THE FLEXIBLE LENDING MECHANISM

FLM

IFAD

Responses to Some Commonly Asked Questions

The flexible lending mechanism (FLM) has generated a great deal of interest within IFAD and has also prompted numerous requests for further information. This brochure seeks to provide responses to the most commonly asked questions about the FLM. It is hoped that IFAD staff, consultants and partners can use it to further their understanding of the FLM and its implications for project design and implementation.

➲ What is the overall rationale for establishing the FLM and what are some of the expected benefits?

The FLM was introduced in 1998 to provide a greater degree of flexibility in project design and implementation. This new operational approach permits a better match between the project time frame and the pursuit of long-term development objectives when a longer implementation period is considered necessary to meet such objectives. It also allows for an increased emphasis on implementation, a greater use of in-country knowledge and more budgetary flexibility – elements that IFAD has long considered essential for effective poverty reduction. The main characteristics of the FLM are:

- **Institutional development.** Experience shows that the typical project duration of five to six years is often not enough to support the development of grass-roots institutions that will be sustainable after external financing ends. Hence the need for project extensions and second-phase projects, which can be time-consuming, costly and even disruptive. Long-term commitment to institutional development can avoid these problems.
- **Participatory approach.** The implementation of an approach under which stakeholders define priorities and corresponding activities as they gain experience during the project requires a degree of flexibility in programming and budgeting not normally foreseen in traditionally structured projects.
- **Design flexibility.** Together with a participatory approach, there is a need for continuous flexibility in the design of projects to be able to accommodate the evolution in stakeholder demand for support and its supply. A mid-term review offers such an opportunity only once in the lifetime of a typical project.
- **Budget flexibility**. While project budgets can be managed in a flexible manner, this requires frequent loan amendments and other formal procedures that often result in delays and frustration. In the FLM, flexibility to accommodate changes in expressed demand can be built in without jeopardizing accountability.

➲ What are the main differences between a loan structured as an FLM and a standard IFAD loan?

There are three major differences between FLMs and standard loans:

- » First, the FLM includes a **longer loan period** of 10-12 years as opposed to the typical five-to-six-year loan. Due to the longer duration, it is generally expected that the lending envelope will be larger than that of a typical loan, but this is not a requirement.
- » Second, the FLM is implemented in three or four cycles of three to four years each. This is to permit a **phased design process** over the extended period of the loan, which in turn allows for greater flexibility in resource allocation and planning as knowledge is gained about beneficiary priorities and what works and does not work. Design documents should clearly identify long-term development objectives, and present a detailed design for the initial three-to-four-year cycle of project activities (similar to that of any other type of loan). Design of the initial cycle is based on the best estimate of stakeholder priorities and demand at design stage, and on the institutional capacities to meet such demand. Subsequent cycles are not planned in detail but based on the most likely scenario of future demand and institutional capacities. All implementation criteria and modalities are defined in detail, and are often set out in an implementation manual.
- » Third, the decision to proceed to subsequent FLM cycles is based on the achievement of a set of **clearly defined preconditions, or 'triggers'**. These preconditions need to be satisfied before a subsequent cycle is undertaken. Among other things, this implies an enhanced role for monitoring and evaluation (M&E) to ensure that projects remain on track in pursuit of their immediate and long-term objectives.

A more detailed comparison of initial design characteristics of standard projects and FLMs can be found on the table below.

Comparison of Selected Characteristics of Standard

Element	**Standard Project**
Overall strategic goal and development objectives	Full specification
Activities	Physical targets highly specified, often with limited flexibility
Budget	Detailed cost estimates for duration of the project
Management and governance structures	Full specification
Project-level M&E	Lack of clear incentives for project managers to make use of M&E inputs in decision-making Emphasis often primarily on physical target achievement
Economic and financial analysis	Overall economic rate of return calculation based on detailed assumptions of beneficiary behaviour and investment choices
Technical analysis	Detailed for all project activities
Institutional analysis	Detailed for all probable development partners
Loan agreement	Schedule 2 specifies financing amounts for each category of expenditure for the duration of the project
Approval	*A priori* Executive Board approval for all aspects of the project

FLM

➲ Under what circumstances does it make sense to consider designing a project as an FLM?

As mentioned earlier, FLMs are worth considering when a time frame longer than five or six years is considered necessary to achieve a project's development objectives. While no hard-and-fast rules exist about when to propose an FLM, projects with a strong institution-building thrust and highly innovative features seem to be appropriate candidates. Some examples could include support to rural decentralization programmes, microfinance institutional development and the strengthening of grass-roots organizations. It is important that institutional development proceeds at its most appropriate pace, with enough time allotted for field-level experimentation and adaptation.

The FLM may also be usefully applied in small countries where it is especially expensive to design projects, since the cost of designing a small loan is roughly the same as designing a larger one. While the average IFAD loan size for a six-year project is about USD 12 million, it may not be prudent to design projects larger than USD 3-4 million for small countries, due to their limited absorptive capacity. Therefore, an FLM over 10-12 years may be more cost-effective in terms of design costs. This was one rationale for FLM programmes in Cape Verde and Sao Tome and Principe.

Obviously, as implementation experience is gained and evaluations are carried out, a greater appreciation of what types of projects and country circumstances are most appropriate for the FLM approach will develop.

Projects and FLMs

Flexible Lending Mechanism
Same
Same for Cycle 1; flexible (within a range of possibilities) thereafter.
Detailed cost estimates for Cycle 1 only; total costs based on best estimate for overall demand and costs.
Full specification for management structure; evolutionary for grass-roots governance structure development.
Clear incentive for project managers to make effective use of M&E inputs, as this is a precondition for proceeding to subsequent cycles. Greater emphasis on monitoring development **processes** and client satisfaction; prominent use of process indicators for determining whether project is on track for achieving impact.
Financial analysis for individual probable programme activities; no overall economic rate of return calculated.
Detailed for major probable activities.
Same, but with greater emphasis on flexible support to targeted institutions as needs evolve.
Two options are possible for budget presentation: • **either** (as for a typical loan) the loan agreement specifies financing amounts for each category of expenditure for the duration of the project, implying that later amendments are not required unless reallocation between loan categories is necessary; • **or** Schedule 2 allocates amounts to typical loan categories for Cycle 1; and a new category entitled 'Cycles 2 and 3' is presented with a single lump-sum amount. It is also stipulated in Schedule 2 that no funds will be disbursed from this category until triggers are satisfied, based on an IFAD-approved assessment. Amendment or addendum will later be required to effectuate these transfers. In Schedule 4, triggers are presented for passage from each cycle to the next; and the year in which each transition is foreseen to occur is specified.
Approval of overall loan envelope by Executive Board; approval of disbursement for subsequent cycles by IFAD management, depending on results of in-depth review at end of each cycle.

➲ What is the approval process for an FLM and its various cycles?

The Executive Board approves the FLM commitment for its overall duration of 10-12 years. Approval to proceed to subsequent cycles is under the authority of IFAD management. Approval is conditioned, however, by the positive conclusion of an in-depth field review by the end of the previous cycle, jointly undertaken by the government concerned, the cooperating institution and IFAD, with active stakeholder participation. The field review and subsequent IFAD reviews verify whether the triggers have been achieved and re-examine the implementation criteria and technical approach for the subsequent cycle. These reviews set (or refine) the triggers to be met at the end of the next cycle and establish the project budget for the next cycle.

The Board receives a copy of individual case evaluation reports before the end of each cycle, but does not play a decision-making role between cycles. It is also informed as soon as IFAD management approves the field review recommendation to continue or not continue to another cycle.

➲ What are 'triggers' and how should they be developed and presented?

Triggers can be defined as conditions to be satisfied before one can proceed from one FLM cycle to the next one. The Executive Board policy paper states:

During the initial design stage, a set of preconditions (or 'triggers') for proceeding to second and subsequent cycles will be developed. These will include the attainment of critical physical targets, a set of indicators for determining whether or not the project is likely to attain its longer-term development objectives, and effective functioning of the M&E system. No release of second and/or subsequent tranches of project funds will be authorized until the preconditions have been met.

Regarding the content of triggers, it is important to demonstrate that eventual assessment of performance on attaining triggers will not be a rubber stamp exercise. If a project is not achieving its triggers within a reasonable time frame, passage to a subsequent cycle will be delayed, or the project will even be closed early. Considerable thought should therefore be put into the development and specific phrasing of triggers at design. The challenge is to strike a careful balance so that indicators are binding, but not excessively so. Indicators should also be stated objectively (i.e with quantitative targets), while allowing some room for discretion and judgement. Admittedly, this is not always easy to do, particularly for critically important indicators related to feedback from beneficiaries on their appreciation of project services and delivery mechanisms.

It is important to recognize that the Executive Board policy paper explicitly states that **effective functioning of the M&E system must always be one of the triggers**. This is because, in the absence of effective M&E, it is not possible to monitor attainment of the other triggers.

➲ How is the loan agreement different for an FLM than for a standard loan?

There are essentially two differences: the way cost categories are reflected in Schedule 2 of the loan agreement (Allocation and Withdrawal of Loan Proceeds) and the explicit presentation of triggers in Schedule 4 (Implementation, Operation, Other Matters):

» **Schedule 2**. In standard projects, the loan agreement specifies financing amounts for each category of expenditure (such as civil works, vehicles and equipment) for the duration of the project. This can be the same in loan agreements for an FLM. In such cases, later loan amendments are not needed unless reallocation between loan categories is deemed necessary. Loan agreements for an FLM can also, however, present a number of categories with amounts allocated for only the initial three-to-four-year cycle. Another category entitled 'Cycles 2 and 3' is presented in each loan agreement with a single lump sum. It is then stipulated in Schedule 2 that no funds will be disbursed from this category until the triggers for each of these cycles has been attained as determined by an IFAD-approved assessment of their status. Passage to subsequent cycles will therefore require a loan amendment or addendum to shift funds from this category to the other categories.

» **Schedule 4**. In loan agreements for an FLM, the triggers are listed for passage from each cycle to the next, together with the year in which each transition is foreseen to occur.

➲ How should project cost tables be presented?

In keeping with the logic of phasing and loan agreement presentation, at design stage detailed cost tables are presented for each year of the first cycle of project activities – just as they appear for a traditionally structured loan. A global amount for each cost category is also presented in order to quantify the total IFAD loan envelope and to have an approximate idea of the total project cost. However, detailed cost calculations for subsequent cycles do not appear. These will only be calculated prior to initiating each future cycle.

➲ How many FLMs has IFAD approved to date?

Since the introduction of the FLM in 1998, IFAD has approved 17 loans (see table below) for a total committed value of USD 269.7 million. IFAD is expected to evaluate its initial experience with the FLM in 2003.

Projects/Programmes Using an FLM, 1998 Through 2001

(by order of Executive Board approval)

Date of Approval	Project/Programme
December 1998	Mali: Sahelian Areas Development Fund Programme
September 1999	Bhutan: Second Eastern Zone Agricultural Programme
September 1999	Cape Verde: Rural Poverty Alleviation Programme
December 1999	Guatemala: Rural Development Programme for Las Verapaces
December 1999	Guinea: Programme for Participatory Rural Development in Haute-Guinée
December 1999	Nicaragua: Technical Assistance Fund Programme for the Departments of León, Chinandega and Managua
May 2000	Niger: Rural Financial Services Development Programme
May 2000	Rwanda: Umutara Community Resource and Infrastructure Development Project
May 2000	India: National Microfinance Support Programme
May 2000	Indonesia: Post-Crisis Programme for Participatory Integrated Development in Rainfed Areas
September 2000	Sudan: South Kordofan Rural Development Programme
December 2000	United Republic of Tanzania: Rural Financial Services Programme
April 2001	Sao Tome and Principe: Participatory Smallholder Agriculture and Artisanal Fisheries Development Programme
September 2001	Malawi: Rural Livelihoods Support Programme
September 2001	Bangladesh: Sunamganj Community-Based Resource Management Project
September 2001	Lebanon: Cooperative Rural Finance Programme
December 2001	Nepal: Western Uplands Poverty Alleviation Project

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