Project Name | Mexico Savings & Rural Finance (BANSEFI) Phase III Project
Region | LATIN AMERICA AND CARIBBEAN
Sector | Banking (45%); Micro-finance and SME Finance (25%); General Agriculture (20%); Other Social (10%)
Project ID | P103491
Borrower(s) | UNITED MEXICAN STATES
Implementing Agency | BANSEFI, Mexico
Government of Mexico, Mexico
Environment Category | [ ] A [ ] B [X] C [ ] FI [ ] TBD (to be determined)
Safeguard Classification | [ ] S1 [ ] S2 [X] S3 [ ] SF [ ] TBD (to be determined)
Date PID Prepared | January 9, 2007
Date of Appraisal Authorization | January 22, 2007
Date of Board Approval | March 22, 2007

1. Country and Sector Background
Overview of Access to Financial Services. Access to financial services in Mexico is limited and costly. Penetration rate is low, with 74% of its municipalities, supporting 22% of its population, having no bank branch. Regional variations are intense with south/south-east and central regions having 87% and 77% of their municipalities without any bank branch. About 75% of Mexico is urban; yet 85% of the adult population in the urban areas (metro-cities) have had no dealings with the formal financial sector institutions. Participation rates in formal financial markets are below those in other Latin American countries of lower per capita income (e.g., Colombia, Peru). These are particularly low for both rural agriculture and non-agriculture enterprises, and very low for individual entrepreneurs and farmers, with household participation rates in the single digits for both savings and credit services.

The low level of formal financial services entails high transaction costs for the unbanked, particularly in areas relating to payments for utility services, remittances from abroad, cashing of checks by non-bank accounts holders (including transfer payments under government social programs, such as Procampo and Oportunidades), high interest rates on alternative credit, and low earnings on savings.

Almost 75% of Mexico City homeowners have borrowed funds for housing investment. Also, savings are maintained in informal avenues by a large proportion of both banked and unbanked segments. There is a demand for financial services with client-oriented features. Offer of such financial services from alternative sources such as Banco Azteca, providing unsecured loans at relatively high rates, and savings options with small deposit amounts at relatively low interest rates have been hugely successful notching up almost 2 million clients in two years of operation.

Clearly, there is an underserved but bankable population, and poverty is not the only factor resulting in low levels of access to financial services. Supply side factors such as inadequate points-of-service network, inappropriate financial products, cumbersome procedural issues relating to opening of accounts, minimum balance required in the accounts, among others, are equally important constraints.

Industry Structure and Reform Program. Institutional factors underlying the limited and costly access to financial services were a severe contraction of the banking system following the 1995 currency crisis, and until recently a non-bank savings and credit sector which, for the most part, was weak and unsupervised. Against this background, Government embarked on a strategy to strengthen all types of financial intermediaries, bank and non-bank.
The commercial banks reform resulted in significantly stronger banks following a vigorous consolidation phase. However, despite a 50% increase in assets over the last five years, deposit and lending activity actually declined, most banking products offered are for high-income clients, savings products offered by almost all banks would result in loss in value to a middle/low-income client, and bank branch location has clustered around business and high-income residential areas. The reasons for such a scenario are understandable: target clientele perceived to present special risks and challenges - informality, low capacity to generate bankable projects, lack of collateral, volatile income, low savings, high transaction costs - and servicing such clientele is perceived as risky and costly. The reform process did not facilitate the expansion of financial services to the underserved urban and rural population.

A number of legal and regulatory reforms were also initiated to improve the efficiency and transparency of development banks’ operations, notably, to orient them toward developing rural financial markets, limiting their capacity to provide subsidies, taking them out of deposit taking, and moving them toward a second-tier lending role. BANRURAL, the main rural and agriculture bank with first-tier lending is now liquidated, and FIRA, the second major player in rural and agriculture sector lending, is mainly a second-tier lender operating through commercial banks and SCI segment. Clearly, in terms of outreach and access to financial services, the impact of the reforms in the development banking segment is limited, since this segment operates mainly through commercial banks’ and the SCI branch network.

Government Strategy to deepen access to financial services. The existing SCI sector has a comparative advantage in expanding outreach since the sector is widely dispersed: only a small number of entities have a national presence; the great majority of institutions have a local presence. The sector, however, consists of about 600 institutions: not all are authorized to mobilize savings; not all are regulated and supervised; and they have various legal forms (cooperatives and associations, credit unions, among others). The sector is also characterized by deficiencies in accounting, governance and self-regulation aspects.

Creating a regulatory environment, and leaving the SCI sector to resolve its deficiencies over time could take an extraordinarily long time with high social, economic and political costs. The government launched a comprehensive strategy that combines legal and regulatory reforms with a substantial public investment in creating and strengthening capacity of the SCI institutions and the regulatory agencies for supervision. The total one-time sector upgrade investment is expected at about US$150 million.

Key legal and institutional reforms were initiated: Ley de Ahorro y Crédito Popular in April 2001 (which became effective on June 4, 2001), and the creation in the same year of the Banco del Ahorro Nacional y Servicios Financieros (BANSEFI), as legal successor of the Patronato del Ahorro Nacional, and with an enhanced development role vis-à-vis the SCI sector, acting as the nodal bank to channel and coordinate government assistance for sector strengthening. The Comisión Nacional Bancaria y de Valores (CNBV), already the regulator for banks and capital markets, became the sole regulatory and supervisory authority for the SCI entities, having the responsibility for issuing all regulations associated with the new law.

BANSEFI strategy to assist the SCI sector. The SCIs faced a deadline of June 2005 to meet the legal requirements for certification, which include adopting one of the two acceptable legal forms, purchasing private deposit insurance, having an accounting and financial management system that meets CNBV standards, regular reporting and supervision, demonstrated financial viability, and effective governance structures. Only those institutions which qualify were to be authorized to remain in operation.

Left to themselves, a very large number of SCIs would probably not have met the requirements for certification, and would have had to be liquidated. To maintain a reasonably robust sector size, which is crucial to achieve the objective of deeper penetration, and a wider access to financial services, BANSEFI launched a sector strengthening initiative since 2002, with support from the World Bank, through two parallel projects:
(a) Savings and Credit Sector Strengthening & TA Services Project (project cost: US$85.4 million; Bank finance: US$64.6 million). This first project was in line with the proposed government strategy, and consists of: (a) providing specialized technical assistance to the institutions to ready them for certification, or in a worst case scenario, for liquidation; (b) training sector staff in key areas of accounting, risk management, credit analyses, governance, and management; (c) developing capacity within the sector for regulation and auxiliary supervision; (d) testing a small pilot technology platform; (e) providing assistance to institutions in marginal areas to deepen outreach; (f) providing basic training and numerical literacy to poor, marginal and vulnerable communities; and (g) carrying out sector wide studies, and installing a strong M&E system to inform sector development policy. BANSEFI is administering this government investment off-balance sheet. The closing date of the project is December 31, 2007.

(b) Savings and Rural Finance (BANSEFI) Phase II Project (project cost: US$159.7 million; Bank financing: US$75.1 million) – This project was conceived based on the challenges that the SCI sector encountered resulting from the experience relating to the implementation both of the new law governing the SCI sector, and the first Bank-financed project. These can broadly be grouped as follows:

1. a higher than expected demand for the technical assistance program under the first project to assist entities with certification;
2. a need for second generation legal requirements to be put in place: accounting, deposit insurance, regulatory reporting, among others;
3. a need to address the longer term financial viability of assisted entities in the sector: identifying solutions to reduce transaction costs, enhance incomes, improve management and portfolio quality, and sector integration, particularly through technology upgrade; and
4. a logical follow-up to reinforce entity certification with initiatives to achieve the objective of deepening sector penetration to reach out to the underserved population, partly through technology and partly through a portfolio of financial products which is responsive to the needs of the underserved population, including field-testing some products for refinement and wider adoption.

The phase II project complemented the first project with its continued focus on: (a) providing specialized technical assistance to the institutions to ready them for certification, or in a worst case scenario, for liquidation, including creating a deposit protection fund; (b) training sector staff in key areas of accounting, risk management, credit analyses, governance, management, and technology platform-related aspects; (c) developing capacity within the sector for regulation and auxiliary supervision; (d) providing for scaling up of the pilot technology platform tested under the first project; and (e) carrying out sector wide studies, and supplementing the M&E system installed under the first project to inform sector development policy. BANSEFI is administering this government investment off-balance sheet. The closing date of the project is January 31, 2009.

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1 The consultant carries out the diagnostics and classifies the entity into one of the four groups: A: Institution ready for certification; B: Institutions that will have to implement a stabilization program before they will be eligible to apply for authorization; C: Institutions that require overhaul and financial support to strengthen their capital. This includes institutions that will require a merger, spin off, or major reorganization process; and D: Institutions that are incapable of meeting the minimum requirements for certification, and will have to be liquidated or dissolved.

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Due to legitimate reasons (discussed later in this document), the Phase II project is experiencing a cost overrun, and the Government of Mexico has requested an Additional Financing loan of US$29.0 million to finance the cost escalation of US$34.8 million. The development objective of the Phase II project continues to remain relevant, but its achievement would be compromised without the proposed additional financing loan.

2. Project Development Objective and Indicators

Project Development Objective. This remains unaltered since the proposed loan is to meet the cost escalation in existing components of the Phase II project, and is as follows: The project will help the government of Mexico develop a robust SCI sector, consisting of a large number of entities which are compliant with the law, financially viable, operationally effective, managerially sound, technologically upgraded, and having an enhanced level of outreach and access to financial services by the underserved Mexican population.

Key performance indicators remain unaltered as follows:
- About 195 entities assisted under the project certified by CNBV to operate as independent or merged entities, or identified for liquidation; and an additional 40 entities with appropriate plans and/or implemented strategy to deepen penetration and outreach;
- Procedures for liquidation of unviable entities initiated by the government (could be about 10% of the universe of 420 entities assisted under this and the on-going project);
- Deposit Protection Fund established for at least one Federation/Confederation;
- At least 45% market penetration for the Technology Platform achieved (about 100 of the 240 entities in the resulting consolidated sector adopt the platform);
- At least 90% of the participating entities show satisfactory outcomes in accounting and governance aspects (internal controls), as evaluated in the process of auxiliary supervision implemented by the CNBV and the supervision committees at federation level; and
- Clients of the sector increased from 4 million to about 9 million.

The National Development Plan of Mexico envisions the Mexican economy to demonstrate, among others, the two key attributes of human development and competitive growth. These two attributes are represented in the three objectives of: (a) increasing and expanding competitiveness; (b) promoting balanced regional development that includes all population segments; and (c) increasing equity and equality of opportunity. The 2004 Country Assistance Strategy (FY 2005 through FY 2008) supports the Mexican government’s efforts to achieve these three objectives through initiatives under the two broad themes of: (a) reducing poverty and inequality; and (b) increasing competitiveness.

Reducing poverty and inequality. The CAS highlights incidence of acute poverty in rural areas, and a skewed regional development. It suggests improving access to financial services to enhance the poor’s ability to save, invest and manage risks. It also recommends that sustainable poverty reduction should go beyond mere human capital development, and suggests economic empowerment of the poor by helping them to build physical and financial assets that would provide a means to better cope with economic shocks.

Increasing competitiveness. The CAS also indicates that a broad-based financial sector is crucial to enhanced competitiveness, and suggests access to financial services for individuals, entrepreneurs, small and medium enterprises, and the agriculture sector to achieve: (a) competitiveness with increased employment opportunities and improved income distribution; and (b) a more regionally balanced development.

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3 The on-going project supports TA for about 375 entities; about 150 of these entities require more intensive and in-depth TA for which funds are not available under the on-going project. These are being supported under this project. About 40 of the 375 entities are ready for more strategic inputs focusing on improving access and outreach, for which too funds are a constraint under the on-going project. These entities will be supported under this project. About 45 entities have indicated their desire to seek TA for the first time.

4 About 40 entities are expected to be liquidated in total, about 20 under each project.
The proposed operation clearly supports the 2004 CAS objectives. It will: (a) deepen the outreach of the non-bank financial sector, and widen access to financial services by the underserved Mexican population, particularly in rural areas; (b) promote “bancarization” of hitherto unbanked segments of the population and economic units, integrating them into the global economy; and (c) facilitate monetization of physical assets, contributing to financial empowerment. It builds on the financial sector strengthening objectives embodied in the Bank Restructuring Facility Projects (Number 67491 and 71323), the Rural Finance Development Structural Adjustment Loan Project (Number 74655), and the on-going Savings and Credit Sector Strengthening & TA Services Project (Number 70108). It also complements the other proposed financial operations identified in the 2004 CAS to reform the development banking institutions, and is in line with the suggestions emanating from recent sector work studies.

3. Rationale for Bank Involvement

Innovativeness of the government policy. The government strategy has a number of very innovative features. It is holistic, and covers a range of issues relating to prudential oversight, auxiliary supervision, deepening outreach, legal reform, institutional reform, technical assistance at the SCI entity level, strengthening regulatory and supervision capacity. It blends public sector action and private initiative, focusing on sustainable and profitable SCIs. It attempts to improve the financial viability of small SCIs by centralizing services that offer economies of scale at BANSEFI and the federations/confederation level. In this sense, the policy approach seeks a balance between cooperation and competition. Moreover, the approach also seeks to enhance the social policy program implementation, by linking social transfers (Oportunidades and Procampo) to “bancarization” of the poor (opening bank accounts to effect such transfers), mainly through the technology platform. It is an initiative worth partnering with the government of Mexico.

On-going Bank support to implement the policy. The Bank has endorsed its support to this sector development policy through interventions under the on-going project. The Bank had also agreed during the preparation of the on-going project that the requirement of technology upgrade would be addressed in a parallel/follow-on project. The rationale for this project is justified on two grounds: (a) to complement the technical assistance program initiated under the on-going project to ensure that the objective of having a robust number of certified entities in the sector is achieved; (b) to invest in “public good”, namely, technology, to have minimum standards of accounting and reporting in the sector entities through homogenous accounting and financial management systems, to improve the credibility and cost-effectiveness of regulatory supervision, to make the sector more efficient, cost-effective, integrated, and inter-linked, and to achieve the broader development objective of enhanced outreach and access to financial services.

The technical assistance program is a once-and-for-all “smart” subsidy. Given the initial diverse financial health of the SCIs, a reimbursable technical assistance approach could have excluded potentially certifiable SCIs willing to, but unable to, afford these services required to meet certification standards. Developing the technology platform represents a public good investment for orderly sector development, which will be offered for adoption by the entities as a “fee-for-service” proposition. In the absence of this public-good investment, the technology needs could be met by individual entities but at varying levels of quality and cost, compromising: (a) system credibility; (b) possibility of improved financial performance; (c) economies of scale in procurement; and (d) the objective of deepening outreach.

Comparative advantage of the Bank. There are three value propositions which place the Bank in a position of comparative advantage to operate in partnership with the government of Mexico in its effort to reform the SCI sector: (a) a good understanding of the Mexican financial sector; (b) considerable international experience on various aspects relating to this sector; (c) the two BANSEFI projects which are under implementation; and (d) a portfolio of other completed and on-going projects in this sector in Mexico.

Understanding of the Mexican financial sector. The Bank has been actively involved in stabilizing and strengthening the financial sector, and in improving access to productive opportunities in poor and rural areas in Mexico over the last decade, supporting operations and sector work in banking, pension, insurance and capital markets, as well as rural development
programs. The Bank has also done considerable sector work notably the 2002 FSAP (joint with the IMF), the Rural Finance Savings Mobilization study (Report 21286-ME, 2001), the Mexico Policy Notes, Finance (2000), and the on-going, Mexico City-Access to Financial Services for the Poor. The project capitalizes on the Bank’s reservoir of Mexican financial sector knowledge.

**International experience in financial sector aspects.** The Bank has: (a) an in-depth knowledge of regulatory, supervision, legal and banking environment elsewhere in the world, including other countries in this region; (b) accumulated considerable international experience in working with banks on payments systems, automation of operations, and the technology associated with extensive service networks; (c) international experience in rural and micro-finance sector and related institutions; and (d) an understanding of the deposit insurance and institutional capacity building needs in the financial sector elsewhere in the world.

**Portfolio of projects in Mexican financial sector.** The Bank has assisted with several projects. These include: the completed Bank Restructuring Facility projects, the Savings and Credit Sector Strengthening & TA project, the Savings and Rural Finance (BANSEFI) Phase II project, the Rural Finance Development SAL (supporting the liquidation of BANRURAL and the concomitant creation of the Financiera Rural), and a loan in support of reforms in housing finance market. All of these projects have assisted, or are assisting, with the strengthening of the financial sector, including SCI segment, to deepen outreach, and expand access of financial services to the underserved Mexican population. This project will promote Bank portfolio synergy in this sector.

**4. Project description**

All three components of the Phase II project, which are crucial to the achievement of PDO, and which are expected to experience a cost overrun, comprise the proposed project. These components are expected to be completed within the original project closing date of January 31, 2009. The escalation of US$34.8 million (Bank share: US$29 million), broken down by components, is as follows: (a) Technical Assistance to Institutions: US$6.7 million; (b) Information Technology Platform: US$26.7 million; and (c) Information Dissemination: US$1.4 million. The causes of cost escalation, and the description of the proposed components, are provided below.

**Component 1:** Technical Assistance to Institutions to prepare them for certification by the regulatory authority (CNBV) US$6.7 million (Bank share: US$5.6 million). The Ley de Ahorro y Credito Popular (LACP) provided a four year period to the sector institutions to demonstrate financial viability and compliance with the legal requirements, to subject themselves to regulation and supervision by the nodal agency (CNBV), to purchase deposit insurance, and to be affiliated with an authorized federation as some key pre-requisites for certification by CNBV.

The project focuses on this key aspect of certification and supports an assessment of institutions to determine whether these qualify for certification, require technical assistance to strengthen or restructure them for certification, or need to be liquidated, based on a set of agreed evaluation criteria. The Phase II project uses expert technical assistance providers to assist the institutions for certification or liquidation.

Due to the difficulties encountered in the certification process (heterogeneity among the sector entities, varying levels of information availability, inadequate governance and internal control systems, a range of accounting systems being deployed, need for accounting migration, valuation of assets, move towards an inflation-based accounting system, compliance with various financial and prudential norms, among others), in May 2005, the government extended the July 2005 deadline for certification by 3.5 years, up to December 2008, but only for those institutions which, by December 2005, were found eligible to remain in the TA program based on a revised evaluation methodology. Those institutions not found to be eligible for continued participation in the program for certification were required to wind down their operations starting January 1, 2006. This notification resulted in:
(a) the TA consultants having to devote close to six months from their existing assignment period to establish the eligibility of the institutions to continue in the program;
(b) an increase in the number of institutions seeking TA from 375 to about 425, as many institutions perceived this as a last opportunity to receive TA and remain in the sector. There are an additional 50 institutions that are awaiting a favourable response from the new government before deciding to participate in the TA program; and
(c) the need to extend the TA assignments since the law required the institutions to be offered technical assistance during this extended period (both for certification and liquidation). The government was obligated to extend the TA assignments beyond their current 2006 completion dates.

Extension of these TA assignments already awarded under Phase II project up to December 2008 would result in a need for additional US$6.7 million (Bank share: US$5.6 million). The TA activities would be focused on the following three groups of institutions:

(a) institutions already receiving TA where the assistance period has now been extended;
(b) institutions seeking TA for the first time, including those that may yet enter the program following a favorable response from the new government; and
(c) institutions those are not eligible to receive further TA for certification, but which will require TA for liquidation. This also includes institutions which are eligible for TA for certification at this stage, but which may fail to meet the certification threshold in the coming months, and therefore require liquidation.

The technical assistance will also extend to federations to which the institutions are affiliated. These federations have the obligation to work closely with the TA providers to prepare the required documentation for certification. The federation managements have to undertake auxiliary supervision through their authorized Supervision Committees for member institutions that are already certified and forward reports to the regulatory agency. There is also a need to provide technical back-stopping to the supervision committees to ensure high quality supervision.

Component 2: Information Technology Platform US$26.7 million (Bank share: US$22.2 million). The Technology Platform is crucial component of the overall sector reform process in that it provides BANSEFI and the institutions with a comprehensive range of computer-based tools to: (a) comply with the new regulations at a relatively low cost; (b) facilitate and support a wide range of product offerings such as low cost remittance services, card-based services, and delivery of government programs such as Oportunidades and Procampo; and (c) support day-to-day operation and management decision-making leading to profitable and sustainable growth of the sector institutions.

The technology platform is a home-grown solution to address the regulatory, accounting, management, and reporting requirements of this sector. A pilot was tested under the first project, and the Phase II project was to have scaled it up to the SCI sector entities. From the outset, the original cost estimates have been viewed as being subject to change with evolving knowledge as to the availability of suitable safe, secure, cost effective and practical technical solutions. For example, it was not possible to estimate with any certainty the specific technical solution and costs that would attach to the provision of the essential data center services, including even the location of the data center. A second example of uncertainty related to the amount of calendar time and practical support that would be required by entities to prepare for and use the new products and services. This is a critical factor as merely providing a modern and comprehensive range of banking, administrative and decision support tools will not assure the delivery of the intended benefits. Initial experience has shown that a much more substantial effort, than originally planned, is required to assist management and staff at the participating entities to institutionalize the new mechanisms. All of these experiences are now behind the project, and a realistic determination of the costs has now been made. In addition, there were issues relating to the performance of the technology provider (IBM) which were resolved satisfactorily following BANSEFI and Bank escalating these to the corporate office of IBM. Having surmounted most
obstacles, the platform today is operational and can support a basic financial intermediary institution’s products and operations.

BANSEFI has been alert to the problems of cost uncertainties and has been monitoring this component under the Phase II project very closely with assistance from an external quality control consultant. Factors contributing to a cost overrun can be grouped into three broad categories:

(a) System complexity: the initial state of the system could not be perceived and conceived precisely by the technology providers, little documentation was available to implement changes, deployment in the diverse institutions turned out to be more complex than anticipated requiring more time, and the technology provider faced considerable difficulty in recruiting specialists with appropriate skills-mix in the required numbers;
(b) Additional functional requirements: these emanated from standard products (operation in different currencies, card platform mode), and new product functionalities (inter-institutional money transfers, hand-held system interface with the platform); and
(c) Changes in configuration: moving from the original three-tier to two-tier architecture using front-end Citrix servers, need for additional mainframe capacity than originally anticipated, need for additional equipment not originally anticipated (cryptographic equipment for cards platform).

An additional US$26.7 million (Bank share: US$22.2 million) is required to make the platform fully functional for small, medium, and large institutions, iron out problems relating to financial product offerings, and address aspects relating to architecture. Expenditures are quantified along four major areas of use/application:

(a) Implementation of additional requirements: the costs associated to the implementation of unplanned requirements within original contract scope of the technology providers, and the costs associated with the implementation of new products/services and/or features beyond the original scope of work of technology providers;
(b) Operating costs for 2006 and 2007: operating expenses of the production environment for the institutions that use the system during the launch period; and the cost of personnel involved in the management of the project, the deployment of the system in institutions, and the management of the operation and production environment;
(c) Computing infrastructure: cost of incremental capacity required to maintain operation with project’s scale and volume, and additional infrastructure derived from changes in configuration; and
(d) Additional administrative expenses: expenses related to the cost of additional external quality audits to support the management of the project.

Component 3: Information Dissemination US$1.4 million is estimated for this activity (Bank share: US$1.2 million). With the technology platform becoming functional, there is a need to market the ATMs, debit and credit card products that the institutions will be offering to the clients. This will deepen the outreach of the participating institutions to the poorer regions of Mexico and also provide a revenue earning source for the technology platform to make it self-sustaining in the medium-to-longer term. An additional

**5. Financing**

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<thead>
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<th>Source:</th>
<th>Phase II (SM)</th>
<th>Proposed Additional Financing Loan (SM)</th>
<th>Total (SM)</th>
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Financial Viability with the AF Loan. The detailed financial and economic analysis of the project with the additional loan would be done at the time of the Project Paper preparation. A preliminary assessment at this stage suggests that the outcome would be robust.

The Phase II project was expected to generate a net NPV of US$33 million at a 12% discount rate, based on a key assumption that this revenue stream would emanate from about 240 institutions eventually comprising the consolidated sector. Given the present certification situation, the sector could end up with an additional 30% institutions, translating into an incremental aggregate revenue stream ranging between US$75-100 million. Even after factoring the expected cost escalation of US$34.8 million, a quick sensitivity analysis indicates that the net present value of the cash flows at the project level would nearly double, with a significant positive effect on the aggregate project level IRR.

6. Implementation
Project duration, execution and oversight. The project will run concurrently with the Phase II project, and close on January 31, 2009. BANSEFI will continue to be the executing agency for the project, and oversight will be provided through the same Core Team, already created and operational under the Phase II project.

Project implementation and management. All of the project activities will be implemented through consultants and hardware/software service providers, and managed/coordinated through appropriate departmental teams within BANSEFI. Procurement and financial management, including accounting, disbursement, financial reporting, and auditing will be the responsibility of the department of Accounting & Finance, under the overall guidance of the Finance Director.

Accounting and Financial Management. The World Bank financial management team has supervised the Second phase of the Savings & Rural Finance (Phase II) Project and the Savings and Credit Strengthening and Rural Microfinance Capacity Building Project, both implemented by BANSEFI. This supervision work involved ensuring that the arrangements of both projects allow for an appropriate level of transparency that facilitates oversight and control while also supporting smooth implementation.

The Bank has been receiving satisfactory audit reports for both projects (taking into account the TOR for each audit, the acceptability in terms of quality and independence of the auditors, and the timeliness among other factors). The auditor’s opinion for both projects has been “unqualified” and the auditors did not identify any major issues during their reviews.

Based on the supervision work and the audit reports, the regional financial management team (LCSFM) concluded that: (a) the FM arrangements for both projects continue to be adequate and provide reasonable assurance that Bank loan proceeds are being used for the intended purposes; (b) BANSEFI’s experience with Bank projects has contributed to a satisfactory work on financial management, and as financial agent, has provided implementation support and oversight based on its many years of experience; and (c) the FM arrangements under the existing projects are commensurate to the needs of the activities under the proposed Additional Financing loan.

Procurement. An ex-post review of procurement activities relating to Phase II project and the Savings and Credit Strengthening and Rural Microfinance Capacity Building Project, both implemented by BANSEFI, was completed in October 2006. The ex-post review conclusions were satisfactory, and indicated that BANSEFI’s procurement team is well-prepared and has enhanced their experience and understanding of procurement related issues. The procurement system installed by BANSEFI allows a satisfactory monitoring, reporting and record keeping of transactions.

For the purposes of activities relating to the Additional Financing loan, it was concluded that: (a) the existing procurement staffing arrangement and capacity is adequate; and (b) the existing procurement system is acceptable.
The existing project Operational Manual will be updated to reflect the changes in the Procurement and Consultant Guidelines (May 2004). A global procurement plan is under preparation, and a specific procurement plan for the first 18 months will be in place no later than January 31, 2007.

Disbursement. The project will continue to use the Phase II project Special Account, and the disbursement arrangements already in effect under the Phase II project.

7. Sustainability
Appropriate mechanisms have been built into the Phase II project to ensure that benefits emanating from interventions as a result of that project, and the proposed Additional Financing loan, are sustained beyond the project period.

Institutional and SCI entity sustainability. The focus of the project is to strengthen the SCI sector and develop sustainable mechanisms for improved financial services provision. Entities are being supported through technical assistance to develop and implement work plans for their long-term financial sustainability. In addition, through the technology platform, the financial viability of the institutions will be further strengthened by reducing transaction costs, improving revenues, and enhancing the quality of management through better MIS and reporting. Supervision capacity will be improved both at the federation and CNBV level which will enable early warning signals to be provided in case of weak entities. Support is also being provided through international experts on the establishment and operationalization of a Deposit Protection Fund. These measures, together with the prudential regulations issued by CNBV, and regular auxiliary supervision by the federations, enhance the probability of long-term sustainability of the SCI entities.

Financial sustainability. The financial sustainability of the entities will be achieved as discussed above. The initial investment in technology provision to the entities is being funded by the project, including the licensing fees for the first three years before the intervention reaches a “stable state”. All operating expenses will be financed by the entities through a “fee-for-service” scheme based on terminal/transaction hybrid mechanism. An analysis of the incremental financial implications for the entities shows that the technology service will generate enough revenues for the entities to meet the operating costs, and still be a financially rewarding option to be sustained in the longer-term. BANSEFI will embrace this service as a future business proposition.

Technical sustainability. This relates to the technology intervention. The core technology platform is appropriate from the technical and operational perspective. The arrangements for hardware, data center, VPN, and connectivity will all be based on “service level” adherence by the service providers to ensure a high level performance. The fee-for-service structure will provide adequate funding for the technical maintenance of the platform. Appropriate support services will be available to assure all participants of technical back-stopping using a combination of skilled implementation support and continuous full-service helpdesk personnel, from federations, BANSEFI and external service providers.

BANSEFI has already established a team of IT professionals to support the design, management, implementation, and maintenance of the platform. This team will gradually expand and get transformed into a business unit, as the technology platform is implemented on a larger scale, to provide a pool of central technical experts, for the entire SCI sector, to monitor the performance of the project technology intervention, review its relevance periodically, and plan and initiate measures for its upgrade in the future.

8. Lessons Learned from Past Operations in the Country/Sector
International experience and best practice indicate the need for an effectively regulated and supervised non-bank sector as a precondition for sound growth of these financial intermediaries. Lessons have been drawn from the Canadian and German systems of delegated supervision to provide cost-effective prudential oversight for the large number of SCI intermediaries.

The Rural Finance TA Loan which closed in late 1999, and some on-going projects in Mongolia and Vietnam provide important lessons regarding the development of more broadly accessible
financial services: (a) collaborate with those financial intermediaries which are already working with clients from a broad range of income groups and geographic areas, including poor and rural households, and for whom the incremental costs of extending client outreach are lower; (b) design the technical assistance component based on the expressed demand of institutions; (c) market the institutions to the clients to engender confidence in the sector and the system; and (d) develop financial products responding to specific client needs. The project design incorporates all these features.

Finally, financial viability of the institutions is crucial to ensuring that no future funding is required to sustain them. In this regard, technology has been identified as an important intervention to improve efficiency, reduce operational costs, deepen the outreach of the institutions, and enhance income streams. Two key considerations (apart from technological integrity) are as follows: (a) the facility needs to be provided on a centralized basis to obtain economies of scale, and be offered to all requesting entities in a spirit of “cooperation and competition”; and (b) the entities should meet all operating expenses as a full-cost recovery strategy to sustain this intervention in the post-project period. The Phase II project design incorporates both these features.

9. Safeguard Policies (including public consultation)

<table>
<thead>
<tr>
<th>Safeguard Policies Triggered by the Project</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>Environmental Assessment (OP/BP/GP 4.01)</td>
<td></td>
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<tr>
<td>Natural Habitats (OP/BP 4.04)</td>
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<td>Pest Management (OP 4.09)</td>
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<td>Cultural Property (OPN 11.03, being revised as OP 4.11)</td>
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<td>Involuntary Resettlement (OP/BP 4.12)</td>
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<td>Indigenous Peoples (OD 4.20, being revised as OP 4.10)</td>
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<td>Forests (OP/BP 4.36)</td>
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<td>Safety of Dams (OP/BP 4.37)</td>
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<td></td>
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<tr>
<td>Projects in Disputed Areas (OP/BP/GP 7.60)*</td>
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<tr>
<td>Projects on International Waterways (OP/BP/GP 7.50)</td>
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</table>

Environment: The Phase II project does not have any adverse impact on environment, and has been rated a "C" category project. The Additional Financing loan is merely a cost-escalation proposal for Phase II project components, and has no new restructured or scaling-up activities which would affect this rating.

Provisions made by the project to ensure compliance with applicable safeguard policy - OP 4.10 (Indigenous Peoples): This is the only safeguard policy that is triggered under the Phase II project. There is full compliance with this requirement. Simplified IPDPs have been prepared and disclosed as required for the seven identified marginal regions, and are an input into the Social Development Model (SDM) which uses consultations with identified groups to ascertain their perceptions on savings, credit, and mechanisms to improve their participation in the project. The output of this SDM is to be used by the technical assistance consultants to formulate appropriate strategy for those institutions that are ready for certification and need assistance specifically to deepen outreach and widen access to financial services. This sub-component under the Phase II project has, however, yet to be implemented at the institution level due to upstream delays in the certification process.

Integrated Safeguards Data Sheet: This is a cost overrun Additional Financing loan, and the loan would be used to complete the original project activities covered under the existing Phase II project. The ISDS for the Phase II project continues to remain applicable “as is” to the Additional Financing loan.

10. List of Factual Technical Documents

* By supporting the proposed project, the Bank does not intend to prejudice the final determination of the parties' claims on the disputed areas
Bank Staff Assessments
  • Financial Management Capacity Assessment Report, January and March 2004
  • Procurement Capacity Assessment Report, March 2004

Technical Note Prepared by BANSEFI for the Additional Financing Loan

Cost Tables, Future Projections, and Financial Projections “With” and “Without” Project Scenarios for Economic and Financial Analysis (April 2004 – to be updated)

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