

PROJECT INFORMATION DOCUMENT (PID) CONCEPT STAGE

Report No.: PIDC28338

Project Name	MX: Expanding Rural Finance (P153338)
Region	LATIN AMERICA AND CARIBBEAN
Country	Mexico
Sector(s)	General agriculture, fishing and forestry sector (20%), SME Finance (40%), Other non-bank financial intermediaries (40%)
Theme(s)	Other Financial Sector Development (80%), Other rural development (20%)
Lending Instrument	Investment Project Financing
Project ID	P153338
Borrower(s)	Financiera Nacional de Desarrollo Agropecuario, Rural, Forestal y Pesquero
Implementing Agency	Financiera Nacional de Desarrollo Agropecuario, Rural, Forestal y Pesquero
Environmental Category	F-Financial Intermediary Assessment
Date PID Prepared/ Updated	12-Jun-2015
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Estimated Date of Board Approval	05-Nov-2015
Concept Review Decision	Track II - The review did authorize the preparation to continue

I. Introduction and Context

Country Context

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 per capita GNI (Atlas Method) of \$9,640. It is a member of the OECD and the G20, with an open economy and trade agreements with more than 40 countries. Short-term macroeconomic management during the 2008-2009 global financial crisis was strong, and Mexico's economy rebounded quickly, reaching an average growth rate of 4.4 percent between 2010 and 2012. Consistent with the global economic slowdown, GDP growth was weak in 2013 and projected to remain weak in 2014, with a growth expected of 2.1 percent. Growth is projected to increase in the coming years as confidence recovers and the benefits of recent structural reforms

materialize.

Like many other countries in Latin America, however, Mexico faces challenges in its quest for shared prosperity—namely low growth and low productivity. In recent decades, weak productivity growth has resulted in slow growth of incomes. Over the past decade, the economy grew at 2.4 percent annually, well below the regional average of 4 percent. Its per capita income has remained at about 30 percent of that of the U.S. By comparison, East Asia Tigers' per capita income tripled over the past three decades and is currently about 60 percent of that of the U.S. 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 and limited market competition, labor market rigidities, scarce skilled labor and an underdeveloped financial system.

Income and productivity growth have been unequally distributed both geographically and across individuals, particularly in rural areas. 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. Extreme poverty declined from over 11.3 percent to 9.8 percent between 2010 and 2012 according to Mexico's multi-dimensional poverty measure. However, the rural poverty headcount according to national poverty lines was 63 percent in 2012, well above the urban poverty headcount of 45.5 percent. The agricultural sector plays an important social role given the importance of agriculture income in the total income of the rural poor.

Agriculture employs an important share of the population, but is contributing less than other sectors to economic growth. Between 1999 and 2011 agriculture grew by an average of 1.6 percent while other sectors grew 3.7 percent. Agriculture's share of GDP was 3.5 percent in 2013, while its share of employment was 13 percent, a reflection of the relatively low productivity of the agricultural sector. The Government has embarked on a reform agenda towards 'democratization of productivity' through microeconomic reforms which recognizes that productivity growth among low income groups will ensure shared prosperity.

Sectoral and Institutional Context

Despite a stable macroeconomic framework and a series of market-enhancing reforms, the financial market has historically failed to provide adequate access to key segments in Mexico. A vibrant financial sector that identifies and funds viable business opportunities is an important micro-economic foundation for shared prosperity by supporting increased incomes while helping to manage risks. However, market failures have left gaps in access to finance both with regard to the depth of credit and to areas outside of major urban centers as discussed below.

Mexico's financial sector is small, and relative to international benchmarks access to credit for productive purposes is limited. Credit to the private sector as a percent of GDP in Mexico is 23 percent in 2013, about half the LAC average of 41 percent and the upper middle income country average of 49 percent. According to the 2010 World Bank Enterprise Survey, only 32 percent of urban formal manufacturing firms have a bank loan or credit line, well below world (56 percent) and regional averages (LAC: 48 percent), including some poorer countries like El Salvador and Guatemala.

The underdeveloped financial system allocates only a small part of credit to small enterprises; few of which have loans or use bank finance for working capital. National data (by the National

Banking and Securities Commission, CNBV) suggest that only 20–25 percent of all small and medium-size enterprises (SMEs) have access to bank credit. Commercial bank lending tends to be short term, costly and increasingly focused on the more profitable consumer credit.

The supply of financial services in Mexico is concentrated in urban areas, limiting the growth of the rural economy. The presence of formal financial institutions is five times higher in urban municipalities than in rural municipalities, despite efforts to expand access points to financial services. Bank branches are present in 42.7 percent of rural municipalities, in comparison to 99.5 percent of urban municipalities. The 2007 Agricultural Census for Mexico found that just 4 percent of rural economic units had a credit or insurance product. Even when rural financial services are present, they are more highly concentrated in particular states of Mexico.

The Mexican financial system has a few large banks focused on larger clients and a dispersed network of smaller financial institutions serving smaller enterprises and lower income household. Five banks in Mexico account for 56 percent of total assets of supervised financial institutions. Meanwhile, 314 supervised non-bank financial institutions make up less than 2.7 percent of 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 transaction costs might be deemed excessively high for banks.

Financial sector policy reforms have supported a stronger legal framework for lending, increased availability of credit information, and enhanced competition with liberal entry into the financial sector including by strong foreign institutions. The strength of legal rights index of the 2015 Doing Business report shows Mexico above the LAC and OECD averages. The Getting Credit indicator of the 2015 Doing Business data ranked Mexico 12 out of 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, is well developed. A class of non-deposit taking financial institutions is permitted to operate without supervision. Foreign banks have been allowed to enter the market, they account for a high share of bank assets, and include larger international conglomerates such as Citi, HSBC, Santander, and BBVA. Although state development finance institutions remain part of the financial system, they are smaller than most other large G20 countries and operate mostly as second tier institutions allowing for a level playing field for the first tier sector. The recent financial sector reform law continues the reform process with attempts to improve the Mexican bankruptcy system.

For several years the Government has assigned a priority to expanding financial access, with a more recent emphasis on expanding credit for productive purposes. In 2008, a unit dedicated to supporting financial inclusion was set up in the Mexican National Banking and Securities Commission (CNBV). An enabling framework for bank agents (corresponsales) was established in 2009, but their penetration in rural areas is still limited. Two coordination bodies, the Committee on Financial Education and the National Council on Financial Inclusion, were established by the Government in 2011 to enhance financial education and financial inclusion in Mexico. Internationally, Mexico has taken a leadership role in promoting financial inclusion. Financial inclusion was also a key priority established by Mexico in their capacity as chair of the G20 in 2012, and the national financial inclusion strategy was launched in 2014. Mexico's National Development Plan (2013-2018) described the importance of creating a productive primary sector with a focus on increasing the profitability, productivity and competitiveness of the sector.

Despite sound economic conditions and financial sector reforms, impediments to formal finance for productive purposes remain. The Doing Business data on the enabling environment for credit reflect the experience of formal firms in Mexico City, which is not necessarily representative of the vast majority of Mexican firms. Impediments to formal finance for productive purposes include the widespread informality of Mexican firms and high collateral requirements (more than double the value of the loan). To manage credit risk, lenders often require micro, small and medium sized enterprises (MSMEs) seeking loans to hold substantial compensatory deposits. The documents required by financial institutions (such as formal financial statements and proof of tax compliance) also reduce the pool of firms eligible for finance.

The financial system has not fulfilled the demands of credit for productive purposes particularly in rural areas. According to Mexico's agricultural census, just 9 percent of the production units with credit or insurance had financial products provided by commercial banks. A study by Love and Sanchez (World Bank, 2009) found that credit constraints were pervasive in the Mexican rural economy, limiting the investments and growth of rural enterprises. 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 with the primary reason cited for lack of use being lack of finance. Banks and microfinance institutions often have lending technology that require frequent repayment that are not well-suited for the harvest dependent agricultural cycle. The challenge remains to build financial institutions that can serve the needs of the rural economy in a sustainable manner.

The Government assigned a priority to address the lack of credit through its system of development finance institutions (DFIs) in Mexico as part of the 2014 financial reform. DFIs in Mexico address access to finance gaps mostly through second tier finance, partial credit guarantees (PCGs), and technical assistance. In 2014, a key pillar of the new Government's economic reforms was a financial reform law with greater incentives for financial intermediaries to lend for productive purposes, including efforts to refocus state development bank operations to address finance gaps and other restrictions related to credit. Mexico has an extensive system of development finance that includes six development banks, six government trusts and four development finance agencies to support key sectors, such as the rural economy. One of these development finance agencies is FND, the proposed borrower for this operation.

Role of the Borrower: Financiera Nacional de Desarrollo Agropecuario, Rural, Forestal y Pesquero (FND)

FND channels resources to the rural economy including by financing numerous small financial institutions that cater to small enterprises. FND, known until 2014 as Financiera Rural, finances agriculture, fisheries, forestry and rural commerce with the goal of improving productivity and improving the quality of life of the rural population. Financiera Rural was created with the technical support of the World Bank as part of the liquidation of Banrural in 2002. 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.

FND plays a key role in the ecosystem of Mexican DFIs. It 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 the 4 percent of production units with financial services in

Mexico. Commercial banks and credit unions 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 participating financial intermediaries (PFIs). PFI lending accounts for about 45 percent of lending volume, but it is more important in outreach and number of loans. In 2014, FND disbursed resources through 438 PFIs for more than 400,000 credits.

In addition to finance, FND provides services to strengthen the capacity of intermediaries. Although the primary purpose of the accreditation process to become an eligible PFI for FND and manage credit risk for FND, the process is aligned with the requirements for supervised institutions and thus helps prepare institutions to graduate to supervised entities. In conjunction with the Secretary of Agriculture, Livestock, Fisheries and Rural Development (SAGARPA), FND also supports technical assistance to PFIs through a network of accredited providers for financial institutions to strengthen business planning, operations, IT systems and risk management with the goal of strengthening the network of sustainable financial institutions. This technical assistance is currently funded with fiscal grants, but is insufficient to cover the range of needs presented by PFIs.

As part of the 2014 financial reform, FND is making increased efforts to expand access to finance in rural areas while maintaining financial sustainability. The financial reform put increased importance on development finance institutions like FND to address credit gaps, particularly in underserved populations such as rural areas. FND's balance sheet projections envision portfolio growth of 62 percent by 2018. In addition, FND aims to increase its developmental impact through expanded activity to small and medium sized primary producers and an expansion of its second-tier lending activities both to leverage the distribution networks already built by other financial service providers and to support their further development.

Relationship to CAS

The proposed operation is fully aligned with the Country Partnership Strategy (CPS) for Mexico for the period of FY2014-19. The operation has been requested by the Ministry of Finance 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 more inclusive and supporting prosperity. The project also supports the core thematic area of the CPS related to unleashing productivity, which includes financial sector development and a more competitive business environment.

The operation supports the shared prosperity goal of the World Bank by providing access to finance for historically disadvantaged agricultural producers thereby supporting their growth. Finally, the project supports the World Bank's 'Universal Financial Access by 2020 agenda' for which Mexico is one of 25 focus countries.

II. Proposed Development Objective(s)

Proposed Development Objective(s) (From PCN)

The project's development objective is to expand the availability of finance to the rural economy and to strengthen the institutional capacity of FND and participating financial intermediaries (PFIs).

Key Results (From PCN)

Results will be measured at three levels of project beneficiaries: FND, the PFIs through which FND

works under the project, and the MSMEs and producers receiving credit.

FND: Results will be achieved through financial intermediation to PFIs, through institutional strengthening, and through product innovation

- * Result 1 - Larger, stronger, more efficient provider of rural finance development support
 - * Indicator 1 – Number of financial intermediaries receiving finance through the project and in total
 - * Indicator 2 – NPLs for financial intermediary lending (PDO indicator)
 - * Indicator 3 – Efficiency ratio: Operational expenses/loans

PFIs: Results will be achieved through financial intermediation and institutional strengthening of intermediaries

- * Result 2 - Expanded, more efficient providers of rural finance - measured by their total portfolios
 - * Indicator 1 – Loan portfolio amount
 - * Indicator 2 – Return on assets
 - * Indicator 3 – Non-performing loans ratio (PDO indicator)
 - * Indicator 4 – Number of PFIs receiving technical assistance
 - * Indicator 5 – Share of responding PFIs that feel the project reflected their needs based on internet and/or SMS based survey (Core citizen engagement indicator)

MSMEs/Producers: Results will be achieved through provision of credit

- * Result 3 - Sustainable and increased production supported by access to financial services
 - * Indicator 1 – Number of MSMEs and producers reached with access to formal financial services
 - * Indicator 2– Number and volume of loans, supported by the project and by participating PFIs (GP Core Indicator and PDO indicator)
 - * Indicator 3– NPL ratio of the rural finance credit line
 - * Indicator 4 – Share of responding MSMEs that feel the project reflected their needs based on internet and/or SMS based survey (Core citizen engagement indicator)

III. Preliminary Description

Concept Description

The project will have two components supporting the development of productive finance for the rural economy in Mexico:

Component 1: A line of credit through participating intermediaries (PFI) to MSMEs (approximately US\$370 million). FND will offer lines of credit to PFIs, which will be either financial intermediaries or producer organizations. The PFIs on-lend to MSMEs enabling them to expand their activities. The loan products will not be restricted by the project and are likely to be mostly working capital, but may also include investment finance and financing for warehouse receipts. In addition to supporting the general objective of improving access to credit, the component will help FND increase its proportion of credit disbursed through intermediaries, which was at 45 percent in 2014. Up to US\$10 million of this component can be applied to piloting of new MSME financing solutions by FND. Up to US\$10 million of this component can be applied to piloting of new MSME financing solutions by FND.

Component 2: Strengthening institutional capacity to provide sustainable finance (approximately

US\$30 million). This component will provide assistance to FND to support enhanced internal processes and IT systems will be important to support improved efficiency and risk management capabilities of FND. This component will also support capacity building activities for PFIs with the goal of a vibrant evolution of the financial sector with new institutions entering the market and existing institutions upgrading their activities. This activity will expand the number of PFIs receiving technical assistance services, including training on business planning, IT systems, credit underwriting, and administration and risk management processes for borrowers in the rural economy. These funds could also be used to assist potential PFIs meet FND eligibility criteria with the goal of helping strong formal financial intermediaries in evolving from the unsupervised segment, and helping existing institutions expand the services they offer by upgrading their licenses.

IV. Safeguard Policies that might apply

Safeguard Policies Triggered by the Project	Yes	No	TBD
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	

V. Financing (in USD Million)

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	

VI. Contact point

World Bank

Contact: Steen Byskov
 Title: Sr Financial Economist
 Tel: 458-7641
 Email: sbyskov@worldbank.org

Contact: Rekha Reddy
 Title: Senior Economist
 Tel: 458-5091

Email: rreddy5@worldbank.org

Borrower/Client/Recipient

Name: Financiera Nacional de Desarrollo Agropecuario, Rural, Forestal y Pesquero
Contact: Arturo Bodenstedt
Title: Executive Director-Programs and Products
Tel: 525552301600
Email: artboden@fnd.gob.mx

Implementing Agencies

Name: Financiera Nacional de Desarrollo Agropecuario, Rural, Forestal y Pesquero
Contact: Catalina Bonnefoi
Title: Adjunct Director
Tel: 525552301600
Email: cbonnefoi@fnd.gob.mx

VII. For more information contact:

The InfoShop
The World Bank
1818 H Street, NW
Washington, D.C. 20433
Telephone: (202) 458-4500
Fax: (202) 522-1500
Web: <http://www.worldbank.org/infoshop>