

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

**MEXICO**

**CONDITIONAL CREDIT LINE FOR PRODUCTIVE AND INCLUSIVE  
RURAL FINANCING**

**(ME-X1024)**

**AND**

**SECOND PROGRAM FOR PRODUCTIVE AND INCLUSIVE RURAL FINANCING**

**(ME-L1170)**

**LOAN PROPOSAL**

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## ABBREVIATIONS

CCLIP	Conditional credit line for investment projects
CNBV	Comisión Nacional Bancaria y de Valores [National Banking and Securities Commission]
ENIF	Encuesta Nacional de Inclusión Financiera [National financial inclusion survey]
FIRA	Fideicomisos Instituidos en Relación con la Agricultura
FND	Financiera Nacional de Desarrollo Agropecuario, Rural, Forestal y Pesquero
ICAS	Institutional Capacity Assessment System
INEGI	Instituto Nacional de Estadística e Informática de México [Mexican National Statistics and Informatics Institute]
LIBOR	London Interbank Offered Rate
Mex\$	Mexican peso
PND	Plan Nacional de Desarrollo [National Development Plan]
REU	Rural economic unit
RFI	Rural financial intermediary
SAGARPA	Department of Agriculture, Rural Development, Fisheries, and Foods
TFP	Total factor productivity

## PROJECT SUMMARY

### MEXICO CONDITIONAL CREDIT LINE FOR PRODUCTIVE AND INCLUSIVE RURAL FINANCING (ME-X1024)

### SECOND PROGRAM FOR PRODUCTIVE AND INCLUSIVE RURAL FINANCING (ME-L1170)

Financial Terms and Conditions				
<b>Borrower:</b> Financiera Nacional de Desarrollo Agropecuario, Rural, Forestal y Pesquero (FND)			<b>Flexible Financing Facility<sup>(a)</sup></b>	
			<b>Amortization period:</b>	25 years
<b>Guarantor:</b> United Mexican States			<b>Original WAL:</b>	15.25 years
			<b>Disbursement period:</b>	36 months
<b>Executing agency:</b> FND			<b>Grace period:</b>	5.5 years
			<b>Inspection and supervision fee:</b>	(b)
<b>Source</b>	<b>Amount (US\$ millions)</b>	<b>%</b>	<b>Interest rate:</b>	LIBOR-based
IDB (CCLIP)	1,000		<b>Credit fee:</b>	(b)
IDB (Ordinary Capital)	400	100	<b>Approval currency:</b>	U.S. dollars from the Ordinary Capital
Cofinancing	0			
Local	0			
<b>Total</b>	<b>400</b>	<b>100</b>		
Project at a Glance				
<b>Objective of the CCLIP:</b> (i) help raise primary sector productivity by improving rural economic units' access to financing to make productive investments; and (ii) promote financial inclusion to benefit the rural sector through access to productive credit for rural economic units.				
<b>Objective of the second program:</b> help raise primary sector productivity through improved access to financing by rural economic units, in particular in segments with the greatest constraints in terms of access to formal productive credit, to make investments in productive activities.				
<b>Special contractual conditions precedent to the first disbursement:</b> (i) formal appointment of a program coordinator, to the Bank's satisfaction; and (ii) approval of the program Operating Regulations, agreed on with the Bank, and their implementation by FND (paragraph 3.3).				
<b>Exceptions to Bank policies:</b> None.				
<b>Project qualifies as:</b> <sup>(c)</sup> SV [ ] PE [X] CC [ ] CI [ ]				

<sup>(a)</sup> Under the Flexible Financing Facility (document FN-655-1) the borrower has the option of requesting changes to the amortization schedule and currency and interest rate conversions. When considering such requests, the Bank will take into account operational and risk management considerations.

<sup>(b)</sup> The credit fee and inspection and supervision fee will be established periodically by the Board of Executive Directors as part of its review of the Bank's lending charges, in accordance with the corresponding policies.

<sup>(c)</sup> SV (small and vulnerable countries), PE (poverty reduction and equity enhancement), CC (climate change, sustainable energy, and environmental sustainability), CI (regional cooperation and integration).

## I. DESCRIPTION AND RESULTS MONITORING

### A. Background, problem addressed, and rationale

- 1.1 **Macroeconomic context.** The Mexican economy suffered a slowdown in 2013 and 2014, with growth of just 1.4% and 2.1%, respectively, after two years of 4% average growth. It has since shown signs of recovery, although the government has cut its GDP growth forecast for 2015 from the 3.4% to 4.2% range to between 2.2% and 3.2%.<sup>1</sup> Inflation has behaved favorably, with an annual rate of 2.93% in the first half of May 2015, almost exactly on the inflation target of 3%. The current account deficit is expected to end the year at 2.2% of GDP, compared with 2.1% in 2014.
- 1.2 **Primary sector growth and productivity.** The primary sector performed poorly from 1999 to 2011, with average annual growth of 1.2%, well short of the 2.3% growth of the economy as a whole.<sup>2</sup> However, in recent years it has been more dynamic, growing at an average rate of 3.9% in 2012 and 2014, compared with 1.4% and 3.1% in the case of the secondary and tertiary sectors, respectively. Its share of GDP has declined over several decades and currently stands at 3.5%.<sup>3</sup> The sector's development is also characterized by regional imbalances. For example, over the five quarters leading up to the end of 2014, the agricultural output index in the north and center-north regions of the country grew by an average of 7%, while the south saw negative growth of 1.3%.
- 1.3 There is a dynamic commercial sector in the Mexican countryside that makes the country one of the world's top 10 producers and exporters of various foods. However, this is offset by the large majority of rural economic units (REUs) being subsistence-oriented with limited market ties,<sup>4</sup> contributing to total output being insufficient to cover domestic demand for certain basic foodstuffs. Of the 5.3 million REUs, only 27% are considered businesses. These are classified by increasing level of sales: In transition (E3), Business with weak returns (E4), Sound business (E5) and Dynamic business (E6). E3s account for approximately 8% of all REUs and have low income levels (average annual sales of around US\$5,000<sup>5</sup>), which makes it difficult for them to accumulate productive assets. E4s have an annual income from sales averaging US\$10,000 and in the range of US\$6,500 to

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<sup>1</sup> Finance and Public Credit Department, communiqué of 21 May 2015. International Monetary Fund estimate of the current account.

<sup>2</sup> Includes the agriculture, rural, forestry, and fisheries subsectors. Figures from the Instituto Nacional de Estadística e Informática de México [Mexican National Statistics and Informatics Institute] (INEGI). According to the [Diagnostic assessment of the rural and fisheries sector](#) by the Department of Agriculture, Rural Development, Fisheries, and Foods (SAGARPA), 2012, the causes underlying the low growth of primary activities are: (i) low levels of productivity among rural economic units; (ii) insufficient technological innovation; (iii) limited market access for agricultural and fisheries products; (iv) inadequate financing for farming and fishing activities; (v) unfavorable heritage of plant and animal health; and (vi) the high level of risk of primary activity.

<sup>3</sup> INEGI. Adding agroindustrial activity boosts its share to 7.8% of GDP. The regional figures are from Banco de México, December 2014 report on regional economies.

<sup>4</sup> SAGARPA, 2012, op cit. A rural economic unit is defined as a natural or legal person, linked to a property or otherwise, conducting agricultural or fishery activities, or other productive, industrial, commercial and services activities in the rural environment. In all, 73% are subsistence or have limited ties to the market (classified as E1 and E2). Also, of the total, 4.1 million are farming or forestry production units.

<sup>5</sup> An exchange rate of Mex\$15 to the U.S. dollar is used throughout this document, and figures are rounded.

US\$15,200. “Weak returns” refers to the fact that more than half of rural economic units in this stratum do not generate sufficient income to cover the depreciation of their assets. These REUs make up 9.9% of the total and are regional markets’ main suppliers. E5s have an annual income from sales averaging US\$37,500 and a maximum of US\$153,000. They make up 8.5% of all REUs and face the challenge of increasing their competitiveness. Those in category E6 (just 0.3% of the total), with annual sales income of over US\$153,000, are considered to be fully integrated with national and international markets.

- 1.4 The sector’s low and uneven performance has not helped improve the living standards of the population depending on it: of the 24 million inhabitants of rural areas,<sup>6</sup> 61% live in poverty. At the regional level, poverty is higher in those Mexican states that are more heavily dependent on the primary sector. Thus, the federative entities of the south and southeast, where more than 30% of the population is employed in the primary sector, have a larger share of their population living in extreme poverty.<sup>7</sup> The primary sector is therefore viewed as a priority sector in the design of Mexico’s public policy,<sup>8</sup> due to its importance not only as a timely provider of food for the population, but also as a significant source of employment, rural income, and territorial balance.<sup>9</sup>
- 1.5 Mexico’s primary sector’s ability to grow over the medium to long term is mainly constrained by its low productivity.<sup>10</sup> Between 2000 and 2012, the productivity of the primary sector, measured in terms of primary GDP per employed person, dropped by almost 7% in real terms.<sup>11</sup> Similarly, official statistics show that over the period 1999-2011, average total factor productivity (TFP) growth of primary sector output was negative (-0.39%).<sup>12</sup> In the case of the agricultural sector, which accounts for 57% of primary activity,<sup>13</sup> the average productivity of land (US\$250 per hectare in 2010) is still well below the region’s averages, and even below that of the Central American subregion (for example, in 2010, output per hectare was US\$710 in the Dominican Republic, US\$680 in Costa Rica, and US\$550 in El Salvador).<sup>14</sup>

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<sup>6</sup> Localities with fewer than 2,500 inhabitants.

<sup>7</sup> INEGI, 2010. National Survey of Household Income and Expenditure. The states with the largest shares of the population living in extreme poverty are Chiapas (32.2%), Guerrero (31.7%), and Oaxaca (23.3%) (INEGI, 2013, Estadísticas a propósito del Día Internacional para la Erradicación de la Pobreza [Statistics for International Poverty Eradication Day]).

<sup>8</sup> The primary sector employs 13.7% of the country’s labor force (INEGI, 2012).

<sup>9</sup> National Development Plan (PND) 2013-2018, Federal Executive Branch, Mexico, 2013.

<sup>10</sup> SAGARPA, 2012, op. cit. For an international review of the literature on primary sector productivity and growth, see Fuglie et al., 2012, *Productivity growth in agriculture: an international perspective*. For the case of Mexico, see McKinsey, 2014, *A tale of two Mexicos: Growth and prosperity in a two-speed economy*. For evidence on the relationship between productivity, agricultural growth and poverty, see Prasada et al., 2004, *Agricultural productivity growth, employment and poverty in developing countries, 1970-2000*, International Labor Organization.

<sup>11</sup> INEGI, using constant 2008 prices.

<sup>12</sup> INEGI, 2013, Total factor productivity 1990-2011.

<sup>13</sup> The livestock sector constitutes 40%, and fishing and forestry 3%.

<sup>14</sup> Inter-American Development Bank (IDB), 2013, *Tiempo de cosecha. Desafíos y oportunidades del sector agrícola en Centroamérica y República Dominicana*. [Harvest time. Challenges and opportunities for the agricultural sector in Central America and the Dominican Republic].

- 1.6 Some of the reasons underlying the primary sector's low productivity are:<sup>15</sup> (i) the sector's undercapitalization, resulting from REUs' lack of investment in productive assets, such as infrastructure, equipment, and other fixed assets;<sup>16</sup> and (ii) the low uptake of technology and technical farming models<sup>17</sup> by REUs.<sup>18</sup>
- 1.7 **Access to finance as an essential factor in increasing the sector's productivity.** Insufficient access to finance by REUs represents a critical obstacle for improving the conditions of the factors of low growth and productivity.<sup>19</sup> Access to financing for productive purposes facilitates the availability of working capital to purchase inputs and allows investments to be made in equipment and infrastructure, crop conversion, adoption of new technologies and technical/production capacities,<sup>20</sup> which translate into

<sup>15</sup> See: PND; Agriculture, Fisheries, and Foods Sector Development Program 2013-2018, SAGARPA, 2013; and SAGARPA, 2012, op. cit. The latter reference identifies low business management capacity as a third fundamental cause of the problem of low productivity levels.

<sup>16</sup> Sector studies show, for example, that access to irrigation increases agricultural productivity (Jin et al., 2012; and Agriculture and Natural Resources Management Sector Framework Document; GN-2709-2, IDB, 2013). In Mexico, irrigated land can be as much as four times as productive as rainfed areas in terms of value. Furthermore, international comparative studies show that the difference in productivity between countries in the agricultural sector is largely due to the gap in capital investment (Mundlak et al., 1997). Just 18% of rural economic units report having made productive investments; 29.6% do not have any type of productive assets; only 37% of farmers use a tractor; and just 28% of the cultivated area is irrigated (Mora Rivera et al., 2011, *Determinantes de la Inversión en la Agricultura Mexicana* [Determinants of investment in Mexican agriculture], Centro de Estudios Económicos, El Colegio de México).

<sup>17</sup> With regard to the use of chemical fertilizers, insecticides and/or herbicides, improved seeds, and manure, together with the use of machinery and implements. These may be not only to boost the productivity of existing activities or crops, but also enable conversion towards higher value activities.

<sup>18</sup> SAGARPA, 2012, op. cit. In this regard, for example, cereal production—one of the crops that yields least value per hectare—occupies half of arable land, whereas fruit and vegetables produce around 70% of the value of cereals output using just 7% of the total cultivated land. Moreover, studies on the sector indicate that in the case of agricultural rural economic units, for example, less than a third of them apply fertilizer in doses based on soil analysis; 76% apply irrigation sheets based on their experience rather than technical backing; and more than 90% retain existing production practices or processes without incorporating new techniques or technologies. As a result of the low take-up of technologies and improved techniques, efficiency in the sector is well below potential.

<sup>19</sup> For example, see: Love, I. and S. Sánchez, 2009, *Credit Constraints and Investment Behaviour in Mexico's Rural Economy*, *The World Bank, Policy Research Working Paper 5014*; Mora Rivera et al., op. cit.; and Escalante, Catalán, and Basurto, 2013, *Determinantes del crédito en el sector agropecuario mexicano: un análisis mediante un modelo Probit* [Determinants of credit in the Mexican agricultural sector: an analysis using a Probit model]. Along with a lack of access to capital, rural productive units generally invest less, particularly in innovation and technology adoption, for other reasons, such as: the benefits of innovation are not fully accessible; there is a lack of public and private capacity to provide extension services, particularly for small farmers; and there are information asymmetries concerning the benefits (i.e. rates of return) from new investments and technologies (*Development Effectiveness Overview*, IDB, 2008-2009).

<sup>20</sup> Access to financing can provide timely resources for the acquisition of inputs, technologies, management and production models, etc. (International Finance Corporation, 2012, *Innovative agricultural SME Finance Models*). Uaiene et al. (2009) empirically analyze the relationship between agricultural credit and technology, and show that producers with access to credit have a greater likelihood of adopting technology. Foster and Rosenzweig (2010) show that credit constraints play a major role in delays in adopting technology.



productive units' increased profitability and productivity.<sup>21</sup> In particular, access to credit is a determining factor in rural economic units' decisions to invest in productive assets and in the number of investments they make.<sup>22</sup> Consequently, removing constraints on access to credit would increase the number and scale of rural producers' investments, thus helping break the primary sector's cycle of low investment, low productivity, and low growth.

- 1.8 However, there are specific obstacles hindering the supply of financial services to the primary sector or making it more expensive. In particular, access to credit is affected by: (i) higher risks than in other sectors, and inadequate tools to manage these risks, which include, in particular, climate, marketing, and price volatility, which have an impact on uncertainty over income levels and inhibit investment, and the concentration of risk in certain activities and geographical areas; (ii) greater limitations in terms of the collateral available and its execution, whether due to a lack of existing capital or, in some cases, the nature of land ownership; (iii) the high transaction costs involved in lending small sums to geographically scattered borrowers;<sup>23</sup> and (iv) the low profitability of most rural economic units, where the absence of economies of scale leads to high production costs (seeds, agrochemicals, machinery and equipment, fuel, and other inputs), in addition to the fact that they are not generally focused on producing high value products and production volumes are small.
- 1.9 These obstacles have led to the financial sector's low penetration in the rural economy and financing for the primary sector being in a state of prolonged stagnation. Just 1.5% of the economy's total financing goes to the primary sector.<sup>24</sup> The value of the total financing of the sector at year-end 2012 was, in real terms, practically identical to that in 2000, covering around 25.4% of primary GDP.<sup>25</sup> For comparison, in 2009, these levels were around 60% in Brazil and over 100% in the United States.<sup>26</sup> Also, the Encuesta Nacional Agropecuaria [National Agricultural Survey]<sup>27</sup> shows that just 7.7% of production units had accessed credit in 2012. Moreover, financing investment projects requires medium and long-term resources. These present additional difficulties as they require financial institutions to have the capacity to acquire resources of this kind and manage the greater risks

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<sup>21</sup> International empirical evidence shows that, in the case of Peru, for example, access to credit could increase agricultural productivity by 26% (Guirking and Boucher, 2008), whereas in the case of China this figure could be as high as 31.6% (Dong et al., 2010). The study by Sidhu et al. (2008) reveals the positive correlation between credit, investment, and productivity in India (*Dynamics of Institutional Agricultural Credit and Growth in Punjab: Contribution and Demand-Supply Gap*).

<sup>22</sup> For example, Love and Sánchez, op.cit., find broad differences in investments in physical assets between farmers and agricultural ventures subject to credit rationing, compared to those with access to formal credit. Mora Rivera et al., op cit., demonstrate the clear importance of having additional financial resources, particularly formal credit, as a determinant of investments in productive activities and their size.

<sup>23</sup> Eighty percent of agricultural producers have holdings of less than five hectares and are scattered over more than 80% of Mexico's territory (SAGARPA, 2012, op cit.).

<sup>24</sup> SAGARPA, 2013, op. cit.

<sup>25</sup> 2013-2018 Institutional Program, Financiera Nacional de Desarrollo Agropecuario, Rural, Forestal y Pesquero (FND), 2013.

<sup>26</sup> FND, Annual Report 2009.

<sup>27</sup> INEGI, 2012.

inherent in this type of project. This is reflected in the fact that in 2012 just 13% of rural productive units with financing had access to investment credit.<sup>28</sup>

- 1.10 The lack of access to credit by such units is part of a wider problem of financial inclusion<sup>29</sup> in Mexico, particularly in rural areas. Just 38% of the rural adult population<sup>30</sup> uses any type of formal financial service, compared with 66% in urban areas. An overall financial inclusion survey also suggests that Mexico is among the countries of Latin America and the Caribbean in which penetration of formal accounts is lowest in rural areas.<sup>31</sup> Most people in these areas face higher costs and longer traveling times to access regulated financial services. Moreover, the lack of rural financial infrastructure<sup>32</sup> is correlated with the region's level of poverty<sup>33</sup> and is also related to the fact that there is more self-exclusion in rural areas (while 74% of people in rural areas have never applied for credit, this figure is 52% in urban areas).<sup>34</sup>
- 1.11 Mexico is also among the five countries with the lowest rural credit indicators in the region, with just 5.8% of the population reporting having accessed credit from a financial institution in the past year.<sup>35</sup> For the remainder of the population, alternative, informal lending mechanisms are the only credit option. These tend to be more expensive or reduce the opportunities to purchase basic supplies or invest to produce or meet special needs for funds.<sup>36</sup>
- 1.12 In addition to the low overall penetration, the problem of rural financial inclusion in relation to credit is characterized by its high concentration in higher income strata and in certain geographical regions, such that the government has given priority to addressing excluded segments<sup>37</sup> (see paragraph 1.17). The income disparity is reflected in the fact that whereas 51% of type E6 REUs had access to credit, this percentage dropped to 28% for E5s, 13% for E4s, and was just 7% for E3s.<sup>38</sup> As paragraph 1.3 points out, the low income levels of E3s and E4s make it hard for them to accumulate productive assets. For its part, the regional disparity reveals

<sup>28</sup> National Agricultural Survey, INEGI, 2012. Also, according to SAGARPA, just 9.5% of all credit to the rural sector was devoted to the acquisition of machinery and/or equipment, and 9.4% was spent on buying livestock and/or plantations.

<sup>29</sup> Understood as access to and use of quality formal financial services (credit, savings, insurance, and payments) by households and businesses, in a context of financial stability for the system and users.

<sup>30</sup> Encuesta Nacional de Inclusión Financiera [National financial inclusion survey] (ENIF), September 2012, INEGI and Comisión Nacional Bancaria y de Valores [National Banking and Securities Commission] (CNBV). Rural settlements are defined as having fewer than 15,000 inhabitants.

<sup>31</sup> *Global Financial Inclusion Database* (Findex), World Bank 2012.

<sup>32</sup> The long distances and low population density in rural areas increase financial agents' operating costs. This situation is reflected in the limited availability of bank counters catering to demand from rural areas, with four times as many branches per 10,000 adults in urban areas than in rural ones.

<sup>33</sup> Fideicomisos Instituidos en Relación con la Agricultura (FIRA), Factores relevantes en el desarrollo de proyectos de inversión en el sector agropecuario en México [Relevant factors in the development of investment projects in the agricultural sector in Mexico].

<sup>34</sup> ENIF.

<sup>35</sup> Findex.

<sup>36</sup> Around 60% of the rural population uses informal mechanisms, such as friends, family, and unregulated savings banks. The ENIF also shows that there is a greater propensity to devote formal credit to investments among people in rural areas than those in urban areas.

<sup>37</sup> As regards credit, financial inclusion focuses on business segments, i.e. not subsistence REUs.

<sup>38</sup> FIRA, based on SAGARPA data. 2008 figures.

- other challenges in terms of financial penetration and productivity.<sup>39</sup> In 2010, 28% of rural economic units in the northeast of the country had obtained credit, whereas this figure was barely 2.9% in the southeast.<sup>40</sup> The reason for this differential lies in the high correlation between the level of income and access to credit. In the northeast region, average annual income per rural economic unit is US\$14,300, whereas in the southeast it is US\$1,900. Municipios with higher levels of marginalization have much lower access to financial services in general.<sup>41</sup>
- 1.13 Also, as part of its financial inclusion efforts, the government is focusing on supporting women to promote opportunities for them in social and production development in rural areas (see paragraph 1.17). In general, women have less access to credit than men, with a gender gap of 5.6 points, which is slightly higher than the Latin American and Caribbean average and that for middle-low income countries.<sup>42</sup> The specific obstacles to accessing credit, such as greater restrictions on available collateral, due in part to more limited ownership and control of assets, which in turn limits the size of their business, and self-exclusion, are more marked in rural settings.<sup>43</sup> These constraints affect small and medium-sized enterprises headed by women in particular, for which loan refusal rates are higher.<sup>44</sup> It is estimated that only 18% of women in rural areas have access to formal credit.<sup>45</sup>
- 1.14 Given the obstacles present (paragraph 1.8), the participation of private banks in financing the primary sector is low. In November 2014, their share with own resources was 33.6%, compared with 45% in 2000, while rural development banks—comprising Financiera Nacional de Desarrollo Agropecuario, Rural, Forestal y Pesquero (FND) and Fideicomisos Instituidos en Relación con la Agricultura (FIRA)—covered the remainder. Moreover, commercial banks are concentrated on the higher-income segments. Against this backdrop, there have been efforts to develop nonbank rural financial intermediaries (RFIs) supported by development banks, given that their specialization and local presence gives them greater capacity to serve rural and more marginalized areas. These RFIs are often the main source of formal finance in regions in which there is a limited penetration of credit, and they generally serve the lowest income segment.
- 1.15 **Program rationale.** Aware of the sector's strategic importance, through the 2013-2018 National Development Plan (PND), the Government of Mexico has addressed the need to build a productive primary sector to ensure the country's food security, promote regional development, address poverty, driven by a strategy focused on the sector's profitability, productivity, and competitiveness. As part of

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<sup>39</sup> See Uc-Hernández, C and J. Matus-Gardea, 2006, *Productividad y penetración financiera rural en México: 1978-2002*. [Rural financial penetration and productivity in Mexico: 1978-2002]. The authors analyze the asymmetry in the distribution of rural credit between the States of Mexico and find there to be a lack of regional convergence in financial penetration and agricultural productivity.

<sup>40</sup> FND, 2013, op cit., based on 2010 information from SAGARPA.

<sup>41</sup> For example, access to services through branches per 10,000 adults in municipios with very high levels of marginalization is 0.10, compared with 0.47 for those with high levels of marginalization, and 1.94 for those with low levels of marginalization.

<sup>42</sup> Findex, 2015.

<sup>43</sup> FND.

<sup>44</sup> "Giving credit where it is due. How closing the credit gap for women-owned SMEs can drive global growth," Goldman Sachs, 2014.

<sup>45</sup> ENIF. Obtained from a survey of a sample of women in rural areas who were asked if they had a formal credit product.

this initiative, the PND and the 2013 financial reform aim to strengthen the role of development banks as a lever for growth, promoting their participation in the rural sector, where their intervention is justified to correct market failures and other credit constraints. In parallel, the government has promoted financial inclusion strongly.<sup>46</sup>

- 1.16 Within the development banking system FND plays an important role in channeling resources towards the primary sector. Its mission is to help stimulate the development of agricultural, forestry, fishery, and other economic activities linked to the rural environment, with a view to boosting productivity, and improving the population's living standards. To fulfill this goal, it grants credit both directly to producers and indirectly, through around 400 regulated and unregulated RFIs.<sup>47</sup> FND's share of total lending to the primary sector rose from 3.9% to 18.3% between 2003 and 2014. It is worth noting that FND carries out activities that help resolve several of the market failures present in the rural financial system (see paragraph 1.8) such as: (i) providing technical assistance to REUs (see [Economic Analysis](#)); (ii) operating a basic compulsory insurance scheme covering minimum risks for its borrowers; (iii) compensating for problems of scale, through so-called "strategic projects," which consist of promoting and financing producers' projects associated with at least two businesses in a value chain; (iv) granting credit against personal guarantees rather than asset collateral; and (v) assuming the transaction costs inherent in operating as a financial institution in the rural sector. Additionally, it helps mitigate several of the other factors affecting capitalization and technology adoption (see footnote 19), for example informing potential beneficiaries about rates of return on investments, and in the case of the adoption of technologies and technical models, promoting, through its suppliers, existing innovations and their more widespread adoption by producers.
- 1.17 FND's goal is to raise its lending balance from US\$1.760 billion at end-2013 to US\$3.333 billion in 2018. This is consistent with increasing its lending portfolio from US\$2.363 billion to US\$4 billion over this period. In 2014 it increased lending by 21% in real terms, ending at US\$2.985 billion. This increased the number of end borrowers by 50,000 to a total of nearly 400,000. To achieve its goals, FND will require external financing as it lacks sufficient lendable resources. As part of the aforementioned financial reform, in August 2014 the government announced a new program for FND, focused on supporting segments with wider gaps in terms of access to credit, such as small producers and women.
- 1.18 In keeping with its public policy targets, the Government of Mexico and the Bank approved the Conditional Credit Line for Productive and Inclusive Rural Financing

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<sup>46</sup> See Finance and Public Credit Department, [Financial Reform](#) and [Financial Inclusion](#).

<sup>47</sup> A financial intermediary is a legally established institution that facilitates transactions in the financial market. This includes entities regulated by the CNBV, such as credit unions, savings and loan cooperatives, and sociedades financieras populares [popular finance companies], and unregulated entities, such as multi-purpose financial companies and credit distribution entities. Second tier operations represent 45% of total FND loans. It has implemented a series of support activities aimed at training rural financial intermediaries (RFIs) and their graduation towards supervised entities, together with the application of evaluation tools that determine their eligibility as a borrower. In all, 70% of second-tier lending is through unregulated entities, most of which are small institutions with less than US\$20 million in assets and which depend strongly on FND's funding as they are unable to take deposits. FND's past-due portfolio index in the second tier is 2.7%.

(CCLIP, ME-X1024) for US\$1 billion.<sup>48</sup> Its objectives are to: (i) help raise primary sector productivity by improving rural economic units' access to financing to make productive investments; and (ii) promote financial inclusion to benefit the rural sector through access to productive credit for rural economic units. This program is the second under the CCLIP, offering a line of funding to FND so that it can scale up credit and fulfill the government's objectives. The first program, ME-L1161 (loan 3302/OC-ME) for US\$400 million, focused solely on the first objective; in order to fulfill the second objective, this second program maintains the productivity objective, but unlike the first program, the target population is concentrated in segments that are largely excluded (paragraph 1.25). In all, 91% of the former loan has been disbursed, helping FND increasing its lending in 2014. The proposed additionality of increasing REUs' productive investments by around US\$270 million has been fulfilled. Of the 10,222 loans granted to date,<sup>49</sup> 65% were to capitalize businesses and the remainder for technical models in agriculture, whose beneficiary REUs, by share of lending, were 65% E5s (medium-sized), 16% E3s and E4s (small) and 19% E6s (large).

- 1.19 The Bank has accumulated considerable experience in the Mexican financial sector through a diverse range of operations that it has carried out with various public financial institutions. With respect to rural financing, in addition to the first program under the CCLIP (paragraph 1.18), lessons were learned from project ME-L1055 (loan 2656/OC-ME), Rural Financing in Mexico.<sup>50</sup> The lessons learned in Mexico and in other countries through development banks include the importance of having entities specializing in credit activities in the rural sector, with advantages in the acquisition and processing of private information (paragraph 1.24), which are able to offer various financial and technical assistance services to support profitability and mitigate risks (paragraph 1.16). In parallel, the First Program for the Financing of Rural Sector Production Restructuring and Investment Projects (ME-L1145) (loan 3335/OC-ME), pending disbursement, aims to provide credit to increase investments in agricultural enterprises and businesses linked to the agroindustrial sector in projects promoting more efficient use of energy and water. Although the objectives of the other programs differ from that of the proposed program, they complement each other in that they promote access to productive credit among REUs and help address the vast investment financing needs of the Mexican rural sector, covering multiple sectors, segments, and regions. Focusing on this program's target population covers segments and regions underserved by previous programs.

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<sup>48</sup> Although there are other [government programs](#) supporting efforts to raise the sector's productivity, the efficiency of credit as an instrument of public policy derives from the linkages it introduces between investment decisions and the opportunity cost of resources, stimulating economically profitable investments. Agriculture and Natural Resources Management Sector Framework Document (document GN-2709-2), IDB, 2013.

<sup>49</sup> Corresponding to 80% of the portfolio substantiated. Of the sum devoted to capitalization, 56% was used to purchase livestock, 23% to purchase machinery and equipment, 11% spent on rural buildings, and 10% on the purchase of transportation equipment.

<sup>50</sup> FND is also the borrower and executing agency for ME-L1120 (loan 2838/SX-ME), Financing Low Carbon Strategies in Forest Landscapes, complemented by grant ME-G1002 (GRT/SX-13509-ME), both financed from the Forest Investment Program. It has also received technical assistance in the past, through ME-T1199 (ATN/FI-13334-ME) and RG-T1866 (ATN/OC-12718-RG).

- 1.20 Unmet demand for rural credit among mainly small and medium-sized business units is estimated to be between US\$3.662 billion and US\$18.312 billion (the lower and upper limit, respectively; see [Demand Analysis](#)). Based on information from the Censo Agrícola, Ganadero y Forestal de 2007 [2007 Agriculture and Forestry Census] and estimates based on surveys used for a study,<sup>51</sup> it was found that the ratio of units facing credit constraints for investments and use of technology to those that did not was 2.2:1. The upper and lower limits above are based on the assumption that average demand from those REUs facing credit constraints is 10%-50% of the average demand of those not facing constraints (highly conservative assumptions). Thus, the resources provided via the CCLIP will contribute to meeting between 5% and 27% of these needs, and those of the first program between 1.5% and 8.1%. There is therefore a broad margin for implementation of the intervention financed by the program.
- 1.21 **Alignment with Bank strategies and policies.** The program will contribute to the lending priorities established in the Ninth General Increase in the Resources of the Inter-American Development Bank (GCI-9) (document AB-2764) for poverty reduction and equity enhancement by addressing the agricultural production of small producers and financial inclusion, as well as the geographical classification, as part of the program targets populations with high and very high levels of marginalization. It will also contribute to the following regional targets: (i) institutions for growth and social welfare, through an increase in the percentage of businesses using banks to finance investments; and (ii) protecting the environment, responding to climate change, promoting renewable energy, and enhancing food security, by supporting agricultural GDP growth through financing for productive investments. It will contribute to the following outputs: (i) micro, small, and medium-sized productive enterprises financed; and (ii) farmers, including women, with access to improved agricultural services and investments as defined in the Results Framework. The program is aligned with the Sector Strategy on Institutions for Growth and Social Welfare (document GN-2587-2) through its component offering access to financial services for the majority, and with the Support for SMEs and Financial Access/Supervision Sector Framework Document (document GN-2768-3) and the Agriculture and Natural Resources Management Sector Framework Document (document GN-2709-2). With respect to the latter, one of the lessons learned is the importance of strengthening rural finance, and the lines of action that stand out include the need to stimulate investments to enhance productivity and help overcome liquidity restrictions in the sector via financial instruments.
- 1.22 The program is aligned with the Country Strategy with Mexico 2013-2018 (document GN-2749), which lists the financial sector among its strategic priorities, seeking to increase the level of financing in the real economy, as an important factor in boosting productivity. It therefore envisages interventions to support development banks in lending-promotion programs in its intervention areas, including the agricultural sector. Similarly, it supports the rural development objective. The expected impacts of the program contribute to two of the results in the country strategy matrix (paragraph 1.26).

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<sup>51</sup> Love and Sánchez, 2009, op cit.

## **B. Objectives, components, and cost**

- 1.23 The program's objective is to help raise primary sector productivity by improving REUs' access to financing, in particular in those segments with the greatest constraints in terms of access to formal productive credit, to make investments in productive activities. The aim is to mitigate the problems that exist concerning the financing of rural productive development through increasing the supply of finance for REUs.<sup>52</sup> plans to invest in productive assets and to adopt new technologies and technical farming models that help boost productivity. Also, by focusing on those REUs facing the greatest constraints in terms of access to formal productive credit, either because of their low income, their being located in municipios with high or very high levels of marginalization,<sup>53</sup> or their being managed by women, the program will promote greater financial inclusion.
- 1.24 The program is for up to US\$400 million and will be structured around a single financing component, aimed at expanding FND's supply of available resources so that it, in turn, can finance those projects considered eligible so as to increase productivity through technological improvements. The following will be eligible: (i) rural economic units' investment projects in productive assets to enable them to build their capital. This includes investments in infrastructure, equipment, and other projects helping to boost productivity;<sup>54</sup> and (ii) projects for the acquisition of technologies and technical models by rural economic units, according to the specific characteristics of crops and products, enabling them to raise their productive efficiency.<sup>55</sup> In accordance with FND's portfolio profile and the demand analysis, it is estimated that around 65% of financing will be aimed at investment projects in productive assets and 35% in projects for the acquisition of technologies and technical models.<sup>56</sup> FND specializes in lending activities in the rural sector, with advantages in the acquisition and processing of private information, ensuring appropriate selection and monitoring of beneficiaries and projects in the scope of this program.

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<sup>52</sup> The criteria used by FND to define medium and long term are based on a minimum lifetime of one year, which reflects the minimum time for investment projects to mature.

<sup>53</sup> According to the Consejo Nacional de Población [National Population Council] classification [Conapo.gob.mx](http://Conapo.gob.mx). The marginalization index allows the country's entities and municipios to be differentiated according to the global impact of the gaps the population suffers as a result of the lack of access to education, living in substandard housing, receiving inadequate monetary income, and the problems arising from their living in small localities.

<sup>54</sup> Capital investments will mainly be concentrated in those incorporating technologies that represent an improvement on those used by beneficiary rural economic units prior to the credit. See [project description](#).

<sup>55</sup> FND finances the acquisition of technologies and technical models as "technology packages," integrating standardized, verifiable, and repeatable components, in order to parameterize a particular activity; for example, in 2013 it financed 271 technology packages, mainly in corn (maize), cattle, sorghum, wheat, oranges, and barley. See paragraph 1.6 and [project description](#) for more information. Being aimed at small rural economic units the maximum financing per package is US\$15,300.

<sup>56</sup> As a development bank FND promotes appropriate use and maintenance of the assets acquired. This is also reflected in the high loan repayment rate.



- 1.25 Eligible beneficiaries will be small and medium-sized REUs engaged in productive activities associated with the primary sector.<sup>57</sup> Only REUs classified as businesses will be financed, thus excluding those engaged in subsistence farming or having few links to markets. However, in order to promote financial inclusion, it will focus on small producers, projects managed by women, and REUs in municipios with high and very high levels of marginalization, which are prioritized by FND (paragraph 1.17) through various promotion programs. On accessing credit, these segments will be able to accumulate productive assets and adopt technical models that will allow them to break the cycle of low credit, low investment, low profitability and productivity. In accordance with the composition of FND's portfolio and its client profile for eligible projects, around 18% is expected to be targeted on women, 13% on REUs in municipios with high and very high levels of marginalization, and 36% on small producers. The remainder will mainly be for medium-sized and large REUs, in keeping with the first program under the CCLIP.<sup>58</sup> FND may channel the Bank's resources directly to eligible beneficiaries or through RFIs. The criteria and processes for promoting and identifying projects, beneficiaries, and eligible RFIs will be laid out in the [program Operating Regulations](#) together with the maximum amounts of finance for large REUs.

### **C. Key outcome indicators**

- 1.26 The expected outcomes of the program are to: (i) increase REUs' productive investments, whether in capitalization projects or incorporation of technologies and technical models; and (ii) improve financial inclusion by focusing on the target population, measured in terms of municipios with high and very high levels of marginalization, with FND borrowers and new borrowers of productive credit in the formal financial sector (see Annex II). This will be achieved by financing an estimated 25,000 REUs to allow them to make productive investments. The number of small and medium-sized enterprises financed will also be measured. In accordance with the program's objective, the expected impact is an increase in the productivity of REUs that have received finance from the program's resources.<sup>59</sup>
- 1.27 The [Economic Analysis](#) identifies the difference between income and expenditure generated in typical undertakings implemented with program-financed credit (technology packages, and agricultural capitalization), based on information provided by FND. After discounting the resulting flows at the rate established by the Bank (12% real), the net present value remains positive over a wide range of variations in the relevant parameters, with a value added of US\$179.2 million in the baseline scenario.

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<sup>57</sup> Under its organic law, FND can only cater to rural economic units in settlements of less than 50,000 inhabitants. Following the stratification of rural economic units (see paragraph 1.3), the program classifies those rural economic units in categories E3 and E4 in terms of income as small producers, and rural economic units with sound business, and in category E5, as medium-sized producers. Potential beneficiaries generally do not receive funds from other government programs supporting capitalization and technology adoption.

<sup>58</sup> It is estimated that the disbursements in the first program will be divided as follows: 7% women, 5% highly marginalized localities, and 19% small.

<sup>59</sup> The value per hectare of output, which is constructed so as to contain the effect of changes in total factor productivity (TFP), is used as a proxy for TFP.



## II. FINANCING STRUCTURE AND MAIN RISKS

### A. Financing instruments

- 2.1 The program complies with the eligibility criteria for individual loan operations under CCLIPs (document GN-2246-4).<sup>60</sup> It will be financed with the Bank's Ordinary Capital resources, under the Flexible Financing Facility, through a global credit loan. The resources will be devoted to financing the single component described above for US\$400 million, of which US\$397 million will be for credit to the eligible beneficiaries, either directly from FND or through the RFIs for eligible projects (paragraphs 1.24 and 1.25), under the conditions and with the characteristics established in the program Operating Regulations; and US\$3 million will be used for administration, monitoring, and evaluation expenses.

**Table 1. Cost and financing** (US\$ million)

Component/Subcomponent	IDB	Percentage
Component I. Credit line	\$397	99.25%
Administration, monitoring, and evaluation expenses	\$3	0.75%
<b>Total</b>	<b>\$400</b>	<b>100.00%</b>

- 2.2 Loans to beneficiaries and eligible projects will have the following characteristics: (i) fixed and/or variable rate, depending on the program funding rate and FND's margins<sup>61</sup> and, where applicable, those of the RFIs; (ii) may be denominated in Mex\$ or US\$; (iii) FND assumes the risks of direct beneficiaries<sup>62</sup> and RFIs and, in the case of indirect loans, the latter assume the risk of their loans; and (iv) with the maturities agreed under the financed project.

### B. Environmental and social risks

- 2.3 This is a financial intermediation operation, governed primarily by Directive B.13 of the Environment and Safeguards Compliance Policy (Operational Policy OP-703), and is not subject to classification. FND started implementing its Environmental and Social Risk Management System<sup>63</sup> in June 2014. Also, due to the nature of the projects to be financed, and their main beneficiaries—mostly small and medium-sized REUs—no negative environmental and social impacts are expected. The specific requirements to be included in the program Operating Regulations are described in the [Environmental and Social Management Report \(ESMR\)](#).

<sup>60</sup> The operation is envisaged in the CCLIP's sectors and components; it is included in the country program; and it has the same executing agency as the previous project (ME-L1161; loan 3302/OC-ME), which has continued to perform satisfactorily. The previous project's performance was satisfactory, with over 75% disbursement, and compliance with the contractual conditions.

<sup>61</sup> FND will set the interest rate, in line with its policies, which consider the institution's sustainability and its character as a development agency. FND's average interest rates have been similar to market rates.

<sup>62</sup> The financing provided under the first program will be complemented with resources from the guarantee facilities managed by FND, principally the Fondo Mutual de Garantías Líquidas [Liquid Guarantees Mutual Fund], constituted with resources from various federal government agencies.

<sup>63</sup> FND received technical assistance for its implementation through ME-T1199 (ANT/FI-13334-ME).

### **C. Fiduciary risks**

- 2.4 The [Evaluation Report](#) prepared in July 2014 for operation ME-L1161 (loan 3302/OC-ME), applying the methodology of the Bank's Institutional Capacity Assessment System (ICAS) indicated that FND has a satisfactory level of development, with an overall score of 96.75 and a low risk in relation to program execution and fiduciary aspects. The methodology encompasses the evaluation of the institution as the executing agency and, additionally, the operating procedures that may affect the program. The fiduciary/financial visits to FND since the ICAS confirm its conclusions (see Annex III).

### **D. Other project risks**

- 2.5 Based on the application of the Project Risk Management tool, a medium risk has been identified, relating to shortcomings in banking infrastructure (human and technical resources, and processes) vis-à-vis FND's lending targets, which could have an impact in terms of a deterioration in the quality of FND's portfolio. As regards mitigation measures, FND is implementing a two-stage institutional strengthening plan. In the short term it is reviewing the processes for granting and supervising credit to make them more efficient and reduce risks, including process simplification, vehicles for managing the small producer portfolio, more targeted supervision visits, and a training plan for staff dealing directly with clients. This is planned for in the budget. In parallel, in order to accommodate the new business model, full process reengineering has been designed from a holistic viewpoint that encompasses the institutional strategy, the substantive business processes, technological and systems infrastructure, and management of organizational change. This project is currently in the process of being approved and a multiyear budget is being earmarked to implement it, starting in the second half of 2016 and ending in 2018.
- 2.6 Combining the priority the government places on the rural sector and the role of development banks, the program's sustainability derives from the demonstration effect to be obtained from the positive impacts on rural producers' productivity through financing their projects, and the feasibility of serving segments previously excluded from the system, which should lead to an increase in demand and supply of credit for them (from both FND and private players).

## **III. IMPLEMENTATION AND MANAGEMENT PLAN**

### **A. Summary of implementation arrangements**

- 3.1 **Borrower and executing agency.** The borrower and executing agency will be FND, a federal government agency, with its own legal status and capital. It is a sound public development financial institution that has conserved its initial and sole contribution, and at year-end 2014 had reached a net worth of US\$2.028 billion<sup>64</sup> and a portfolio balance of US\$2.179 billion. Its arrears rate is 5.2% and past-due

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<sup>64</sup> Prior to amendment of its organic law in 2013, FND had a legal obligation to preserve and maintain its capital.

portfolio coverage ratio 137%.<sup>65</sup> FND is clearly solvent as it has 0.93 times capital to cover its loan portfolio ([Audited Financial Statements 2014](#)). The United Mexican States will be the guarantor for the financial obligations under the loan contract, which will be agreed on by the borrower and the Bank.

- 3.2 FND will use its organizational structure, establishing the responsibilities and functions necessary for program implementation. It has the necessary fiduciary and operational capacity for successful program implementation, it has adequate risk management practices in place, is governed by financial system regulations and subject to National Banking and Securities Commission (CNBV) supervision and monitoring. The procurements to be made by FND will be executed in accordance with the provisions of the procurement policies set forth in documents GN-2349-9 and GN-2350-9.
- 3.3 FND will be responsible for execution and supervision of the appropriate use of subloan resources, and for providing the human and technical resources necessary in due time and form. **The following will be special contractual conditions precedent to the first disbursement: (i) formal appointment of a program coordinator, to the Bank's satisfaction; and (ii) approval of the program Operating Regulations, agreed on with the Bank, and their implementation by FND.** The program Operating Regulations must be consistent with the standards and policies of FND and the Bank, and the country's laws and financial practices. This will include the main characteristics of the program described above, together with the eligible beneficiaries, projects and RFIs, and provisions on environmental and social considerations. No procurement of goods and services is included.
- 3.4 Based on FND's experience, and that of the previous operation under the CCLIP, the execution period will be up to 30 months and the disbursement period up to 36 months, as of the effective date of the loan contract. Disbursements will take the form of rediscounting or advances. Considering that the disbursements to FND may be in Mexican pesos, due to currency conversion, the estimated cash flow will be for a period of up to 12 months to facilitate the executing agency's financial management and reduce the number of conversions required.

## **B. Summary of arrangements for monitoring results**

- 3.5 **Reports.** The program will be monitored by means of semiannual reports prepared by the executing agency and submitted to the Bank within 60 days after the end of each six-month calendar period, as well as a final report. These will measure the progress of the outcome indicators and fulfillment of the eligibility criteria at the project and program level. Monitoring meetings will be scheduled as needed. The program's financial statements will be audited annually by an independent firm of auditors acceptable to the Bank, hired and paid for by FND, and will be delivered no later than 120 days after the end of the executing agency's fiscal year, following procedures and terms of reference agreed on by the Bank with the Civil Service Department (SFP).

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<sup>65</sup> Figures as of May and March 2015, respectively. The arrears rate adjusted by the Fondos Mutuales de Garantías Líquidas [Liquid Guarantees Mutual Fund] to support FND operations is 6.9%. For comparison, according to FND data, the commercial banks' arrears rate for the primary sector at March 2015 was 2.5% and that of Sociedades Financieras de Objeto Múltiple [Multipurpose financial institutions] (SOFOMES) was 5.6%.

- 3.6 **Information and evaluation.** The borrower and the executing agency will compile and retain all the relevant information, including all the documentation required to prepare the project completion report, which will be prepared six months after the disbursement period. The impact evaluation is described in the [Monitoring and Evaluation Plan](#), and consists of using a discontinuous regression method and will be used to evaluate the CCLIP's first two programs.

Development Effectiveness Matrix				
Summary				
I. Strategic Alignment				
1. IDB Strategic Development Objectives		Aligned		
Lending Program		-Lending for poverty reduction and equity enhancement		
Regional Development Goals		-Percent of firms using Banks to finance investments -Annual growth rate of agricultural GDP (%)		
Bank Output Contribution (as defined in Results Framework of IDB-9)		-Micro/small/medium productive enterprises financed -Farmers given access to improved agricultural services and investments		
2. Country Strategy Development Objectives		Aligned		
Country Strategy Results Matrix		GN-2749	(1) Increase the level of finance to the real economy, (2) Raise productivity in the agricultural sector	
Country Program Results Matrix		GN-2805	The intervention is included in the 2015 Operational Program.	
Relevance of this project to country development challenges (If not aligned to country strategy or country program)				
II. Development Outcomes - Evaluability		Evaluable	Weight	Maximum Score
		8.9		10
3. Evidence-based Assessment & Solution		8.4	33.33%	10
3.1 Program Diagnosis		3.0		
3.2 Proposed Interventions or Solutions		2.4		
3.3 Results Matrix Quality		3.0		
4. Ex ante Economic Analysis		8.5	33.33%	10
4.1 The program has an ERR/NPV, a Cost-Effectiveness Analysis or a General Economic Analysis		4.0		
4.2 Identified and Quantified Benefits		1.5		
4.3 Identified and Quantified Costs		1.5		
4.4 Reasonable Assumptions		0.0		
4.5 Sensitivity Analysis		1.5		
5. Monitoring and Evaluation		9.7	33.33%	10
5.1 Monitoring Mechanisms		2.5		
5.2 Evaluation Plan		7.2		
III. Risks & Mitigation Monitoring Matrix				
Overall risks rate = magnitude of risks*likelihood		Low		
Identified risks have been rated for magnitude and likelihood		Yes		
Mitigation measures have been identified for major risks		Yes		
Mitigation measures have indicators for tracking their implementation		Yes		
Environmental & social risk classification		B.13		
IV. IDB's Role - Additionality				
The project relies on the use of country systems				
Fiduciary (VPC/FMP Criteria)		Yes	Financial Management: Budget, Treasury, Accounting and Reporting, External control, Internal Audit. Procurement: Information System.	
Non-Fiduciary				
The IDB's involvement promotes additional improvements of the intended beneficiaries and/or public sector entity in the following dimensions:				
Gender Equality		Yes	The intervention will focus, among other groups, in projects managed by women. According to the composition of the portfolio of the FND and profile of customers for eligible projects, it is anticipated that about 18 % will go to women.	
Labor				
Environment				
Additional (to project preparation) technical assistance was provided to the public sector entity prior to approval to increase the likelihood of success of the project				
The ex-post impact evaluation of the project will produce evidence to close knowledge gaps in the sector that were identified in the project document and/or in the evaluation plan		Yes	The quasi-experimental evaluation of the gains in productivity from the investments realized through the project will help demonstrate the importance of these activities for the growth of the primary sector.	

The project is part of a CCLIP that seeks to increase productivity in the primary sector in Mexico via greater access to finance by the Rural Economic Units (UERs, given their acronym in Spanish). This is the second program under the CCLIP and its specific focus is to be inclusive of those segments with greater restrictions to access formal productive credit – thus it will target a population of UERs led by women, or located in those municipalities of low financial deepening or consisting of small producers.

Primary sector productivity, as measured by the primary sector-GDP/ labor, has declined by 7% in real terms between 2000 and 2012, as detailed in the document. Moreover, this sector employs 40% of the economically active population. Low productivity stems from the low capitalization in the sector which is tied to a lack of credit. According to the national agricultural survey of 2012, only 7.7% of the UERs had accessed credit. The obstacles to accessing finance, such as limited availability of collateral, high transaction costs, and greater risks relative to other sectors, amongst others, are specified in the document.

The project seeks to place 400MM in credit through second-floor banking for the primary sector in an inclusive manner. The demand analysis substantiates that this second program under the CCLIP should satisfy up to 8.1% of the breach for those that are financially constrained. The vertical logic is adequate. The cost benefit analysis is mostly adequate and monetizes the main benefits while being inclusive of all associated costs, including those beyond the IDB credit line. The monitoring and evaluation plan is adequate and outlines clear responsibilities. It provides the framework for an impact evaluation that will allow impacts on the productivity of end-beneficiaries to be measured. The document identifies risks and provides mitigating actions.

## RESULTS MATRIX

<b>Program objective:</b>	To help raise primary sector productivity by improving rural economic units' access to financing, in particular in segments with the greatest constraints in terms of access to formal productive credit, to make investments in productive activities.
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Indicators	Unit	Baseline	2015	2016	2017	Target	Description
<b>OUTPUTS</b>							
<b>COMPONENT 1: LINE OF FINANCE FOR PRODUCTIVE INVESTMENTS<sup>1</sup> (TOTAL COST=US\$400 MILLION)</b>							
<b>Output 1:</b> Number of rural economic units (REUs) capitalized with program financing.	Number of REUs	0	4,638	4,638	4,584	13,860	Measures the number of REUs capitalized with program resources. Assumes an average loan of around \$18,759 <sup>2</sup> per REU. <sup>3</sup> Of these, at least 18% will be managed by women, 13% will be located in municipios with high and very high levels of marginalization, and 36% will be small (E3 and E4).  <u>Source:</u> FND reports.
Annual cost:	US\$ million	0	87	87	86	260	
<b>Output 2:</b> Number of REUs with technologies and technical models incorporated with finance from the program.	Number of REUs	0	2,692	2,692	2,634	8,018	Measures the number of REUs that have incorporated technical models, based on the use of technology packages. Assumes an average loan of around \$17,459 per REU. Of these, at least 18% will be administered by women, 13% will be located in municipios with high and very high levels of marginalization, and 36% will be small (E3 and E4).  <u>Source:</u> FND reports.
Annual cost:	US\$ million	0	47	47	46	140	

<sup>1</sup> Productive investments mainly include capitalization projects (or productive assets) and investments to adopt technologies and technical models, and permanent working capital. The cost/benefit study was conducted on the assumption that 65% of the investment was in capitalization and 35% in technology adoption.

<sup>2</sup> Assuming an exchange rate of Mex\$15.4/US\$.

<sup>3</sup> Assuming one loan per REU.

Indicators	Unit	Baseline	2015	2016	2017	Target	Description
<b>EXPECTED OUTCOMES</b>							
<b>FINAL OUTCOME 1: INCREASED PRODUCTIVE INVESTMENTS BY REUS</b>							
<b>Indicator 1.</b> Leveraging of productive investments by REUs managed by women, made with the program.	US\$ million	0	6	6	6.25	13.5	<p>This indicator corresponds to the leverage of the total investments that can be made using the program's financing. Based on an assumed typical investment by an REU (see <a href="#">Economic Analysis</a>), it is estimated that the total financing by FND represents around 80% of the total investment.</p> <p>This indicator is intended to measure the program's total investment flow, including the share of the project promoters' own capital.</p> <p><u>Source of verification:</u> FND information systems.</p>
<b>Indicator 2.</b> Leveraging of productive investments by REUs in municipios with high and very high levels of marginalization, made with the program.	US\$ million	0	4.25	4.25	4.25	12.75	<p>This indicator corresponds to the leverage of the total investments that can be made using the program's financing. Based on an assumed typical investment by an REU (see <a href="#">Economic Analysis</a>), it is estimated that the total financing by FND represents around 80% of the total investment.</p> <p>This indicator is intended to measure the program's total investment flow, including the share of the project promoters' own capital.</p> <p><u>Source of verification:</u> FND information systems.</p>
<b>Indicator 3.</b> Leveraging of productive investments by small REUs, made with the program.	US\$ million	0	12	12	12	36	<p>This indicator corresponds to the leverage of the total investments that can be made using the program's financing. Based on an assumed typical investment by an REU (see <a href="#">Economic Analysis</a>), it is estimated that the total financing by FND represents around 80% of the total investment.</p> <p>This indicator is intended to measure the program's total investment flow, including the share of the project promoters' own capital.</p> <p><u>Source of verification:</u> FND information systems.</p>
<b>Indicator 4.</b> Leveraging of productive investments by medium-sized and large REUs, made with the program.	US\$ million	0	11	11	11	33	<p>This indicator corresponds to the leverage of the total investments that can be made using the program's financing. Based on an assumed typical investment by an REU (see <a href="#">Economic Analysis</a>), it is estimated that the total financing by FND represents around 80% of the total investment.</p> <p>This indicator is intended to measure the program's total investment flow, including the share of the project promoters' own capital.</p> <p><u>Source of verification:</u> FND information systems.</p>

Indicators	Unit	Baseline	2015	2016	2017	Target	Description
<b>EXPECTED OUTCOMES</b>							
<b>FINAL OUTCOME 2: FINANCIAL INCLUSION INDICATORS IMPROVED</b>							
<b>Indicator 1.</b> Municipios with high and very high levels of marginalization with FND borrowers.	Number of municipios	445	480	500	515	515	This indicator corresponds to a geographical coverage indicator, reflecting the total FND portfolio. Municipios with high and very high levels of marginalization are defined according to the latest marginalization classification available (CONAPO, 2010).  <u>Source of verification:</u> FND information systems.
<b>Indicator 2.</b> New productive credit borrowers in the formal financial sector.	Number of REUs	0	5,000	5,000	5,000	15,000	This indicator corresponds to new FND borrowers who have not had credit from another formal institution in the previous two years. This will be evaluated using a methodology in which the credit bureau and FND systems are consulted. Reflects the whole FND portfolio, not just that of the program.  <u>Source of verification:</u> FND information systems and credit bureau.

Indicators	Unit	Baseline	2015	2016	2017	Target	Description
<b>EXPECTED IMPACTS</b>							
<b>IMPACT 1: PRODUCTIVITY<sup>4</sup> RAISED IN REUs THAT HAVE BEEN FINANCED BY THE PROGRAM</b>							
<b>Indicator 1:</b> Sales per hectare by REUs that have received finance increased relative to nonbeneficiary comparator REUs for 2017.	%	n/a*			20%	20%	The indicator is equal to: $\{[(X_t - X_b)/X_b] - [(Y_t - Y_b)/Y_b]\} \times 100$  Where $X_t$ , $X_b$ are the sales per hectare of the REUs supported by the capitalization programs in year $t$ and in the base year, respectively, and $Y_t$ , $Y_b$ represent the same items for units in the control group. The control group is determined as explained in the evaluation proposal.  *The baseline will be reconstructed ex post. This is possible because the characteristics of the beneficiaries allow it.  <u>Source:</u> FND, based on the ex post impact evaluation, as described in the monitoring and evaluation plan.

<sup>4</sup> The value per hectare of output, which is constructed in such a way as to incorporate the effect of changes in TFP, is used as a proxy for TFP.



Indicators	Unit	Baseline	2015	2016	2017	Target	Description
<b>SECTOR OUTPUT INDICATOR</b>							
Micro, small, and medium-sized enterprises financed	Number of REUs	0	5,865	5,865	5,862	17,592	Measures the number of small (E3 and E4) and medium-sized (E5) REUs that have received productive credit from program resources.  The sum of small and medium-sized enterprises financed and the cost assigned need not be equal to the sum of the program as a whole. <sup>5</sup> However, outputs 1 to 2 do sum to the program total.  <u>Source:</u> FND reports.
Annual cost	US\$ million	0	107	107	106	320	

<sup>5</sup> The program includes additional financing for large REUs (E6) that have received productive credit with program resources, the maximum amount of credit being that defined in the program's operating regulations.

## FIDUCIARY AGREEMENTS AND REQUIREMENTS

<b>Country:</b>	Mexico
<b>Project number:</b>	ME-L1170
<b>Name:</b>	Conditional Credit Line for Productive and Inclusive Rural Financing (ME-X1024). Second Program for Productive and Inclusive Rural Financing (ME-L1170)
<b>Executing agency:</b>	Financiera Nacional de Desarrollo Agropecuario, Rural, Forestal y Pesquero (FND)
<b>Fiduciary team:</b>	Gloria Coronel, Fiduciary Financial Management Lead Specialist; Víctor Hugo Escala, Fiduciary Procurement Lead Specialist (FMP/CME)

### I. EXECUTIVE SUMMARY

- 1.1 FND is a decentralized federal government agency, under the aegis of the Finance and Public Credit Department (SHCP), and was constituted with its own legal status and capital. Its objectives include: (i) increasing the balance of lending, improving conditions for first tier, second tier and intermediary sectors served; (ii) boosting investment in fixed assets for the agrifoods and rural sector; (iii) expanding the supply of financing, with particular emphasis on small producers; and (iv) developing and strengthening rural financial intermediaries to achieve national coverage.
- 1.2 This is the fourth loan to FND (known as Financiera Rural until 2013) and the second operation under CCLIP ME-X1024, approved in 2014 to: (i) help raise primary sector productivity by improving rural economic units' (REUs) access to finance to make productive investments; and (ii) improve financial inclusion to benefit the rural sector through access to productive credit for REUs. Two loan operations and an investment grant are currently under way: (a) the first loan under the CCLIP (loan 3302/OC-ME; ME-L1161), approved in 2014 for US\$400 million and 91% disbursed on 31 March 2015; (b) loan 2838/SX-ME (ME-L1120) approved in November 2012, for US\$10 million for Financing Low Carbon Strategies in Forest Landscapes, eligible in October 2013; and (c) grant GRT/SX-13509-ME (ME-G1002) for US\$5 million and approved jointly with the loan in 2012. The first loan to FND was loan 2656/OC-ME (ME-L1055) for US\$20 million, approved in December 2011, and which completed execution in September 2014.
- 1.3 **The executing agency's fiduciary context.** In addition to its accounting systems, FND uses the TERFIN system to record its credit operations. This is reconciled daily with the accounting books, automatically generating transactions and daily checks on balances. During the visits to FND during execution of the loans mentioned above, the Bank confirmed that FND has a good control

environment, systems, processes, and records for executing operations and identifying the expenses financed with IDB resources.

- 1.4 As in the previous loan operations, in view of its nature no procurement by FND or the financial intermediaries in this new operation is scheduled.

## II. FIDUCIARY RISK EVALUATION AND MITIGATION ACTIONS

- 2.1 The Bank performed the [first ICAS in 2009](#) and updated it for project ME-L1161, the findings of which are summarized in the table below. The financial/fiduciary visits to FND's head office and regional office in the state of Puebla confirmed the ICAS's conclusions.

EVALUATION OF INTERNAL CONTROL SUMMARY OF RESULTS						
Executing agency:		Financiera Nacional (project ME-L1611)				
Period evaluated:		2014				
Capacity	System	Quantification			Development (ND, ID, MD, SD)	Level of Risk (HR, SR, MR, LR)
		Rating %	IR%	Weighted %		
CPO	SPA	100.00	50	50.00	SD	LR
	SOA	91.30	50	45.65	SD	LR
TOTAL				95.65	SD	LR
CE	SAP	100.00	30	30.00	SD	LR
	SABS	100.00	30	30.00	SD	LR
	SAF	97.37	40	38.95	SD	LR
TOTAL				98.95	SD	LR
CC	SCI	96.55	80	77.24	SD	LR
	SCE	85.71	20	17.14	SD	LR
TOTAL				94.38	SD	LR
OVERALL TOTAL				96.75	SD	LR

## III. CONSIDERATIONS FOR THE SPECIAL PROVISIONS OF CONTRACTS

- 3.1 In order to streamline the project team's contract negotiations, and in particular those of the Legal Department, the following agreements and requirements should be envisioned in the special provisions of the loan contract:
- Special contractual conditions precedent to the first disbursement:**
    - formal appointment of a program coordinator, to the Bank's satisfaction;
    - approval of the program Operating Regulations, agreed on with the Bank, and their implementation by FND.
  - The exchange rate agreed with the executing agency for accountability** will be the exchange rate on the payment date registered on FND's financial and **accounting** systems in accordance with the Mexican government's standards, this being that in force in the borrower's country on the effective date of the payment.

- c. **Audited financial statements:** FND will present audited financial statements annually during the execution period within 120 days after the end of the accounting period, and a final audited financial statement 120 days after the last disbursement. These statements will be audited by firms eligible for IDB operations and **with** terms of reference agreed on with the Civil Service Department (SFP) and the Bank.
- d. **Semiannual financial reports:** FND will present semiannual reports on the financial progress of the program in a form agreed on with the SFP and the Bank. These **reports** will be presented before 30 August with a closing date of 30 June of the same financial year, and 28 February with a closing date of 31 December of the previous financial year.
- e. **Procurement:** As this is a credit operation that will be demand-driven, no significant or relevant procurements are planned, except for a few primarily for consulting services to be performed by the executing agency for program administration, monitoring, and evaluation. When the end borrowers are private entities **they** will use current private sector or commercial practices acceptable to the Bank, in accordance with Appendix IV of the Bank's procurement policies. When the end borrowers are public entities other than those envisaged in paragraph 3.12 of the Policies for the Procurement of Goods and Works Financed by the Inter-American Development Bank (document GN-2349-9) or paragraph 3.14 of the Policies for the Selection and Contracting of Consultants Financed by the Inter-American Development Bank (document GN-2350-9), the respective sections of the policies applicable to public sector entities will be applied.
- f. For the executing agency's procurements, the corresponding procurement plan must be submitted to the Bank for review and approval, in accordance with the Bank's aforementioned procurement policies. This plan will be updated at least once every 12 months during program implementation, and each update will be subject to review and approval by the Bank. Procurements must be carried out according to this procurement plan, which will indicate the contracts that are to be revised ex ante and ex post.

#### IV. AGREEMENTS AND REQUIREMENTS FOR PROCUREMENT EXECUTION

- 4.1 When the executing agency undertakes any procurement with financing from the loan, the following provisions apply:
  - a. **Procurement execution: Procurement of works, goods, and nonconsulting services:** Contracts for works, goods and nonconsulting services<sup>1</sup> generated under the project and subject to international competitive bidding (ICB) or national competitive bidding (NCB) will be executed using bidding documents harmonized between the SFP and the Bank. These are **available** online at: (<http://www.funcionpublica.gob.mx>). The review of the technical specifications for procurement during the preparation of selection processes will be the responsibility of the project's sector specialist.

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<sup>1</sup> Policies for the Procurement of Goods and Works Financed by the Inter-American Development Bank (document [GN-2349-9](#)) paragraph 1.1: Nonconsulting services will be treated as goods.

- b. **Consultant selection and contracting:** Contracts for consulting services to be provided by consulting firms financed with project proceeds will be executed using the standard request for proposals agreed on by the Bank and the SFP. These may be consulted online at: <http://www.funcionpublica.gob.mx>. The review of the terms of reference for contracting consulting services is the responsibility of the project's sector specialist.
- c. **Selection of individual consultants:** Contracts for consulting services with individual consultants will be executed using the model contract for individual consultants agreed on with the Bank, which may be consulted at: (<http://www.funcionpublica.gob.mx>).
- d. **Other:** Around US\$3 million from the financing may be allocated to procurements by FND, primarily for consulting services.
- e. When the end borrowers are private entities they will use market standard procurement procedures acceptable to the Bank, in accordance with Annex IV of the Bank's Procurement Policies. The requirements of paragraph 3.12 "Procurement in Loans to Financial Intermediaries" of document GN-2349-9 or paragraph 3.14 "Commercial Practices" of document GN-2350-9 must also be met.

#### 1. Table of threshold amounts (US\$ thousands)

- 4.2 For the executing agency's procurements, the following selection and contracting methods will be used, based on the specified threshold amounts below:

Works			Goods <sup>2</sup>			Consulting services	
International competitive bidding	National competitive bidding	Shopping	International competitive bidding	National competitive bidding	Shopping	International publicity - consultants	Shortlist 100% national
≥15,000,000	<15,000,000 and ≥500,000	<500,000	≥3,000,000	<3,000,000 and ≥100,000	<100,000	≥ 200,000	<500,000

#### 2. Main procurements

- 4.3 Around US\$3 million from the financing will be allocated to procurements by FND, primarily for consulting services. The remainder of the loan proceeds will be earmarked for FND to channel resources for the financing of economic activities in the rural environment.

#### 3. Supervision of procurement processes

- 4.4 In view of the project's low fiduciary risk, one annual inspection visit will be made. Similarly, when establishing the supervision arrangements the executing agency's experience from previous operations was taken into account.
- 4.5 For the review of external auditing and overall program monitoring, ex post procurement reviews will be conducted by an external audit firm, which will

<sup>2</sup> Includes nonconsulting services.

submit a special procurement report, if any procurement takes place, pursuant to the terms of reference agreed upon by the IDB and the SFP.

Threshold for ex post review		
Works	Goods	Consulting services
15,000,000	3,000,000	500,000

Note: The thresholds set for ex post review are based on the executing agency's fiduciary capacity for execution and may be modified by the Bank as that capacity varies.

#### 4. Special provisions

- 4.6 **Measures to reduce the likelihood of corruption:** The executing agency will diligently observe the provisions on fraud and corruption established in the Bank's procurement policies.

#### 5. Records and archives

- 4.7 The basic original documentation for the substantiation of expenses with the Bank will be held by FND. FND's international affairs unit will be responsible for consolidating the financial and program procurement information and will handle liaison with the Bank.

### V. FINANCIAL MANAGEMENT

#### 1. Programming and budget

- 5.1 FND has well developed fiduciary systems and is obligated to follow national standards, established in the annual budget act issued by the SHCP. The planning and programming functions and responsibilities are documented in the Financial Planning and Programming Manual and in its planning and policies, which are authorized by FND's governing board and the Congress, pursuant to the organic law. Clear procedures for programming and budgeting exist, certified under ISO 9001-2000.

#### 2. Accounting and information systems

- 5.2 FND has an accounting system whose processes mostly have annual ISO 9000 certification. The ICAS conducted in 2014 for operation ME-L1161 confirmed three fundamental operational aspects: (i) FND is carrying out automatic account/budget reconciliation, i.e. there is an adequate linkage between the two applications; (ii) the portfolio application (TERFIN) registers portfolio dispersion and collections automatically and updates credit balances at the end of the day, generating an automatic record in the accounts; and (iii) there are no conflicts of interest between the various functions performed by FND. Also, the operations and treasury management areas, which are mainly operate automated, have authorized procedure manuals. The financial area's staff have the necessary experience and qualifications for their roles and have experience with IDB operations.
- 5.3 As an entity, FND is audited annually by (i) the Federal Audit Office (ASF); (ii) the CNBV, and (iii) an external audit firm. Under the IDB's policy, FND will deliver

audited financial statements annually, within 120 days, during the disbursement period, on the use of the proceeds from the Bank's loan.

### **3. Disbursements and cash flow (in coordination with the use or not of the National Treasury System)**

- 5.4 Program resources will be deposited in a special or program-specific bank account. Proceeds for creditor beneficiaries may be through direct loans from FND or credit to intermediaries who grant loans to end beneficiaries. Once FND has identified the operations that will be financed by the IDB, it identifies them in TERFIN for each loan and disbursement tranche when it results from currency conversion.
- 5.5 Disbursements of the IDB finance may be made in the form of (1) fund advances or (2) reimbursement of expenditures. Expenditure disbursements effectively paid by FND will be reviewed ex post. As in the case of the previous loans, IDB disbursements to FND are expected to be in local currency, by currency conversion.

### **4. Internal oversight and internal audit**

- 5.6 The Ley Federal de Responsabilidades Administrativas de los Servidores Públicos [Federal Law on the Administrative Responsibilities of Civil Servants] regulates the conduct of personnel working in federal government agencies and departments. The management of the internal oversight body (OIC) comprises civil servants appointed by the SFP, and staff of the OIC are FND officials or contract staff for sporadic activities.
- 5.7 As of 10 January 2014 the OIC ceased reviewing FND's substantive functions and therefore no longer reviews credit processes. FND is establishing the internal audit function to support the administration with the continuous improvement of the control environment.

### **5. External control and reports**

- 5.8 As noted above, FND is audited annually by the ASF, the CNVB, and an external audit firm appointed by the SFP. Under the law establishing the responsibilities of the SFP, the SFP's Dirección General de Auditorías Externas [External Audit Office] (DGAE) is responsible for coordinating the appointment of external auditors to conduct audits on projects funded by international financing agencies.
- 5.9 FND will deliver an audited financial statement to the Bank annually within 120 days after the end of the accounting period, issued by a firm acceptable to the IDB and with terms of reference agreed on by the IDB and SFP. FND's institutional audited financial statements are posted on its website; it is not, therefore, considered necessary to require their submission.

## 6. Financial supervision plan

Supervision activity	Supervision plan			
	Nature and coverage	Frequency	Party responsible	
			Bank	Third party
OPERATIONAL	Review of: (a) technical progress of eligible credit activities and (b) backing of disbursement requests	Annual	Technical and Fiduciary/ Financial team	(b) External auditor
FINANCIAL	Visit to review/validate control processes for the proper recording and financial supervision of eligible activities.	Annual	Fiduciary/ Financial team	External auditor
	Ex post review of disbursements and financial audit	Annual		External auditor
	Review of disbursement requests and attached financial reports	Periodic	Fiduciary/ Financial team	
Reports and CPs	Delivery of audited financial statements	Annual	Fiduciary/ Financial and technical team	Executing agency/ external auditor
	Conditions precedent to the first disbursement	Once	Technical and Fiduciary/ Financial Team	

## 7. Execution mechanism

- 5.10 The technical and financial execution mechanism will be centralized in FND; the commitments and payments chargeable to the operation will be made by the respective technical and financial areas responsible. Coordination with the IDB will be handled by the Dirección de Asuntos Internacionales [International Affairs Division], which also acts as the financial agent for operations with the Mexican federal government.



DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE-\_\_\_/15

Mexico. Individual Loan \_\_\_\_/OC-ME to Financiera Nacional de  
Desarrollo Agropecuario, Rural, Forestal y Pesquero (FND)  
Program for Productive and Inclusive Rural Financing  
Second Program under the Conditional Credit Line  
for Productive and Inclusive Rural Financing  
(ME-X1024) approved by  
Resolution DE-138/14

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with Financiera Nacional de Desarrollo Agropecuario, Rural, Forestal y Pesquero (FND), as Borrower, and with the United Mexican States, as Guarantor, for the purpose of granting the Borrower a financing aimed at cooperating in the execution of the Program for Productive and Inclusive Rural Financing, second individual operation under the Conditional Credit Line for Productive and Inclusive Rural Financing (ME-X1024) approved by Resolution DE-138/14. Such financing will be in the amount of up to US\$400,000,000, from the resources of the Bank's Ordinary Capital, and will be subject to the Financial Terms and Conditions and the Special Contractual Conditions of the Project Summary of the Loan Proposal.

(Adopted on \_\_\_\_\_ 2015)