.

The legal framework has been strengthened in Mexico in support of MSME finance.

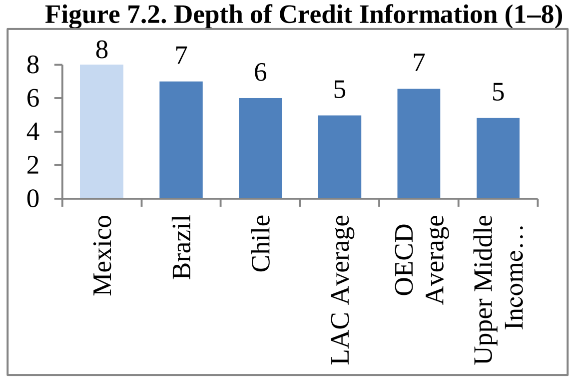
Figure 7.1. Strength of Legal Rights (1–12)



Source: Doing Business 2015.

Credit information coverage, scope, and accessibility is relatively good.

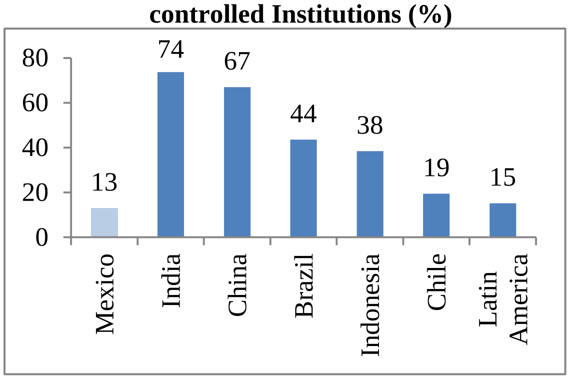
Figure 7.2. Depth of Credit Information (1–8)



Source: Doing Business 2015.

Mexico's state bank sector is smaller than in many comparator countries.

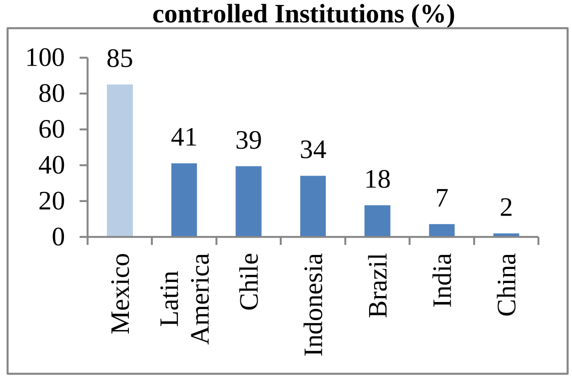
Figure 7.3. Share of Bank Assets in Government-controlled Institutions (%)



Source: World Bank. Global Financial Development Report 2014.

Foreign banks are an important part of the financial system.

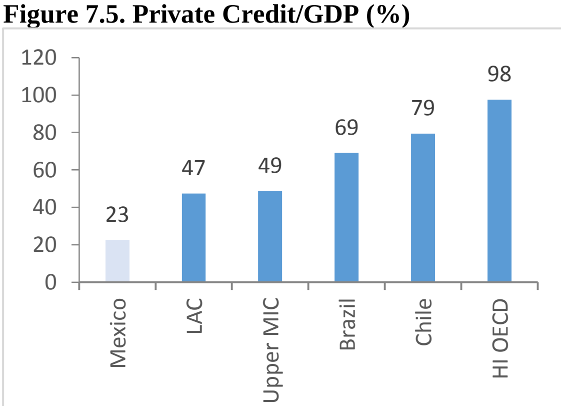
Figure 7.4. Share of Bank Assets in Foreign-controlled Institutions (%)



Source: World Bank. Global Financial Development Report 2014.

Credit depth in Mexico is about half of what income level, regional, and individual peers suggest it should be.

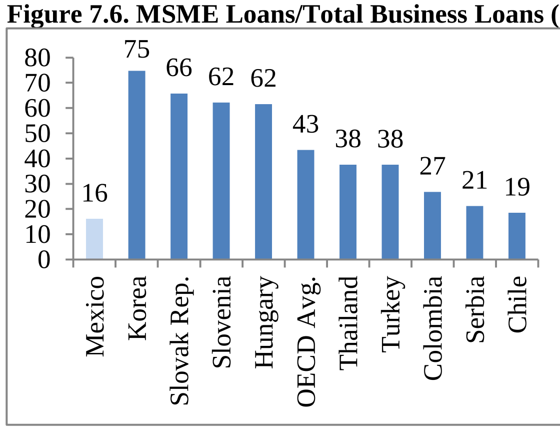
Figure 7.5. Private Credit/GDP (%)



Source: IMF International Financial Statistics (IFS) 2014.

Within the enterprise sector, MSMEs in Mexico receive a small portion of the business lending.

Figure 7.6. MSME Loans/Total Business Loans (%)

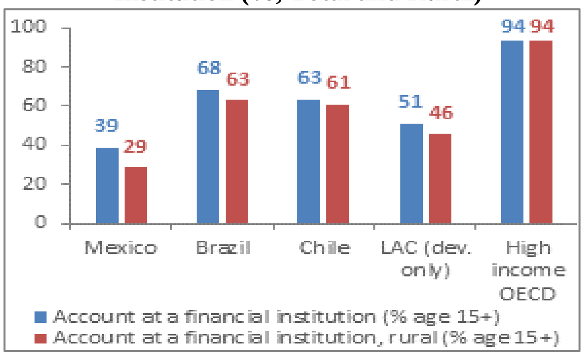


Source: Financing MSMEs and Entrepreneurs 2014: An OECD Scoreboard.

Panel 2: Commercial credit depth is much lower in rural areas than in urban or semi-urban ones. Credit/value added at the firm level is indicative of how much credit is used for productive purposes.

Access in Mexico is lower than in peer countries and rural areas are even further from the national average.

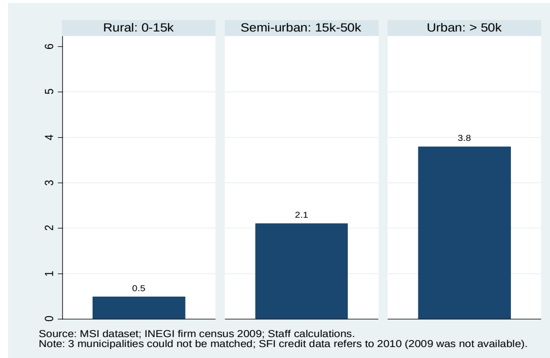
Figure 7.7. Adults with an Account at a Financial Institution (%, Total and Rural)



Source: World Bank Global Findex 2014.

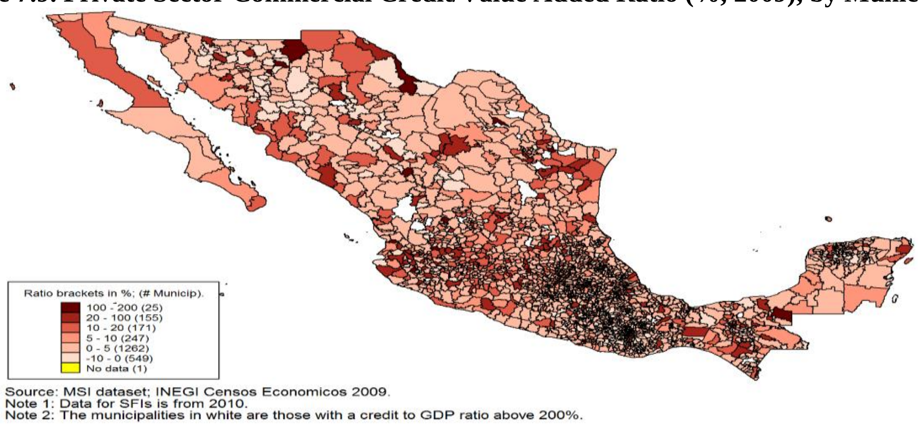
Finance for productive purposes is more scarce in rural areas.

Figure 7.8. Median Commercial Credit[36]/Value Added[37] Ratio (%), by Municipality Type



Source: CNBV and INEGI *Censos Economicos 2009.*

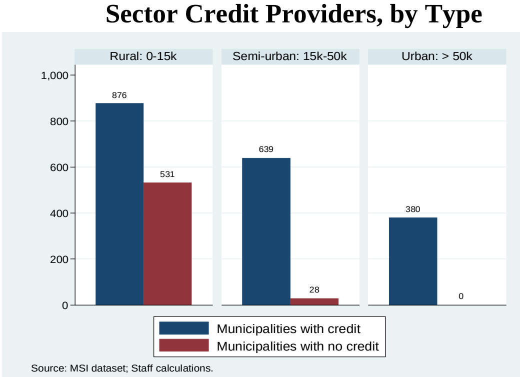
Figure 7.9. Private Sector Commercial Credit/Value Added Ratio (%, 2009), by Municipality



Source: CNBV and INEGI *Censos Economicos. 2009.*

Almost all the municipalities without credit (95%) are rural.

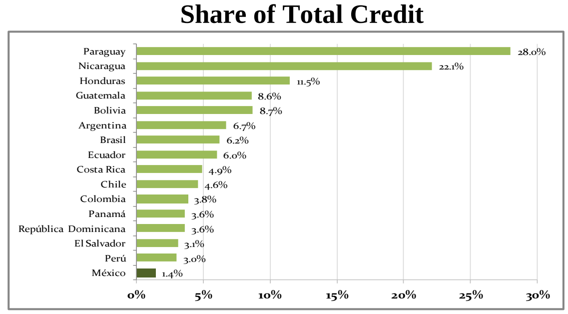
Figure 7.10. Municipalities with/without Private Sector Credit Providers, by Type



Source: CNBV and INEGI *Censos Economicos*, 2009.

The Mexican agricultural sector is poorly served, relative to other countries.

Figure 7.11. Credit to the Agricultural Sector as Share of Total Credit



Source: "Banca de desarrollo para el agro: Experiencias en curso en América Latina", de Carolina Trivelli y Hildegardi Venero, Instituto de Estudios Peruanos, 2007.

[36] Includes only credit from commercial and development banks, regulated SOFOMES and cooperatives, SOFOLES, and SOFIPOS.
[37] The measure is equivalent to commercial credit/GDP at the national level.