SIMULTANEOUS DISCLOSURE

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

MEXICO

RURAL FINANCING IN MEXICO

(ME-L1055)

LOAN PROPOSAL

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ELECTRONIC LINKS

REQUIRED

1. Monitoring and evaluation plan
http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=36327825

2. Environmental and Social Management Report (ESMR)
http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=36325866

OPTIONAL

1. Main sectors generating environmental benefits
http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=36313747

2. The agriculture, forestry, and other-land-uses sector (AFOLU) in Mexico
http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=36401513

3. Financial position of Financiera Rural at 30 June 2011
http://www.financierarural.gob.mx/inf_fin_programa/Paginas/EstadosFinancierosal30dejuniode2011.aspx

4. Bank support for the climate change mitigation and adaptation agenda
http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=36251411

5. AFOLU sector eligibility criteria
http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=36401620

6. Draft Program Operating Regulations
http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=36369565

7. Cost-benefit analysis
http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=36370787

8. Institutional capacity assessment (ICAS) report
http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=36346861

ABBREVIATIONS

AFOLU	Agriculture, forestry, and other land uses
DGAPEAS	Dirección General Adjunta de Planificación Estratégica y Análisis Sectorial [Strategic Planning and Sector Analysis Bureau]
ESMR	Environmental and social management report
FIP	Forest Investment Program
FIRA	Fideicomisos Instituidos en Relación con la Agricultura [Agricultural Trust Funds]
FR	Financiera Rural
GHG	Greenhouse gas
ICAS	Institutional Capacity Assessment System
IMF	International Monetary Fund
INEGI	Instituto Nacional de Estadística, Geografía e Información [National Institute of Statistics, Geography, and Information]
ISO	International Organization for Standardization
Mex$	Mexican pesos
PEU	Program executing unit
PND	Plan Nacional de Desarrollo [National Development Plan]
REDD+	UN Program on Reducing Emissions from Deforestation and Forest Degradation in Developing Countries
SMEs	Small and medium-sized enterprises
tCO2	Tons of carbon dioxide
UNFCCC	United Nations Framework Convention on Climate Change

PROJECT SUMMARY

MEXICO
RURAL FINANCING IN MEXICO
(ME-L1055)

<table>
<tr><th colspan="4">Financial Terms and Conditions</th></tr>
<tr><td colspan="2">Borrower: Financiera Rural</td><td>Amortization period:</td><td>25 years</td></tr>
<tr><td colspan="2">Guarantor: United Mexican States</td><td>Grace period:</td><td>5 years</td></tr>
<tr><td colspan="2">Executing agency: Financiera Rural</td><td>Disbursement period:</td><td>5 years</td></tr>
<tr><td colspan="2"></td><td>Interest rate:</td><td>LIBOR-based</td></tr>
<tr><td rowspan="2">Source</td><td rowspan="2">Amount (US$ thousand)</td><td>Inspection and supervision fee:</td><td>*</td></tr>
<tr><td>Credit fee:</td><td>*</td></tr>
<tr><td>IDB (Ordinary Capital)</td><td>Up to 20,000</td><td rowspan="2">Currency:</td><td rowspan="2">United States dollars from the Single Currency Facility of the Bank’s Ordinary Capital</td></tr>
<tr><td>Local</td><td>80</td></tr>
<tr><td>Total</td><td>Up to 20,080</td><td>Local Currency Facility:</td><td>Conversion to Mexican pesos</td></tr>
<tr><th colspan="4">Project at a Glance</th></tr>
<tr><td colspan="4">Project objective and description: The program aims to increase investment in projects that have a positive environmental impact and in fixed assets for rural productive units in very poor areas by facilitating access to medium and long-term credit (see paragraph 1.33).</td></tr>
<tr><td colspan="4">Condition precedent to the first disbursement: Approval and entry into force of the program’s Operating Regulations, duly agreed upon with the Bank (see paragraph 3.2).</td></tr>
<tr><td colspan="4">Procurement: The Bank’s policies will be applied (documents GN-2349-9 and GN-2350-9).</td></tr>
<tr><td colspan="4">Exceptions to Bank policies: None.</td></tr>
<tr><td colspan="4">Special considerations: This operation provides for retroactive financing as from 29 July 2011 (the date on which the project profile was approved) for up to US$4 million from the loan, pursuant to Operational Policy OP-504 (see paragraph 2.1).</td></tr>
<tr><td colspan="4">Project consistent with country strategy: Yes [X] No [ ]</td></tr>
<tr><td colspan="4">Project qualifies as: SEQ [X] PTI [X] Sector [ ] Geographic [ ] Headcount [ ]</td></tr>
</table>

* 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 applicable provisions of the Bank’s policy on lending rate methodology for Ordinary Capital loans. In no case will the credit fee exceed 0.75% or the inspection and supervision fee exceed, in a given six-month period, the amount that would result from applying 1% to the loan amount divided by the number of six-month periods included in the original disbursement period.

I. DESCRIPTION AND RESULTS MONITORING

A. Frame of reference, problem addressed, rationale

1. Frame of reference

1.1 **Macroeconomic framework.** The Mexican economy grew by 5.4% in 2010, following a 6.1% contraction the previous year; nonetheless, growth expectations for 2011 continue to be revised downward. As of September, the International Monetary Fund (IMF) was forecasting 3.8% growth in Mexico this year. Economic growth remains driven by external demand, although this has been faltering. Between January and July 2011, total exports grew at an annual rate of 21.0%, compared to 35.2% in the same period in 2010. For 2012, the Mexican government is forecasting GDP growth of 3.5%;[1] but risks persist that could cause a slowdown in economic activity, mainly external factors such as a slowdown in the United States economy in 2012, and a worsening of fiscal and financial problems in the euro zone countries.

1.2 The IMF expects gross public sector debt to remain at sustainable levels in 2011 and 2012 (around 43.0% of GDP), while the public-sector deficit in 2012 is expected to be 2.2% of GDP,[2] 0.3 percentage points below its estimated 2011 level.

1.3 Inflationary pressures have eased, and prices are set to rise by 3.6% by the end of 2011, 1.2 percentage points less than in 2010. For 2012, private-sector analysts forecast that inflation will remain in line with the target of 3% ± 1 percentage point. The Mexican financial system is in a solid position, and this has enabled it to successfully withstand the financial crisis.

1.4 **The rural sector**. Although the primary sector as a whole contributes less than 4% to national GDP, about 22% of the population lives in rural communities.[3] Factors affecting sector output and, hence, rural incomes, include the following: (i) low technological efficiency of productive units; (ii) credit constraints that hinder crop restructuring, investment in fixed assets, and the adoption of new technologies, together with a shortage of working capital to purchase inputs; (iii) infrastructure weaknesses, particularly for efficient water management; and (iv) inconsistent public policies.[4] Low income levels and poverty are also associated with highly dispersed localities.

2. Problem to be addressed

1.5 Financing plays an important role in the rural sector's growth and development. The availability of credit under adequate conditions and when it is needed enables producers and firms to make new investments resulting in higher production,

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1 The government's General Economic Policy Criteria.

2 The government's General Economic Policy Criteria.

3 National Institute of Statistics, Geography, and Information of Mexico (INEGI).

4 Agriculture Sector Note, Mexico: Country Strategy 2010-2012.

increased productive capacity, innovation, and lower operating costs—all of which generates more profitable productive units.

1.6 The rural sector faces specific obstacles in expanding the financial services frontier, particularly towards small-scale producers, given the higher associated risks compared to other sectors,[5] and the high transaction costs implied by geographic dispersion and the small size of productive units.

1.7 In Mexico, these obstacles have meant that the formal financial sector has little penetration in the rural economy.[6] In 2007, just 4% of rural production units had access to secure credit, which means that over 3.9 million units lacked financing.[7] In terms of amount, in 2010, outstanding loans to the primary sector represented 20% of total sector GDP. These figures stand in contrast to the level of financing available in Chile and Brazil, where credit for agricultural activities represent 45% and 60% of sector GDP, respectively; and with the United States, Mexico's main trading partner, where the level is above 100%.[8]

1.8 The low level of financing is compounded by weak participation by the private sector. In 2010, only 32% of the total balance on the rural sector loan portfolio was commercial banks' own resources.[9] The remaining 68% came from the resources of two public entities, the Agricultural Trust Funds (FIRA)[10] and Financiera Rural (FR). As commercial banks have a minimal track record in financing the sector, the government has used development banks to develop formal nonbank intermediaries to lend to the agriculture sector and rural area.[11]

1.9 Investment projects that require long-term funding pose additional difficulties, since the financial institutions involved must have the capacity to capture this type of funding themselves and manage the greater risks involved in projects of this type. As an illustration, just 1% of rural productive units with access to credit have access to fixed-asset loans, which are generally considered long-term.[12]

1.10 To successfully contribute to the development and consolidation of viable productive projects in Mexico's rural sector, innovative mechanisms are needed to facilitate financing and investment in innovation, infrastructure, and rural sector

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[5] These include weather, marketing, and price risks, compounded by a concentration of risk by activity and geographic zones. Constraints are also greater in terms of available collateral and its execution.

[6] For example, 74% of municipios, which encompass 22% of the population, have no bank branches, according to the National Survey of Rural Financial Markets (World Bank/FIRA).

[7] Agricultural, Livestock and Forestry Census 2007.

[8] Financiera Rural, Annual Report 2009.

[9] Financiera Rural, Annual Report 2009.

[10] This operates as a second-tier bank, providing credit, guarantees, training, technical assistance, and technology transfer to the agroindustrial, agricultural, rural, and fishery sectors.

[11] For example, limited-purpose finance companies (SOFOLs); credit unions; multipurpose finance companies (SOFOMs); and community saving and loan associations.

[12] National Institute of Statistics, Geography, and Information. Agriculture, Livestock and Forestry Census 2007.

diversification. This means expanding access to credit and financing for medium and long-term investment, since this type of financing enables producers to invest for capitalization and in developing new markets and potential activities.

1.11 Investments of this type include those intended for capitalization and rural sector diversification through the development of strategic sectors that affect environmental sustainability criteria, such as projects in agriculture, forestry, and other land uses (AFOLU),[13] sustainable rural tourism, and small and medium-scale renewable energy projects, among others (see link**)**.

1.12 Mexico is one of Latin America's main greenhouse gas (GHG) emitters, producing approximately 643 million tons of carbon dioxide (tCO_2) per year.[14] It also has mitigation potential of approximately 130-320 million tCO_2 per year. The sectors mentioned above have a high potential to generate environmental benefits by reducing GHG emissions, so their promotion and development is crucial in the country's climate change strategy. The AFOLU sector, which included crop farming and livestock breeding, accounts for 16.3% of total emissions.[15] In addition to the compliance markets (the United Nations Framework Convention on Climate Change–UNFCCC and the Kyoto Protocol), voluntary markets have gradually expanded to include carbon sinks other than forests. Grazing areas and scrubland have started to be considered in this type of market. Mitigation potential within the agriculture sector can be achieved through carbon sequestration in soils, using various strategies: crop management, grazing, restoration of degraded land, bioenergy, and water management. The government's 2009-2012 Special Climate Change Program predicts that 30% of the reduction in GHG emissions by 2012 could come from the AFOLU sector.

1.13 Nonetheless, these sectors have very limited access to financing, whether public or private. The portfolio of loans to the forestry sector in 2008 accounted for just 0.01% of total credit to the private sector, and 0.55% within the primary sector. The low level of financing is largely explained by the long project gestation periods, which increase the risk of the activity. Other reasons include community ownership (which, by nature, cannot be taxed) and the scale of production.

3. Financiera Rural

1.14 **Background.** FR is a decentralized federal government agency, with sector affiliation through the Finance and Public Credit Department. It was created in 2002, with its own legal status and capital, as part of the Mexican government's comprehensive strategy to expand the supply of financial services in the rural sector. Its main goal is to promote the development of economic activities in rural areas, with the aim of boosting productivity and improving rural living standards.

[13] Projects related to land use practices that promote carbon capture and serve as greenhouse gas mitigants.

[14] National Ecology Institute (INE, 2000).

[15] According to the national inventory of GHG emissions (INEGI) in Mexico's fourth communication to the United Nations Framework Convention on Climate Change (UNFCCC) of 2009.

To that end, it seeks to generate innovative lending and technical assistance tools and schemes, targeting productive units that have gone unserved by other financial institutions but represent a high productive potential for Mexico.

1.15 **Financial situation.** FR has achieved economic and financial sustainability. Its starting capital was 17.515 billion Mexican pesos (Mex$), and in June 2011 this had grown Mex$26.152 billion.[16] The Financiera Rural Organic Law requires it to preserve and maintain capital for the purpose of granting loans and managing resources prudently, efficiently, and transparently.[17] In this regard, the General Policies on Interest Rates specify a lending rate consistent with the institution's financial balance and maintenance of its capital value in real terms.

1.16 Since its creation, the institution has been subject to strict prudential criteria and sound corporate governance. Its operations are regulated by the National Banking and Securities Commission, and it also has an integrated risk management system.[18] These efforts have led risk raters such as Fitch and Moody's to award the best ratings for long- and short-term counterpart risk on their local scale. These risk ratings reflect the explicit support provided by the federal government to loan operations obtained by FR, as specified in its Organic Law.[19]

1.17 **Operation.** FR has worked to design lending products and programs in accordance with the current situation and problems faced by the country's rural sector and each of its regions. Its 2007-2012 Strategic Plan sets forth the following objectives: (i) greater access to financing under better conditions; (ii) diversification of credit; (iii) rural financial intermediary development and services; (iv) promotion of rural sector profitability; (v) promotion and strengthening of producers and social organizations; (vi) poverty reduction; (vii) conservation of the environment; and (viii) institutional strengthening.

1.18 FR finances producers both directly and indirectly, through credit unions, nonbank financial institutions, microfinance institutions, and cooperatives. Second-tier operations have grown to account for about half of the funding provided, but only represent 2.5% of the number of customers. This is one of the basic problems faced by FR in its second-tier operations, namely the lack of sustainable intermediaries, particularly to serve community-land (*ejidal*) farmers and highly excluded communities.[20]

1.19 FR has increased the geographic coverage of its financing, expanding from 690 municipios in 2004 to 1,105 in 2009, with lending rising to over

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16 http://www.financierarural.gob.mx/inf_fin_programa/Paginas/EstadosFinancierosal30dejuniode2011.aspx

17 Article 2.

18 FR performs a monthly analysis of the expected loss on its historical portfolio, identifying indicators of the likelihood of default, exposure, and severity of the credit portfolio by type of credit, regional coordination, type of product, the type of authorization, type of portfolio, among others.

19 Article 8 bis.

20 FR has undertaken a number of actions to support potential financial intermediaries. By late 2010, it had helped form roughly 300 intermediaries.

Mex$125 billion in the period 2002-2010. On average, FR serves 5,897 new clients per year.

1.20 As of the end of 2010, FR held a 15.2% share in total primary sector financing, with total assets of Mex$25.318 billion. The balance of its portfolio under management stood at Mex$16.723 billion, with an arrears rate of 6.7%.

1.21 Nonetheless, the FR portfolio has a heavy short-term concentration. In 2010, 62.7% of its loans were for periods of less than one year, 14.6% for three years, 20.4% between three and five years, and the remaining 2.3% for longer than five years. Although FR has succeeded in improving its portfolio diversification, the agriculture sector accounted for 53% of its total portfolio in 2010, with the commercial sector and services absorbing 42.8%, and forestry 0.9%.

1.22 Alongside its general objective of extending the supply of financing to a larger number of rural economic agents, the institution aims to strengthen its strategy of portfolio diversification toward sectors of high productive potential that require long-term investment, particularly those with a high impact in terms of environmental benefits and poverty reduction.

1.23 In terms of environmental conservation, FR is developing programs that facilitate investment in sustainable agricultural techniques; forestry projects to promote forestry production and reduce the high rates of degradation and deforestation of natural forests; alternative energies; and the exploitation of natural resources. In relation to poverty reduction, FR is trying to direct more of its funding toward projects in the most excluded zones, since about half of its resources are channeled to medium- and low-income producers, who are mainly concentrated in the north and northeast of the country.

4. Rationale

1.24 **Consistency with the Ninth General Increase in the Resources of the Bank (GCI-9) and its strategy with the country.** The present program is in line with the Bank's country strategy with Mexico and the Country Program Document (CPD) 2011.[21] The strategy is centered on four pillars encompassing 10 priority sectors. The second pillar relates to the productive domain and mentions that steps will be taken to promote access to financing in the micro, small and medium-sized enterprise (MSME) sector, and greater productivity in the agriculture sector. In the latter case, one of the three main objectives is to increase financing, including to forestry and silviculture activity. The present program contributes to the target (expected outcome) in the country strategy by financing projects in this sector, particularly forestry/silviculture,[22] because it will be among the eligible sectors since it generates environmental benefits.

[21] Documents GN-2595-1 and GN-2617, respectively.

[22] The indicator is total bank lending to the agriculture, forestry, and fisheries sector.

1.25 The fourth pillar of the country strategy involves support for the climate change adaptation and mitigation agenda. This program contributes to the target of helping to increase institutional capacity to implement climate change mitigation and adaptation programs at both the federal and subnational levels. The indicator in this case is the number of entities with mitigation and/or adaptation programs (including development banks). The program could also contribute toward the target for reducing GHG emissions, as measured by the volume of reduction in GHG emissions obtained annually from programs to finance low-carbon projects. These projects need to relate to the areas of renewable energy, housing, energy efficiency, biofuels, and the United Nations program on Reducing Emissions from Deforestation and Forest Degradation (REDD+).[23]

1.26 The Bank has wide-ranging experience in the Mexican financial sector, including a number of operations currently under way with various public financial institutions.[24] It is also familiar with FR regulations and operations, having supported the creation of the institution through the rural financial system consolidation program.[25] The Bank has played a key role in developing and supporting the government's climate change mitigation and adaptation agenda.

1.27 This program is also aligned with the strategic objectives of the Ninth General Increase in the Resources of the Bank both in financing to support poverty reduction and enhanced equity, and in financing to support climate change, renewable energy, and environmental initiatives. The latter area reflects the fact that, by definition, increasing the supply of credit to the AFOLU sector will have an effect on reducing emissions generated by deforestation and degradation (see AFOLU).

1.28 **The country's strategy in the sector**. The program is consistent with the objectives of Mexico's National Development Plan 2007-2012 (PND). Within the competitive and job-creating economy pillar, the Plan sets the goal of achieving an efficient financial system, for which development banks will be responsible for increasing credit to strategic sectors that still have limited access to financing, including small and medium-sized enterprises (SMEs) and middle- and low-income rural producers. Its objectives for the rural sector also mention a strategy to promote financing and capitalization in the rural sector, which entails designing differentiated financing schemes, taking account of the development level and capitalization of producers, with preferential and flexible terms, rates, and types of collateral. Lastly, the Special Climate Change Program 2009-2012 contributes to achieving the PND's environmental sustainability objectives. It should be noted that the other factors affecting this sector, referenced in paragraph 1.4, are being

[23] Projects to reduce emissions through actions to avoid deforestation and forest degradation, as well as forest conservation.

[24] Loan operations with NAFIN, Bancomex, Sociedad Hipotecaria, and Banobras, as well as various technical assistance programs with other public institutions in the financial sector.

[25] ME0243.

addressed by the government and the IDB through the Program to Strengthen Rural Public Goods,[26] which are essential for promoting a positive direct impact on productivity and on spending efficiency in the sector. The program promotes reducing the lag in the level and quality of investment in such goods, stressing agricultural and rural infrastructure services, such as agrifood health, generating agricultural technology, fisheries research, and farmer service systems. The Bank also supports the PROCAMPO[27] program, which contributes to the effectiveness of policies supporting the sector and helps increase family income for low and middle-income farmers and make it more stable.

1.29 **Complementary technical cooperation operations**. The program will be complemented by a number of technical cooperation operations from the Bank for Financiera Rural. The Bank is currently preparing or executing three technical assistance operations for institutional strengthening:

a. **Analysis of the FR portfolio in the AFOLU sector.**[28] This analysis aims to make FR a key player in promoting emissions reduction in Mexico and fully exploit its skills in structuring and financing carbon mitigation projects in that sector. This will be done through an analysis of the institution's loan portfolio and its associated emissions potential. It will also include a training component, with the organization of a workshop for loan officers and the design of training and basic capacity-building materials on the fundamental aspects of carbon markets for the AFOLU sector, and projects that generate emissions reduction. The aim of the latter is for accounts managers to collaborate actively in the internal portfolio review and identification of projects, with potential to be included within the Clean Development Mechanism and REDD.[29]

b. **Portfolio review to identify financing instruments and new areas of opportunity and development in terms of environmental sustainability,** under the program to support climate change financing from national development banks.[30] This technical cooperation operation will enable FR to design financial instruments that are suitable for projects that have an impact on GHG mitigation. It will also seek to influence the development of projects that support ecological sustainability and also make it possible to provide alternative income sources for the accredited population.

[26] ME-L1045.

[27] ME-L1041.

[28] RG-T1778.

[29] The Clean Development Mechanism was established, as part of implementation of the UNFCCC, to promote GHG mitigation actions in countries not listed in Annex 1.

[30] RG-T1866.

c. **Strengthening and modernization of its environmental and social risk management systems.**[31] This technical cooperation aims to design and implement an environmental and social risk management system that is tailored to the needs and portfolio of Financiera Rural. This will provide the institution with tools needed to evaluate the environmental risks associated with its financial operations, thereby ensuring greater knowledge for decision-making on projects to be financed. It will also afford FR greater knowledge of its social and environmental impact. Installed capacity will be reviewed, the flow of operations of existing systems and resources assigned will be analyzed, and proposals will be designed for the policies, procedures, and resources needed to implement an effective system. The project will include training workshops and an internalization process within the institution. This technical cooperation is considered decisive in ensuring that the aim of this program between the Bank and Financiera Rural is consistent with the institution's long-term vision.

1.30 **Other relevant issues** As indicated in paragraphs 1.7 and 1.8, FR fills a gap in the general market, namely rural sector formal financing, particularly from private entities; and it seeks to do so particularly for economic segments or sectors needing long-term funding and/or that have higher risk, as outlined in paragraphs 1.6, 1.9, and 1.13. FR has the task of managing the higher risks implicit in the rural sector, and has done so under sustainable criteria. Impact evaluations of FIRA programs show positive results in similar interventions;[32] and the global economic impact of its support in 2009 represented 23.6% of average beneficiary incomes. The support provided to FR reflects a more general IDB strategy[33] to support the region's development banks and enable them to successfully fulfill their social mandate and achieve sustainability over time.

1.31 Given the sectors and objectives it encompasses, the program is also an innovative multisector loan that will generate experience in financing sectors that are crucial for sustainable development and in Mexico's most deprived areas. The program is also aligned with the Bank's Sector Strategy on Institutions for Growth and Social Welfare, both in terms of promoting broader access to financial services, and in terms of boosting productivity and expanding SMEs.

1.32 The program is important for Financiera Rural, because it will provide its first opportunity to obtain long-term funding to enter new markets more actively. Following the amendment of its Organic Law in 2009, FR is now authorized to obtain funds from other financial entities. Until now, its operations have been financed almost entirely out of its own capital.

[31] In process.

[32] Evaluation of FIRA programs (FIRA, 2009).

[33] For example, see RG-K1175 and RG-K1177.

B. Objectives and expected outcomes

1.33 The program aims to increase investment in projects with a positive environmental impact, and investment in fixed assets[34] by rural productive units in very poor areas through access to medium and long-term credit.

1.34 The program responds to the need for greater financing in the rural sector, particularly targeting sectors and activities that require long-term investment and, additionally, generate a positive environmental or social impact. It will show potential beneficiaries and the financial system that financing these long-term projects and generating greater investment in these sectors can be profitable. The program will consist of two components.

1.35 **Component 1: Medium and long-term financing for rural productive units.** Credits will be channeled directly by FR,[35] which will execute and supervise adequate use of the resources to fulfill the objective of this operation. The target of the funding will be:

a. Environmental sustainability projects, mainly in the AFOLU sector, including projects in forestry investment, renewable energy (such as investments in biodigesters), and in rural tourism that promote good management of natural resources under sustainability criteria. This will represent a pilot program to finance these sectors given the characteristics of the eligible projects.

b. Projects to increase investment in fixed assets by rural productive units in highly marginalized areas,[36] by financing new borrowers in these areas.

1.36 Financing for the AFOLU sector could be complemented by a Forest Investment Program (FIP) within the Climate Investment Fund, which targets community forestry activities and is currently going through the approval process.[37] If granted, the resources would be channeled and executed through Financiera Rural, creating synergies and generating value-added for the present program.

1.37 The projects that could be financed will be defined through eligibility criteria, which will be included in the program's Operating Regulations. The criteria and basic guidelines for projects in the AFOLU sector are attached, based on the recommendations made by consulting services hired for this purpose by the Bank's Sustainable Energy and Climate Change Unit (INE/ECC) (see Link). Credits that are capitalized are fixed-asset loans and simple credits for the purchase of fixed

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34 This involves the purchase of fixed assets, including machinery and equipment.

35 They would be channeled as first tier credits, because the capacities needed to enter these new markets and evaluate their success need to be developed.

36 Classified as such by the National Population Council. For the purposes of the program, very poor areas include those defined as having a high and very high level of poverty.

37 The Mexican government has requested resources from the FIP of US$15 million (US$10 million in concessional credit, and US$5 million as a grant) for a financing program to strengthen the management of forests and forest landscapes, as well as the promotion of investment projects and economic integration, with emphasis on communities. These resources do not form part of this program, but complement it.

assets. The borrowers will be small and medium-sized productive units.[38] In keeping with FR's regulations, it can only finance primary activities, as well as any other activity in communities with fewer than 50,000 inhabitants. The specific projects will be determined by FR according to the programs or lines they have with these objectives and the eligibility criteria defined in the program's Operating Regulations. These include a maximum program contribution to projects of up to US$4 million, and a minimum three-year term.[39] An estimated 75% of the resources are destined for environmental sustainability projects, and 25% for projects to increase the capitalization of rural enterprises in highly marginalized zones. About 22 environmental sustainability projects are expected to be financed, and 120 firms will be financed with fixed-asset loans.

1.38 **Component 2: Institutional strengthening.** This component will support FR in implementing a long-term asset and liability risk management system, since this is the first time it will be receiving funding from a multilateral agency, and the first time it contracts a long-term liability in general. The capacity of the Integrated Risk Management Unit will be strengthened for the analysis, monitoring, evaluation, and tracking of risks in projects of this type. The program will provide the resources needed (estimated at US$80,000) to hire an individual consulting service to support this implementation, including training for FR staff and to finance the purchase of the necessary software (see Fiduciary Risks section). This entire component will be financed with local counterpart funding.

1.39 This component should be seen as complementary to existing efforts under the nonreimbursable technical cooperation programs mentioned in paragraph 1.29.

C. Outcome indicators

1.40 Program monitoring and evaluation will be based on monitoring the indicators in theprogram's Results Matrix. Two indicators of expected outcomes will be used for each type of project financed: (i) the increase in the amount of credit granted by FR in projects with a positive environmental impact or fixed capital in marginalized rural zones; and (ii) its profitability, measured through an FR index of the probability of the credits financed being repaid. Two indicators will be used to measure expected impact: (i) increase in the level of investment targeting projects with a positive environmental impact at the municipal level; and (ii) an increase in fixed-asset investment by productive units located in marginalized rural zones. The demonstration effect of successful projects directly financed by the program is expected to result in an increase in financing available for projects of this type and

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[38] The beneficiaries will be the so-called Developing Producers 1 (DP1) and 2 (DP2), who are producers whose net annual income does not exceed 1,000 times the minimum daily wage of the zone in which the firm is located (DP1), and those whose net annual income is between 1,000 and 3,000 times (DP2).

[39] The criteria used by FR for medium and long-term start with a minimum term of three years—the minimum maturity period for investment projects. The per-project loan ceiling is to ensure a minimum number of projects, while bearing in mind that some of these require a minimum scale to be viable in terms of their sustainability and recovery.

hence raise investment levels in these sectors on a broader scale. In the case of investments in the AFOLU sector, a pilot program is being set up to finance a highly complex sector owing to its risks. So the expected outcome is that these investments are undertaken and repaid (thus indicating their financial viability).

II. FINANCING STRUCTURE AND MAIN RISKS

A. Financing instrument

2.1 This operation is a Global Credit Program to be granted to FR to enable it to onlend to final borrowers (sub-borrowers) for the purpose of financing multisector projects. It provides for retroactive financing as from 29 July 2011 (the date on which the project profile was approved) for up to US$4 million from the loan, pursuant to Operational Policy OP-504.

2.2 The costs of the program are summarized in the following table:

Component	IDB (US$)	Counterpart (US$)	Total (US$)
Component 1	20,000,000	0	20,000,000
Component 2		80,000	80,000
TOTAL	20,000,000	80,000	20,080,000

B. Main risks and mitigating measures

2.3 **Environmental and social risks.** According to the Bank's Environment and Safeguards Compliance Policy, the operation is classified as a global credit instrument. Nonetheless, an Environmental and social management report (ESMR) was produced, to evaluate FR's institutional capacity to implement the Bank's environmental and social safeguards, and to define management tools to enable FR to identify, manage, and mitigate the potential environmental and social impacts and risks of each project. As some projects involve significant risks, FR will be asked to strengthen its environmental and social risk management system, with Bank assistance.

2.4 At the present time, FR is embarked on an internal process to ensure compliance with Mexican environmental regulations; and it will also use the sequential tools contained in the ESMR to determine the eligibility of projects under the program, which includes a list of exclusions.

2.5 **Fiduciary risks.** Based on the institutional capacity assessment undertaken through the institutional capacity assessment system (ICAS), FR has attained a satisfactory level of development for program implementation, which means that risk is low for each of the capacities evaluated (programming and organization, execution, and control). Nonetheless, there are two major areas of opportunity to achieve optimal execution. Firstly, FR needs a system to manage long-term project risks. Accordingly, Component II of the program will include measures to implement such a system.

2.6 Secondly, there is an interface problem between the accounting, treasury, and budget systems, which operate independently from one another. Within the respective areas, there are tasks that are done semiautomatically through Excel worksheets. This problem was identified through a field check of each of the processes involved. The risk is being mitigated by FR through its adherence to ISO certification of all back-office processes, and budgeting for the procurement of an Enterprise Resource Planning system in the second half of 2011. The visit made to review certified processes detected improvements that have been made as part of the certification requirements, as well as indicators reflecting adherence to the certified processes.

2.7 **Other key risks and issues.** The project risk management (PRM) methodology was applied. The only high risk is that mentioned in paragraph 2.4 concerning the possibility of inadequate measurement of long-term risks.[40] Risks rated as medium include the possibility that inadequate design of program outputs may cause delays in execution or insufficient demand for resources. In this regard, the technical assistance operations described in paragraph 1.29 will assist in designing the instruments, and FR will perform technical market studies. The demand for resources could also be affected by the macroeconomic risks described in paragraph 1.29, particularly a slowdown in economic activity.

III. IMPLEMENTATION AND MANAGEMENT PLAN

A. Summary of implementation arrangements

3.1 Financiera Rural will be the borrower, with the United Mexican States serving as guarantor. It will be supported by a program executing unit (PEU) with responsibility for consolidating the program's financial information and relations with the Bank for the purposes of financial management, technical supervision, external audit, and overall monitoring of the program. FR will implement the program from within its organizational structure. The PEU will be the Strategic Planning and Sector Analysis Bureau (DGAPEAS), who will appoint the program coordinator. The DGAPEAS will be supported by the institution's other bureaus.

3.2 **As a condition precedent to the first disbursement, the borrower will approve and implement the program's Operating Regulations duly agreed upon with the Bank.** These set out operational standards governing program implementation, and will be based on the financial regulations and practices currently in force in Mexico. The Operating Regulations will contain subloan eligibility criteria, based on the provisions established in current FR policies and in this program.

3.3 **Disbursements and execution period.** Program resources will be committed within a maximum of 54 months and will be disbursed over a period of no more than 60 months, measured from the date on which the loan contract enters into

[40] According to the PRM rating, the Risk Matrix (Annex II) indicates low development risk.

force. Completion and final justifications will be made in accordance with the Bank's policy OP-273.

3.4 **Financial management.** The Operating Regulations include flexible disbursement modalities enabling FR to meet the needs of eligible projects under the best possible financial conditions, including funding advances, recognition of expenditures, or on the basis of commitments entered into by FR. Disbursements will be made according to the program's liquidity needs. The PEU will present the disbursement request to the Bank, together with a disbursement program for Annual Work Plan activities for the following 180 days. Disbursements will be reviewed ex post.

B. Monitoring and evaluation arrangements

3.5 Program implementation will be monitored by the executing agency through semiannual status reports, presented within 60 days following the end of each six-month period. The reports will be based on the Results Matrix and the financial status reports indicated in the General Conditions.

3.6 A midterm evaluation will be performed 24 months after the date of the first disbursement, or once 50% of the loan proceeds have been committed, whichever occurs first. This evaluation will consider the fulfillment of objectives and results obtained, based on the Results Matrix, with a view to identifying possible corrective actions. FR will compile, store, and maintain all information, indicators, and parameters needed for preparation of the project completion report. The ex post impact evaluation will be performed using the quasi-experimental methodology. FR will develop the methodology and will compile the necessary data over the course of the program, with Bank support during this process.

3.7 FR will present the program's audited financial statements to the Bank, duly certified by an independent firm of auditors, in accordance with the terms of reference previously agreed upon by the Bank and the Civil Service Department (SFP). It will also present the entity's audited financial statements to the Bank annually within 120 days following the end of the fiscal year; and the final program audit report no later than 120 days after the final disbursement.

Development Effectiveness Matrix			
Summary			
I. Strategic Alignment			
1. IDB Strategic Development Objectives	Aligned		
Lending Program	(i) Lending for poverty reduction and equity enhancement, and (ii) Lending to support climate change initiatives, renewable energy and environmental sustainability.		
Regional Development Goals	Percent of firms using Banks to finance investments.		
Bank Output Contribution (as defined in Results Framework of IDB-9)	(i) Micro/small/medium productive enterprises financed, and (ii) Climate change pilot projects in agriculture, energy, health, water and sanitation, transport, and housing.		
2. Country Strategy Development Objectives	Aligned		
Country Strategy Results Matrix	GN-2595-1	Increase lending to the agriculture sector. Support implementation of the climate change adaptation and mitigation agenda at the federal and subnational level.	
Country Program Results Matrix	GN-2617	The project is included in the 2011 Country Program Document.	
Relevance of this project to country development challenges (If not aligned to country strategy or country program)			
II. Development Outcomes - Evaluability	Highly Evaluable	Weight	Maximum Score
	9.0		10
3. Evidence-based Assessment & Solution	8.8	25%	10
4. Ex ante Economic Analysis	8.5	25%	10
5. Monitoring and Evaluation	8.6	25%	10
6. Risks & Mitigation Monitoring Matrix	10.0	25%	10
Overall risks rate = magnitude of risks*likelihood	Medium		
Environmental & social risk classification	B.13		
III. IDB´s Role - Additionality			
The project relies on the use of country systems (VPC/PDP criteria)	Yes	The project relies on the use of: Budget, Treasury, Accounting and Reporting, External Control and Internal Audit, as well as, information System and Shopping Method.	
The project uses another country system different from the ones above for implementing the program			
The IDB's involvement promotes improvements of the intended beneficiaries and/or public sector entity in the following dimensions:			
Gender Equality			
Labor			
Environment	Yes	The program promotes environmental best practices both in managing Financiera Rural and in the rural sector.	
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	Yes	The program will be complemented by a series of technical cooperation from the IDB to Financiera Rural. The Bank is currently preparing or executing three technical assistance for institutional strengthening.	
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 evaluation will demonstrate both to potential beneficiaries and to the financial system the benfit of funding these long-term projects and it will generate increased investment in these sectors.	

The project document identifies priorities related to the Bank's lending program and the project's contribution to the IDB's lending objective "Lending for poverty reduction and equity enhancement" and "Lending to support climate change initiatives, renewable energy and environmental sustainability". It also contributes to the regional development goal "Percent of firms using Banks to finance investments" and to the Bank output contribution to "Micro/small/medium productive enterprises financed" and "Climate change pilot projects in agriculture, energy, health, water and sanitation, transport, and housing". The project is aligned with the IDB Country Strategy with Mexico and included the 2011 Country Program Document.

The project document and its annexes include a good diagnostic of the problems affecting the financing of the rural activities in Mexico, though the discussion on previous evidence rather limited and only partially related to the proposed intervention. The project logic is clear. The project's metrics are reasonable and complete. The economic analysis is complete and based on reasonable assumptions, though a broader set of benefit should have been considered. The project includes a complete monitoring and evaluation plan. The impact evaluation design is quasi-experimental. The risk matrix is complete and includes mitigation measure and indicators to track their implementation.

RESULTS MATRIX

Project objective:	The program aims to increase investment in projects that have a positive environmental impact and investment in fixed capital by productive rural units in very poor areas, by facilitating access to medium and long-term credit.

EXPECTED IMPACT

Indicators	Unit of measurement	Baseline		Intermediate measurements		Targets		Source/Means of verification	Comments
		Value	Year	Value	Year	Value	Year		
Expected impact: An increase in the level of investment targeting projects with a positive environmental impact.									
Amount of investment channeled to projects in the agriculture, forestry and other land uses (AFOLU) sector at the municipal level	Million pesos (Mex$ million)	20[1]	2011	Will not be measured		The mean of the treatment group should be three standard deviations from the mean of the control group	2015	Financial terminal (Terfin) - Executive Directorate of Liaison and Evaluation of Regional Coordination Office (DEEECR).	The value of this indicator will be obtained from by the ex post evaluation. See comments on Final Outcome 1 for an explanation of the baseline.
Expected impact: An increase in investments in fixed assets by productive rural units in very poor areas.									
Amount of investment in fixed assets in marginalized zones	Mex$ million	4,408[1]	2011	Will not be measured		$5,100	2015	DEEECR.	Calculation of the baseline includes fixed asset loans granted by the Agricultural Trust Funds (FIRA) to the agriculture sector, amounting to $3.327 billion in 2010.

[1] The value indicated as the baseline is a provisional estimate owing to the lack of precise information on the actual amount of investment in these categories. The figure was obtained by multiplying the total value of loans granted for this purpose by a factor of 1.2, since an estimated 80% of the value of these investment projects is normally financed.

EXPECTED OUTCOMES

Indicators	Unit of measurement	Baseline		Intermediate measurements				Targets		Source/means of verification	Comments
		Value	Year	Value	Year	Value	Year	Value	Year		
Final Outcome 1: Increased credit granted by FR in projects that have a positive environmental impact or fixed capital in marginalized zones of the rural sector.											
Rate of growth of the amount of credit granted by Financiera Rural (FR) in the AFOLU sector[1]	Percentage	Mex$17 million	2011	185%	2012	86%	2013	46%	2014	Terfin-DEEECR	To date FR has no information on projects operating under AFOLU criteria. It is therefore impossible to calculate an exact baseline. The information required will be generated as from 2012. See note 1 for explanation on the assumptions underlying the baseline and targets.
Growth rate of the amount of credit granted by FR in projects financed with credit that is capitalized in marginalized municípios[2]	Percentage	Mex$347 million	2011	4.4%	2012	6.3%	2013	5.9%	2014	Terfin-DEEECR	

[1] Refers to total credit granted by Financiera Rural in the forestry sector under AFOLU criteria. As FR does not have precise information on the forestry projects that use these criteria, the baseline was estimated by defining these as first-tier credits to finance planting and reforestation. It is estimated that about two thirds of the resources of the credit line destined for the AFOLU sector would be for forestry projects. Thus according to the exchange rate forecast for 2012 in the General Economic Policy Criteria document issued by the Finance Department (12.2 pesos to the dollar), about Mex$122 million are channeled into this sector. As the average amount of credit granted to forestry projects over the last few years is about Mex$5.31 million, about 22 projects would be financed in three years. The estimated breakdown would be as follows: six projects in the first year, eight in the second, and eight in the third. Accordingly, and as the baseline is Mex$17 million, expected growth was estimated at approximately Mex$31 million pesos, Mex$46 million, and Mex $46 million pesos in the first, second, and third years, respectively. In other words, with Bank financing, the portfolio channeled into this type of project would rise from Mex$17 million to Mex$49 million in the first year; from Mex$49 million to Mex $91 million in the second year; and from Mex$91 million to Mex$134 million in the third year.

[2] Credits that are capitalized refer to fixed asset loans and simple credit for fixed assets. About one quarter of the proceeds of the Bank financing is expected finance low-income producers who seek credit for capitalization purposes, thus investing about Mex$61 million in this sector. As the average value of projects in the period 2008-2011 has been Mex$510,000, about 120 projects would be financed in the three years, with the following estimated distribution: 30 projects in the first year; 45 in the second; and 45 in the third. Accordingly, and as the baseline amounts to Mex$347 million in marginalized zones, expected growth was estimated at approximately Mex$15 million, Mex$23 million, and Mex$23 million, in the first, second, and third years respectively. In other words, with Bank financing, the portfolio channeled into this type of project would rise from Mex$347 million to Mex$362 million in the first year; from Mex$362 million to Mex$385 million in the second; and from Mex$385 million to Mex$408 million in the third.

Indicators	Unit of measurement	Baseline		Intermediate measurements				Targets		Source/means of verification	Comments
		Value	Year	Value	Year	Value	Year	Value	Year		
Final Outcome 2: Projects financed under the program prove profitable.											
Index of the likelihood of default by projects in the AFOLU sector/ Index of the likelihood of default in the total FR portfolio.	Quotient	1[1]	2011	≤1	2012	≤1	2013	≤1	2014	Integrated risk management unit	The default likelihood index used by FR measures the probability of a credit in a certain segment being classified as overdue (arrears of principal or interest payments; in the case of credits longer than 18 months, 90 days' arrears). This is calculated as the number of overdue loans divided by the total number of loans in the corresponding segment.
Index of the likelihood of default in projects supported with credits that are capitalized/ Index of the likelihood of default in the total FR portfolio.	Quotient	1[1]	2011	≤1	2012	≤1	2013	≤1	2014	Integrated risk management unit	

[1] The baseline is 1 because the AFOLU sector project portfolio is assumed to the same probability of default as the total FR portfolio.

OUTPUTS

Output	Unit of measurement	Base Level	Year 1	Year 2	Year 3	Target
Component I: Long-term financing for rural productive units						
Output 1: Productive units financed by FR in sectors with a positive environmental and social impact						
Productive units financed in the AFOLU sector[1]	No. of productive units	0	6	8	8	22
New borrowers with credits they capitalize, in marginalized zones[2]	No. of productive units	0	30	45	45	120
Note: The cost of Output 1 each year is: US$4 million in 2012; US$8 million in 2013; US$7,999,970 in 2014						
Component II: Institutional strengthening						
Output 2: Long-term risk management system implemented						
Consulting service and training contracted	#	-	1			1
Software purchased	#	-	1			1

[1] AFOLU projects are defined as those that implement land use practices that encourage carbon capture and serve as greenhouse gas mitigants. AFOLU encompasses agriculture, forestry and other land uses. It is estimated that about half of the resources of the credit line will be used to finance the forestry sector. Thus, according to the exchange rate estimate for 2012 in the General Economic Policy Criteria document issued by the Finance Department (Mex$12.2 to the dollar), about Mex$122 million will be channeled into this sector. Bearing in mind that the average amount of credit granted to forestry projects during the last few years is about Mex$5.31 million, about 22 projects would be financed in three years, broken down as follows: six projects in the first year; eight in the second; and eight in the third. As FR does not have precise information on the forestry projects that use these criteria, the baseline was estimated by defining these as first-tier credits to finance planting and reforestation. To obtain the number of units financed, it is assumed that each project is related to one productive unit, which FR has indicated has been the norm.

[2] Credits that are capitalized refer to fixed asset loans and simple credit for machinery and equipment. It is estimated that about one quarter of the credit line resources will finance low-income producers that seek credit for capitalization purposes. In this way, is expected to channel about Mex$61 million into this sector. As the average amount of projects in the period 2008-2011 has been Mex$510,000, about 120 projects would be financed in the three years, with the following estimated distribution: 30 projects in the first year; 45 in the second; and 45 in the third.

Note: The cost of Output 2 each year is: US$30,000 in 2012, plus US$50,000 in counterpart funding

FIDUCIARY AGREEMENTS AND REQUIREMENTS

Country:	Mexico
Project number:	ME-L1055
Name:	Rural Financing Program in Mexico
Executing agency:	Financiera Rural (FR)
Prepared by:	Gloria Coronel, Raúl Lozano, and Miriam Garza

I. EXECUTIVE SUMMARY

Financiera Rural (FR) is a decentralized federal government agency, with sector affiliation to the Finance and Public Credit Department. It was constituted with its own legal status and capital, under its Organic Law published in the Official Gazette of the Federation on 26 December 2002. The mission of FR is to provide financial services in the rural sector, specifically to productive units that are not served by other financial institutions and have high productive potential.

FR's fiduciary capacity was evaluated on the basis of an institutional analysis, the risk analysis exercise, discussions with its key staff, and meetings held with the project team in June 2011.

The institutional capacity assessment system (ICAS) found that the institution scored in the range of 88.21% to 94.16% for each of the three capacities evaluated (programming and organization, execution, and control). These indicate development levels that are sufficient for program execution and, therefore, low risk in all of the capacities evaluated. The weighted average score was 90.89%.

Although FR's institutional capacity is sufficiently developed to implement the project, there are opportunities for improvement in its systems, such as: (i) the integration of budgetary and accounting systems; (ii) development of methodologies for the risk area, to measure the long term and new risks; and (iii) environmental and social impact. These issues have been taken into consideration in the design of the operation.

II. FIDUCIARY CONTEXT OF THE EXECUTING AGENCY

FR has seven divisions. Pursuant to the public regulation issued by the Civil Service Department (SFP), FR has an internal oversight body appointed by the SFP.

FR will act as borrower in this operation and will set up a program coordinating unit within its organization. The institutional capacity analysis performed on FR shows that it is a well organized institution with up-to-date manuals defining the segregation of functions, description of posts, and responsibilities in line with federal government regulations. Computer systems such as the hardware network are considered satisfactory, albeit with areas for improvement particularly in terms of systems integration to make processes more efficient. For example, the budget systems are independent of the accounting records and financial systems. Nonetheless, this risk is mitigated through manual ISO-certified control processes. FR is considering the implementation of an enterprise resource planning (ERP) platform in the near future, to link the corresponding information (late 2011 or early 2012).

As FR staff do not have experience in projects with multilateral organizations, in relation to financial issues, the personnel who will coordinate program activities should be identified quickly, to be able to provide them with training on fiduciary issues promptly.

III. EVALUATION OF FIDUCIARY RISK AND MITIGATION ACTIONS

The risk evaluation (ICAS) performed at the design stage found that FR has sufficient development for program implementation; and its result produced a weighted average score of 90.89%, which is a low-risk level. The detailed results for each capacity evaluated are shown in the table further below.

The Finance and Public Credit Department (SHCP) has indicated that this operation will not have a financial agent, or else the financial agent will be a unit within FR. In view of this, plus the fact that this is FR's first loan operation with a multilateral organization and it does not have staff with prior experience in the financial-fiduciary processes required by the Bank, key personnel should be identified to start the training process as soon as possible.

IV. CONSIDERATIONS FOR THE SPECIAL CONDITIONS OF THE LOAN CONTRACT

1. Special conditions precedent to the first disbursement: Project operating manual approved by the Bank, which will include eligibility criteria and forms for the reports and requests to be submitted to the Bank.
2. The exchange rate for accounting purposes will be the payment date.
3. Annual financial statements audited according to general terms of reference harmonized with the SFP and by auditors acceptable to the Bank.
4. Procurements will be made in accordance with the Bank's procurement policies (documents GN-2349-9 and GN-2350-9) of March 2011.
5. For the selection and contracting of works, goods, nonconsulting services, consulting firms and individual consultants, the executing agency will use the bidding documents and contracts agreed upon between the SFP and the Bank, which are published online at www.funcionpublica.gob.mx/unaopspf/credito/normace.htm.
6. Before launching any call for bids or awarding a contract, the executing agency will present the proposed procurement plan for review and approval by the Bank, pursuant to the Bank's procurement policies. This plan will be updated every 12 months during program implementation; and each updated version will be reviewed and approved by

the Bank, so the plan will indicate which contracting processes are subject to ex ante and ex post review.

V. AGREEMENTS AND REQUIREMENTS FOR PROCUREMENT EXECUTION

Procurements will be undertaken pursuant to documents GN-2349-9 and GN-2350-9.

a. **Procurement of works, goods, and nonconsulting services:** Contracts for works, goods, and nonconsulting services[1] generated under the project and subject to international competitive bidding (ICB) will be implemented using the standard bidding documents (SBDs) agreed upon with the Bank. Bidding processes subject to national competitive bidding (NCB) will also be undertaken using bidding documents harmonized between the SFP and the Bank, to guide the selection and contracting procedures financed through external loans. These are available online at http://www.funcionpublica.gob.mx/unaopspf/credito/normace.htm. The project's sector specialist will review the technical specifications of procurements during preparation of the corresponding selection process.

b. **Consultant selection and contracting:** Contracts for consulting services to be provided by consulting firms will be implemented using the standard request for proposals (SRP) agreed upon by the Bank and the SFP, to guide the selection and contracting procedures financed with external loan proceeds. These can be consulted online at: http://www.funcionpublica.gob.mx/unaopspf/credito/normace.htm. The project's sector specialist will review the terms of reference for consulting services.

   Individual consultant selection: Contracts with individual consultants will be based on the consultant's qualifications to undertake the work, with the qualifications of at least three candidates being compared. Contracting processes will use the individual consultant contract model agreed upon with the Bank, which can be viewed at: http://www.funcionpublica.gob.mx/unaopspf/credito/normace.htm.

c. **Table of thresholds (US$ thousand)**

Works			Goods[2]			Consulting services	
ICB	NCB	Price comparison	ICB	NCB	Price comparison	International advertising, consulting services	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

[1] Policies for the procurement of goods and works financed by the Inter-American Development Bank (document GN-2349-9) Paragraph 1.1: Nonconsulting services are treated similarly to goods.

[2] Includes nonconsulting services.

1. Main procurements

As nearly all of the loan proceeds will be channeled into Component 1–Multisector credit program–which finances private investment projects in rural productive units, and since FINRURAL can only lend to the private sector (private individuals and legal entities), the only procurements that are possible will be undertaken in Component 2–Technical assistance program for institutional strengthening. At this stage of formulation of the operation, only one consulting service has been identified.

Activity	Type of bidding	Estimated date	Estimated amount US$ thousand
Individual consultant			
1) Individual consultant to implement the credit risk management model for long-term projects, and to train staff	NICQ	31-Dec-2011	30,000

2. Supervision of procurement processes

In view of the project's low fiduciary risk, one annual inspection visit will be made. To establish the supervision regime, account was also taken of the fact that few procurements are expected. Procurements will be reviewed ex post by a firm of external auditors, which will submit a special procurement report pursuant to terms of reference agreed upon by the Bank and SFP.

3. Record-keeping and archives

The program's archives must be kept physically located in the executing agency's offices, and under the corresponding security conditions; and an electronic version will be kept in the credit system, accessible from central offices.

VI. Financial Management Agreements and Requirements

1. Programming and budget

FR is subject to the planning regulations applicable to federal government institutions. Article 17 of the Planning Law requires government-run entities to prepare their institutional programs pursuant to the provisions contained in the corresponding sector program. Article 27 of that law requires dependencies and entities to prepare annual programs of activities that will serve as a basis for integrating the preliminary drafts of the annual budgets.

FR prepares an annual work plan (AWP) that is monitored through verification of indicators, some of which are tracked on a daily basis, while others are reported in board meetings and audit committees. The preparation and monitoring of the AWP abides by the regulatory requirements defined by the SFP for the federal public administration as a whole.

An institutional weakness is that budget systems are independent of accounting systems and financial records; this risk is mitigated with ISO certified manual control processes. FR is considering implementing an ERP platform in the near future to link the corresponding information; in the meantime it is seen as an area of opportunity.

2. Accounting and information systems

The executing agency will set up specific program accounts, and it will add an identification code in Credit System to identify loans made using Bank resources. The Bank's Country Office in Mexico will coordinate with FR during the process of revising the operational manual, in relation to the data that need to be sent to the Bank with each disbursement request. The FR reporting system is considered flexible and has capacity to generate the reports required by the Bank directly from its own databases.

Audited annual financial statements will be required for project supervision purposes, which will be produced according to the general terms of reference harmonized with the World Bank and SFP, and audited by firms of auditors acceptable to the Bank.

3. Disbursements and flow of funds

Disbursements will be released according to the project's real liquidity needs (financial planning). The executing agency will send each disbursement request to the Bank, together with a program of disbursements for AWP activities covering the following 180 days. Disbursements will be justified in the next request to the extent of at least 80%, through the expenditure and investment statements. For each disbursement request, FR will present the project's financial plan to the Bank, showing the schedule of disbursements for the following six months, which can be updated periodically. The executing agency will open a bank account in U.S. dollars exclusively to manage Bank resources. Documentation supporting expenses incurred will be reviewed ex post by Bank staff and/or consultants and by the external auditors. Reports will be issued on each ex post review visit.

The exchange rate to be used to convert expenses incurred in local currency to U.S. dollars will be the rate prevailing on the payment date. Expenses that are ineligible for Bank funding will be reimbursed with the local counterpart or other resources, depending on the nature of the ineligibility.

4. Internal oversight and internal audit

The internal control environment, oversight activities, communication and information, and the monitoring of FR activities will be governed by Mexican regulations, which are based on the National Oversight System Law.

The internal audit function in FR consists of the internal oversight body (OIC), which reports directly to the SFP, independently of FR. Key staff of the office report to the SFP. The scope of OIC work does not generally extend to the projects. Nonetheless, under SFP regulations, the OIC is responsible for coordinating external audits and for following up the external auditor's recommendations.

5. External control and reports

FR has an external auditor appointed for a period of up to four years by the SFP (Gossler) to audit the entity's annual financial statements. The Bank has agreed with the SFP that it would be best for FR's auditor to also audit the program. This audit will be undertaken according to the general terms of reference harmonized with the SFP.

According to FR, there is an external auditor recommendation that remains to be implemented, namely integration of the budget and accounting systems on a single technological platform. This point is currently under study and analysis by FR.

Audit costs will be defined ex post, and it currently remains to be decided whether these costs will be financed from the loan proceeds or the national counterpart funding.

6. Financial supervision plan

Supervision activity	Supervision plan			
	Nature and scope	Frequency	Entity in charge	
			Bank	Third party
OPERATIONAL	Review of eligible portfolio with the executing agency	Periodic	Technical team	
	Ex post review of disbursements	Annual	Fiduciary team	External auditor
FINANCIAL	Financial audit	Annual		External auditor
	Review of disbursement requests and attached reports	Periodic	Fiduciary-financial team	
	Inspection visit/analysis of internal controls and oversight environment	Annual	Fiduciary-financial team	
	Annual allocation of budgetary funding needed for project execution	Annual	Fiduciary-financial team	Executing agency
COMPLIANCE	Submittal of financial statements	Annual	Fiduciary and technical team	External auditor
	Conditions precedent to the first disbursement	Once	Fiduciary and technical team	

7. Execution mechanism

Considering the execution mechanism described in the Proposal for Operation Development (POD), a financial management execution scheme will be needed, centralized through the executing agency. This will be responsible for annual formulation of the budget, both for the local counterpart and for the Bank's contribution. The executing agency will make payments and manage disbursements and funding justifications with the Bank; and it will coordinate all activities with the regional managers' offices. The corresponding processes will be clearly indicated in the project's operating manual.