MULTISECTOR GLOBAL FINANCING PROGRAM

(CH-0157)

EXECUTIVE SUMMARY

BORROWER:	Republic of Chile
EXECUTING AGENCY:	Corporación de Fomento de la Producción (CORFO)
AMOUNT AND SOURCE:	IDB: (ordinary capital) US$240,000,000 Local counterpart funding: US$160,000,000 Total: US$400,000,000
FINANCIAL TERMS AND CONDITIONS:	Amortization period: 20 years Commitment period: 3 years Disbursement period: 4 years Interest rate: variable Inspection and supervision: 1% Credit fee: 0.75% on the undisbursed balance Currency: United States dollars from the Bank's Single-Currency Facility
OBJECTIVES:	The proposed operation will provide medium and long-term financing for financially and economically viable projects undertaken by SMEs in the private sector. It represents the continuation of support under a credit facility created through a similar, earlier program that was financed in part by the Bank. The funding to be provided will comply with the additionality criterion, i.e. will not be used as a substitute for financing available from other sources.
DESCRIPTION:	The program is intended to provide a responsive and flexible source of financing to enable SMEs to obtain medium and long-term funding for investment and related working capital requirements. Resources from the facility may be used to finance: (i) investments such as machinery, equipment, installations, construction, plantations and services associated with such investments; (ii) working capital associated with a project, most of which would be covered by the local counterpart contribution; (iii) financing lines in support of commercial leasing, both financial and operating; and (iv) exports.

Private SMEs will be defined as those with annual sales of up to US$30 million. Borrowers will not be allowed to exceed a total outstanding balance equivalent to US$5 million.

CORFO would use the program funds to make loans to banks and leasing companies that qualify as intermediary financial institutions (hereafter IFIs), in accordance with the program's credit regulations. The IFIs will in turn use these funds to finance eligible investments.

Loans to the IFIs would be denominated in local currency, indexed to UFs (Unidades de Fomento) or US dollars. The borrower will assume the exchange risk the between the US dollar, the currency in which the Bank loan will be denominated, and operations denominated in UFs. Interest rates on loans to the IFIs will be variable or fixed. In the latter case, the Bank will be advised of the procedure for determining the spread of fixed rates over variable rates before any loans of this kind are made, and the application of this procedure, as well as any subsequent amendments thereto, must carry the concurrence of the Bank.

Loans provided by CORFO to the IFIs will be allocated under the following procedures: (i) leasing operation funds will be awarded at auction, according to the best rates offered for each term; and (ii) other transactions will be discounted at market rates, in accordance with their term and currency. The cut-off rate for bids will be set not lower than average market lending rates. The Bank will be advised of the procedure for setting these rates before the first bids are called, and its application, as well as any subsequent amendment, must have the Bank's concurrence.

ENVIRONMENTAL REVIEW: The Environment and Social Impact Committee (CESI) reviewed and approved this operation at its meeting of November 13, 1998. The CESI recommendations have been included in the proposed loan and the credit regulations (paragraphs 2.32, 2.33, 3.31 and 3.32). Mechanisms have been set up to identify projects with potential environmental impact, and the credit regulations exclude the procurement of goods involving technologies that pollute. Since the operation is targeted to SMEs, social impact will be positive.

BENEFITS: The additional resources to be provided under the proposed program will facilitate financing for SME

investment projects, and this will have a significant impact on increasing output and employment. The availability of medium and long-term funds will provide an incentive to the financial system to grant credit to SMEs, thereby allowing them to strengthen and expand their operating capacity and introduce modern technologies into their productive processes. In addition, it will help the IFIs to diminish the current mismatch between sources and applications of funds.

The program takes on particular importance in the current situation, as the supply of loanable funds for SMEs at appropriate terms is declining. By bringing the allocation of credit more closely into line with the operating realities of participating IFIs, and adopting new IFI selection criteria, the program will help make better use of financial resources in fulfilling program objectives.

RISKS:

Any disruption of the current macroeconomic context of price stability, as a result of exogenous factors, could discourage investment and the demand for credit, and could act as a disincentive for the financial system to grant loans to the target group. Nevertheless, the national government's commitment to the principles of a free market and an open economy, and its determination to maintain current policies, should considerably reduce the prospects for any such change, even under the pressure of external economic events.

THE BANK'S COUNTRY AND SECTOR STRATEGY:

The proposed program is consistent with the Bank's 1996-1998 strategy for Chile, one priority of which is to finance programs aimed at expanding productive investment in the private sector and enhancing its export capacity through gains in competitiveness.

In this context, the government intends to strengthen the availability of medium and long-term credit for small and medium-sized enterprises. The present operation will support this government objective, by expanding and consolidating the progress made under the previous multisector credit program, with respect to both the expansion of financing and the consolidation of support for the target group.

POVERTY TARGETING AND SOCIAL SECTOR CLASSIFICATION:

This program is not poverty-targeted.

SPECIAL CONTRACTUAL CONDITIONS:

Prior to the first disbursement: (i) the borrower must issue appropriate legal regulations to establish the conditions for transferring funds to CORFO, and the obligations of both parties (paragraph 3.1); and (ii) CORFO must submit evidence that the credit regulations agreed with the Bank are in force (paragraph 3.5).

Within 12 months after the first disbursement by the Bank, the borrower and the Bank must review the program objectives and achievements and the interest rates applied to subloans (paragraphs 3.39 and 3.40), as well as the environmental assessment and control procedures (paragraph 3.32). The disbursement schedule will be as indicated in paragraph 3.38.

The borrower has requested that the Bank recognize expenditures (lending) incurred since October 27, 1998 and anticipated prior to approval of the financing. The project team considers that the Bank could recognize up to US$41.6 million as part of the local counterpart contribution (paragraph 3.45).

EXCEPTIONS TO BANK POLICIES:

None.

PROCUREMENT:

Not applicable.

I. FRAME OF REFERENCE

A. Macroeconomic context

1.1 Over the last two decades, Chile has pursued a strategy of a more open economy and free markets. The country has undertaken in-depth programs of structural reforms, eliminating serious bottlenecks and distortions that were limiting the responsiveness of the private sector. This strategy has helped to improve the productive potential of the economy both directly, thanks to the dynamic export sector, and indirectly, thanks to the external financing that businesses and banks have been able to raise on international capital markets. As well, the inflation rate has been significantly reduced, from 27% in the early part of the decade to 4.7% in 1998.

1.2 Although the fundamentals of the Chilean economy are sound, the financial crisis that began in Asia has had an impact, primarily through its negative effects on external trade and on the capital account, and the rate of growth has accordingly had to be moderated until stability is restored to international markets. The effect of instability in international trade has been felt in lower export volumes and lower prices for most export products. In 1997, roughly 33% of total exports (US$17.0 billion) were directed to Asian markets, a percentage that is much higher than that recorded in other countries of the region.

1.3 The decline in export prices has been most notable for mining products, primarily copper, the price of which fell from US$1.19 to as low as US$0.68 per pound in November 1998. The slower pace of growth in the value of imports, due in particular to falling prices for hydrocarbons, was insufficient to offset the net effect on the international trade balance or the terms of trade. In fact, during the first half of 1998, export prices fell further than import prices. As a result of these factors, the trade deficit stood at US$2,495 billion in December 1998, the highest deficit recorded since 1986. The current account deficit reached US$5.0 billion (6.2% of GDP) in 1998.

1.4 The fragile state of the world economy has led the government to adopt a disciplined and prudent approach in the formulation of economic objectives. The government program seeks to maintain confidence in the country's macroeconomic financial stability, by keeping the current account deficit on a sustainable path over the medium and long term, consolidating progress to date in reducing inflation, and maintaining a rate of economic growth consistent with this context.

1.5 International market volatility has forced the central bank to adopt a monetary policy that included raising interest rates and selling international reserves. At the same time capital inflows

have declined since early 1997, with the perception of Chile's weaker growth prospects. In the first six months of 1998, international reserves fell by US$2.29 billion. Despite this decline, reserves stood at US$15.55 billion in June 1998, equal to approximately 10 months of imports.

1.6 In October 1998, the "Tariff Reduction Law" was promulgated, under which the average customs tariff rate will be gradually reduced from 11% to 6% between 1999 and 2003. As result, Chile will become one of the most open economies in Latin America in terms of its trade regime. The new law will reduce production costs by expanding the variety and availability of intermediate inputs and capital goods, and the accelerated inflow of modern technology will encourage national economic development. The 1% drop in annual revenues occasioned by lower tariffs will be offset through higher taxes on tobacco, gasoline, and revenue stamps and seals, which will come into effect at the same time as tariffs are being reduced.

1.7 Private investment declined significantly between 1997 and 1998, to judge from two variables: imports of capital goods and new housing starts. Imports of capital goods for the first nine months of 1998 were 25% lower than those recorded for the same period in 1997. The number of new housing starts approved in the first eight months of 1998 was also lower than that recorded for the same period of the previous year. The reduction between January and August 1998 was 12%.

1.8 For 1999, GDP is expected to grow by approximately 2%, lower than the rate recorded in recent years. This slower growth can be ascribed to the international context described above, with depressed world demand and smaller inflows of foreign capital. In this respect, it is deemed essential to maintain a favorable environment and an economic policy stance compatible with sustained economic growth, and the government will continue to pursue its current policies to this end. A program of the type proposed will help to sustain the flow of funding for private investment, by facilitating medium and long-term financing for investment projects in the productive sectors.

B. The financial system

1. General considerations

1.9 The banking sector includes 29 institutions, of which 16 are foreign-owned and 13 are domestic. This number includes the Banco del Estado, which operates as a commercial bank in all areas of business and has investments in subsidiary companies, one of which is engaged in leasing. In addition, there are three finance companies that are entitled to take public deposits, except in the form of current accounts. Their market share is less than 2%, and their activities are focused on consumer credit. In the leasing

area, there are 21 companies of which 13 are bank subsidiaries. The latter are regulated by the Superintendency of Banks and Financial Institutions (SBIF), while the former, like other corporations in general, are supervised by the Superintendency of Securities and Insurance.

1.10 An important and long-standing feature of the system, particularly of the banks, is the fact that most of their funding is raised on terms of less than 1 year. The shortage of long-term deposits has led to a concentration of short-term lending; and this has kept the portfolio of investment loans at low levels, since they require financing at relatively long maturities, especially for projects undertaken by medium and small-scale enterprises.

1.11 Some 96% of deposits from the public are in local currency, roughly one half of them denominated in UFs. The UF (Unidad de Fomento) is a financial unit of account that is adjusted periodically to reflect changes in the consumer price index. In this way, the spread over the UF always constitutes a real interest rate.

2. The new General Banking Law

1.12 The General Banking Law promulgated in November 1997, makes significant changes to the previous regime, including the following:

(i) **Banking licenses**. Under previous legislation, the SBIF had full discretion to approve the start-up of new banks. In contrast, the new law makes such approvals subject to a set of criteria relating to the solvency and integrity of the founding shareholders. The same conditions are reviewed whenever an individual seeks to acquire 10% or more of the equity of a financial entity. As well, the minimum capital requirements for establishing new units in the financial system were doubled, and now stand at the equivalent of US$24.0 million for commercial banks and US$12.0 million for finance companies.

(ii) **Basle criteria**. The previous requirement to maintain liabilities and deposits below a ceiling of 20 times paid-in capital and reserves was replaced by the requirement to maintain a minimum ratio of 8% between net worth and risk-weighted assets. Net worth includes base capital, subordinated debentures not exceeding 50% of base capital, and voluntary reserves up to 1.25% of risk-weighted assets.

(iii) **New classification**. Banks and financial institutions are classified in five categories, based on solvency and performance indicators. To be placed in

category 1, institutions must have a capitalization (Basle) index equal to or greater than 10%.

(iv) **New domestic business**. Banks are authorized to undertake new activities, including: financial leasing, securitization, safekeeping and transport of securities, underwriting, mutual fund administration, insurance brokering (other than social security) and financial services to Pension Fund Associations (AFPs). Similarly, finance companies are allowed to establish subsidiaries within the country.

(v) **Globalization**. Banks are empowered to make loans to Chilean companies operating abroad, to open branches or representation offices, to make foreign trade loans to foreign corporations, to finance cross-border leasing, to purchase banks, and to make loans to foreign companies.

(vi) **Limitations**. The extension of guarantees and endorsements is limited to an amount equal to net worth. A limit of 5% of net worth plus reserves is set for loans granted directly or indirectly to any one individual or corporate borrower.

(vii) **Interest rates**. The SBIF is responsible for regulating maximum interest rates according to loan size. The concept of "maximum conventional interest" is maintained, and may not exceed 50% of current average interest.

3. The banking sector

1.13 The Chilean banking sector went through a severe crisis in the early 1980s, which led to major adjustments in the second half of that decade. Since then, the banking system has performed very positively, and has achieved high levels of solvency and a significant capacity for intermediating savings and investment. During 1998, the banking sector faced some difficult periods of tight liquidity. This led to a slight deterioration in the non-performing portfolio ratio, which rose from 1% in September 1997 to 1.31% in September 1998.

1.14 The liquidity squeeze has led to changes in the structure of assets and liabilities, and a reduction in loanable funds. An analysis of financing sources for the banking system shows a decline of 18% in demand deposits, and of 10% in loans from abroad, between December 1997 and September 1998. Bank profits fell 4.2% during the first nine months of 1998, compared to the same period the previous year, largely as a consequence of the need to make greater provisions for contingencies. Nevertheless, the average

capitalization index, pursuant to the standards set by the Basle Committee, has remained at three points above the 8% required by law, and it has seen no deterioration during the period under review. Thus, the capitalization index for domestic banks stood at 10.4%, for foreign banks at 14.5%, and for finance companies at 9.6%. Despite increasingly adverse economic conditions in 1998, the process of capitalization has continued at the pace recorded in recent years. This reflects both the need to adjust to legal capital requirements and the presence of growing competition within the sector.

1.15 The cash reserve requirement against deposits in local currency is 9% for demand deposits and 3.6% for term deposits. For deposits in foreign exchange, the reserve is set at 19.6% for demand deposits and 13.6% for term deposits. Slightly more than one-third of bank lending goes to SMEs, and the banks are considered to have satisfactory experience in providing financing for the sector.

1.16 Thanks to the efforts of the authorities, the financial system has maintained its solvency ratios at appropriate levels, and the regulatory and supervisory structure has been significantly strengthened. Nevertheless, lessons learned during the crisis have inspired cautious lending practices when it comes to selecting borrowers. Past experience is still having a dampening effect on the availability of credit, especially for small and medium-scale potential borrowers, at a time when the banks have no resources to expand their lending.

1.17 The consolidated financial statements for the banking sector at September 1998 show a mismatch of terms between sources and applications of funds. In fact, while only 5% of deposits and liabilities were for terms of more than one year, 18% of loans and placements were for the medium and long term. This situation prevents the banks from putting more funds into investment project financing, and is only partially offset by the provision of funding by CORFO.

1.18 The total assets of the banks and finance companies at September 30, 1998, stood at the equivalent of US$111,119 billion, of which US$50,862 billion represented the actual portfolio. Of this amount, US$9,452 billion was in loans of more than one year and represented 1.7 times the sector's capital and reserves. Moreover, deposits with a term of over three years were only US$884 million, or approximately twice the amount of the proposed program. As will be appreciated, there is a mismatch of terms within the group, demonstrating the clear need for medium and long-term resources.

4. Leasing companies

1.19 In response to the financing needs of small enterprises, leasing companies have taken on considerable importance as a source of

medium and long-term financing. One feature of leasing finance is that approximately two-thirds of such transactions are directed at the productive sector of the economy. Between 1990 and 1998, such financing increased sevenfold. Nevertheless, the financial structure of the leasing companies shows a term risk: the proportion of long-term to total liabilities is 49%, while the proportion of long-term assets is 58%.

1.20 Leasing companies finance their operations through bank loans (51%), debenture issues (18%), shareholder capital (13%), resources under CORFO programs (9%) and other minor liabilities (9%). In addition to the reduced availability of credit, they now face the limitation imposed by the new banking law, which establishes a cap of 5% of a bank's capital on individual loans. Another difficulty is the term risk, since the banks offer short-term loans, while leasing transactions are generally for three years or more. This situation demonstrates the need for long-term financing to reduce the financial risk within the group.

1.21 Leasing company assets increased by the equivalent of US$150 million in 1990 to US$2.48 billion by the middle of 1998. While a single company accounted for 54% of contracts in 1990, by 1998 nine companies had gained a strong presence in the market, with contracts exceeding US$88 million. The share of the largest company had been reduced to 22%. The legal limit on the indebtedness of leasing companies is 15 times their capital and reserves, although it is apparent that the market will not accept a leverage ratio greater than 12 for debenture issues. Nonetheless, the average indebtedness index for the most recent fiscal year varied between 6 and 7 times capital and reserves.

1.22 The group has become significantly stronger, and on September 30, 1998, its outstanding contracts stood at US$2,508 billion, 18 times the amount recorded in 1984. The SBIF has the authority to supervise leasing companies belonging to the banks, and the Superintendency of Securities supervises those that raise financing through debenture issues. The average profitability of the group in 1998 was 10.3%, and the group's competitiveness is reflected in continuously declining indicators of concentration.

1.23 A classification of contracts by economic activity shows that the share of trade and services stands at 31%, followed by industry and mining at 19%, farming and forestry 9%, telecommunications and transport 14%, and other 27%.

C. Program rationale

1. Previous experience

1.24 Since the 1980s, the Bank has supported the country with various credit transactions for the development and strengthening of private firms in the productive sector. The first was aimed at

four specific sectors: industry, agriculture, fisheries and mining. CORFO was directly involved in these transactions as the first-tier bank, with administered interest rates. The timing of the transaction coincided with the reduced availability of external credit as a result of the banking crisis that occurred in Chile in 1982 and 1983. The financial system became more volatile as a result of the devaluation of the national currency, the concentration of portfolio in related-party loans, and the financial weakness of the system's major commercial banks, in which the Central Bank was forced to intervene. The program was carried out in a satisfactory matter and funds were disbursed within the planned time limits. Projects were subjected to a rigorous cost-benefit analysis, and for the most part their outcome was positive and consistent with expectations.

1.25 In the second program, the range of productive sectors was broadened, although not so far as to meet the multisector criterion adopted for the third program. Commercial banks were allowed to participate as financial intermediaries, but CORFO remained the only direct lender. Interest rates continued to be administered, in accordance with the criterion of covering administrative and financial costs for the program. At that time, the general increase in Chilean interest rates made CORFO resources relatively attractive for banks and subborrowers alike. The program was less successful in terms of additionality, and funds tended to be used for large-scale private projects that, although important for the country, could had been financed with non-concessional resources from other sources. Because of this situation, small and medium-scale enterprises tended to be displaced, and their participation fell short of expectations.

1.26 In the third program, approved in November 1989, the multisector financing concept was applied to the full, and the concept of additionality was introduced, by setting an appropriate market price for the credits to be financed. In this context, the appropriate market price is an interest rate equal to or greater than the prevailing rate available from other potential sources of financing at similar terms and conditions. This criterion was intended to ensure that the program would complement rather than substitute for domestic savings. Bids were invited for funds as the most appropriate method of pricing resources under the program.

1.27 In addition, the number of participating financial institutions was increased, to allow the entry of leasing companies as entities eligible to intermediate transactions under the program. Intermediary institutions remained free to set their spreads in accordance with their perception of the risk in each case.

1.28 Mixed results were achieved with the method of allocating funds by auction. In the first place, the method tended to raise interest rates to levels higher than those on the market, thereby excluding banks and finance companies from participating. Second, leasing

companies, with fewer possibilities for raising local resources, were the winners in most of the early auctions. Despite the relatively small amounts tendered at each auction, in comparison with the total supply of credit, the practice stimulated an upward trend in interest rates, to the detriment of the goods-producing sectors of the economy. The presence of the leasing companies, which were more readily able to raise the price of their products, made it impractical for other financial entities to compete. Faced with this situation, CORFO agreed to conduct separate auctions for banks and leasing companies, adhering to the principle of taking the highest market rate as the cutoff rate for each tender, depending on the term and expected market movements. Third, there was a time lag between the date that project financing was committed and the date the funds were auctioned. Several banks found it impossible to commit themselves to financing a given project without knowing in advance the date, terms, currency and conditions that would govern the eventual transaction, since they would be running the risk that they would be unsuccessful in obtaining the funds at the time of bidding. CORFO addressed this situation by adopting a procedure of providing funds for given projects presented by the banks outside the auction process, but respecting the underlying principle by applying representative market interest rates prevailing at or close to the date of the auction.

2. <u>The new program</u>

1.29 The proposed program builds on previous experience and responds to the current situation, where the supply of loanable funds at appropriate terms for SME investment projects has declined. Chilean exports are vulnerable to shifting external market conditions, and credit has contracted, particularly for maturities of more than one year, a situation that has affected the target group in particular. In addition to building on experience with previous programs in which the Bank has participated, the proposed operation will retain their multisector character.

1.30 The financing needs of SMEs are related in part to the fact that they have been crowded out of their traditional sources of credit. While the SME share of total bank lending between 1994 and 1997 was 30%, this share fell to 21% in the first nine months of 1998.

1.31 The banking sector's concerns about the volatility of funding has made them reluctant to finance investment projects that require medium and longer terms. Moreover, the traditional preference of the banks for short-term lending has been accentuated. The current situation shows a clear imbalance between the supply of and demand for medium and long-term financing (see paragraph 1.17). Various banks and leasing companies report significant demand for funds to finance investment projects. The new program will seek to alleviate the situation by providing resources at appropriate terms and market interest rates, and will in addition ensure

additionality and so will not prejudice the growth and utilization of domestic savings.

1.32 CORFO will execute the operation as a second-tier entity, a function that it has performed in previous programs. A new concept will be introduced for selecting IFIs, involving the Risk Classification Commission (CCR), an agency that classifies entities issuing securities and assigns a risk category to most banks and leasing companies, on the basis of reviews and opinions from four private rating agencies, three of which are related to external houses of international repute.

D. The Risk Classification Commission (CCR)

1.33 The CCR was created in 1985 for the purpose of rating debt instruments and approving capital assets for purchase by pension funds. The CCR has its own legal personality and a capital structure consisting of contributions by Pension Fund Associations (AFPs). It is an autonomous entity, and its operations are governed by regulations that spell out the functions and responsibilities of its members and of the administrative secretary. The board of the CCR is made up of seven members: four representatives of the AFPs and three for each of the Superintendencies of Banking and Financial Institutions, Securities and Insurance, and AFPs. The CCR evaluates the ratings issued by the four private agencies, confirming or amending their opinions, and in this way can compile a classification for a given sector and remove the incentive to inflate ratings in order to retain clients.

E. Small and medium-sized enterprises (SMEs) 1/

1.34 The SME sector consists of formal entities and represents an important source of employment creation and income generation for the country. Small enterprises are defined as those with annual sales of between UF 2,400 and UF 25,000 (approximately US$75,000 and US$780,000) and employing up to 49 workers. Medium-sized enterprises are classified as those with annual sales between UF 25,001 and UF 960,000 (approximately US$30 million) and employing up to 1,000 workers.

1.35 The basic statistics on Chilean enterprises prepared by the Internal Revenue Service (SII) demonstrate the importance of SMEs in the industrial and services sector. Of the total 526,920 businesses registered, 93,976 (17%) are SMEs, 432,431 (82%) are micro enterprises and only 513 (1%) are considered large businesses. The geographic distribution of SMEs shows them to be heavily concentrated in the metropolitan region of Santiago, where 50% of all SMEs are to be found.

1/ Data supplied by CORFO.

1.36 In recent years, SMEs have shown an increasing interest in competing internationally, and many of them have embarked on modernization efforts, particularly in the areas of quality control, marketing and costs. In 1997, the SSI and PROCHILE identified 5,763 exporting enterprises nationwide: of these, 2,923 or more than 50% were SMEs. In the same year, exports originating with SMEs reached the equivalent of US$1,796 billion, representing a 29% increase over the figure recorded in 1991. These exports were destined primarily for markets within the region, and their future growth prospects are highly significant, especially under the headings of food products, garments and footwear.

1.37 At the end of 1997, SMEs provided employment for 2.6 million people, equal to 49% of total employment in the industrial and services sector (excluding the central government and municipalities). The breakdown of SMEs by economic activity is as follows: trade and commerce (36%), industry and manufacturing (13%), agriculture (10%), construction (7%), technical services (7%) and other (27%).

F. Financing for SMEs

1.38 Banking rules and regulations do not discriminate against providing credit to SMEs. The prevailing rules apply equally to the granting of loans to businesses of all sizes. The SBIF reports that in 1997, of the 453,166 loans granted by commercial banks to private sector businesses, 125,374 (28%) went to SMEs. In that year, total bank lending to SMEs amounted to the equivalent of US$9,135 billion, or approximately one-third of all business lending.

1.39 The leasing company industry has paid particular attention to transactions with SMEs. In terms of the number of contracts, SMEs and micro enterprises account for 87% of the total contracts generated by the sector. The growth in the number of companies and the amount of transactions has favored the SME sector, and has provided timely financing support for their operations. In general, the SMEs have kept their debt-to-equity ratios at below 1.8, which illustrates their cautious approach to seeking bank financing. Nonetheless, the figure also reflects the reduced availability of funding on appropriate terms.

1.40 In spite of the above, it should be noted that most of the loans to SMEs carry short terms, and have been used primarily for working capital. The concentration of banking branches in the metropolitan area of Santiago has influenced the distribution of lending. CORFO programs have sought to resolve the situation by providing medium and long-term resources and encouraging greater attention to lending in other regions, particularly in areas that are economically disadvantaged (see paragraph 4.9).

II. THE PROGRAM

A. Objectives

2.1 The proposed operation will provide medium and long-term financing for the development of financially and economically sound projects undertaken by SMEs in the private sector. It represents the continuation of support under a credit facility created through a similar, earlier program that was financed in part by the Bank. The funding to be provided will comply with the principle of additionality, i.e. will not be used as a substitute for financing available from other sources.

B. Program description

2.2 The program is intended to provide a responsive and flexible financing source so that SMEs can obtain medium and long-term funding for investment and related working capital requirements. Resources from the facility may be used to finance: (i) investments such as machinery, equipment, installations, construction, plantations and services associated with such investments; (ii) working capital associated with a project, most of which would be covered by the local counterpart contribution; (iii) support lines for commercial leasing, both financial and operating; and (iv) exports.

2.3 Private SMEs will be defined as those with annual sales no greater than US$30 million. Borrowers will not be allowed to exceed a total outstanding balance equivalent to US$5 million.

2.4 CORFO will use the program resources to grant credits to banks and leasing companies that qualify as intermediary financial institutions (hereafter IFIs), in accordance with the program's credit regulations. The IFIs will in turn use the funds to finance eligible investments.

2.5 Loans to the IFIs will be denominated in local currency, indexed to UFs, 2/ or US dollars. Financial intermediaries (see paragraph 2.24) will be able to make subloans in both currencies. The borrower will assume the exchange risk between the US dollar, the currency in which the Bank's loan will be denominated, and transactions denominated in UFs, as well as the interest-rate risk in those cases where credits are granted to the IFIs on the basis of fixed rates. The Bank will be advised of the procedure for determining the differential of fixed rates over variable rates for

2/ Unidad de Fomento (UFs): this is a financial accounting unit that is adjusted to reflect changes in the consumer price index. The margin over the UFS always constitutes a real interest rate.

loans in UFs or US dollars, before any loans of this kind are made, and the application of this procedure, as well as any subsequent amendments thereto, must have the concurrence of the Bank.

2.6 Loans provided by CORFO to the IFIs will be allocated under the following procedures: (i) leasing operation funds will be awarded at auction, according to the best rates offered for each term; and (ii) other transactions will be discounted at market rates. The cut-off rate for leasing transaction bids will be set no lower than average market rates. The Bank will be advised of the procedure for setting these rates before the first bids are called, and its application, as well as any subsequent amendment, must have the Bank's concurrence.

C. Corporación de Fomento de la Producción (CORFO)

1. Institutional considerations

2.7 CORFO was established in 1939 as a public agency with the mandate to promote the industrialization of Chile. It initially conducted its activities directly, and succeeded in creating the large producing and service companies that were essential for the country's development. Among these were: Empresa Nacional de Electricidad (ENDESA), Empresa Nacional del Petróleo (ENAP) and Compañía de Aceros del Pacífico (CAP, a steel producer). During the 1960s, it sponsored a basic investment plan that led to the creation of Empresa Nacional de Telecomunicaciones (ENTEL) and Televisión Nacional (TV), and began to provide general financial and technical support, through creation of the Servicio de Cooperación Técnica (SERCOTEC) and the Instituto de Capacitación (INACAP, for training). In the early 1970s, the government embarked on a business nationalization program, and as a result CORFO became the most interventionist of government economic agencies, to the point where it controlled more than 500 producing units.

2.8 CORFO launched a privatization policy in 1974, culminating in the transfer of most state enterprises to the private sector. In light of these new circumstances, CORFO was assigned a new mission: "to promote national productive activity by supporting private initiative and ensuring the efficient operation of all public enterprises under its supervision". 3/ In addition, it was expected to promote the balanced development of the country's various regions, encouraging private investment, especially in zones where growth was slowest, through special programs designed to suit the conditions of each region (Lota, Arica, the southern zone of Palena, Aysen and Magallanes, etc.).

3/ In late 1997, CORFO owned 22 enterprises (primarily in sanitation, electricity, transport and coal), representing 70% of the agency's assets.

2.9 CORFO's efforts with respect to SMEs took the following directions: (i) promoting modernization through the incorporation of new technical, management and organizational skills; (ii) fostering technological innovation for products and processes; (iii) facilitating financial intermediation and access to funding from IFIs and creating new financial instruments; and (iv) promoting economic diversification and stimulating investment in economically depressed zones. At the end of 1993, CORFO withdrew from direct activities in both lending and technical assistance, transferring these functions to various private entities acting as IFIs in credit programs and as "operating agents" for technical assistance.

2.10 As noted in chapter I, CORFO was the executing agency for a directed credit program and two multisector operations that were financed in part by the Bank. The unit responsible for these operations was the Gerencia de Intermediacion Financiera (GIF, the Financial Intermediation Division), which will also be responsible for execution of the proposed program. CORFO is administered by a board of directors, an executive vice-president and four division managers responsible for: (i) development and technology, (ii) financial intermediation, (ii) administration and finance, and (iv) strategic programs.

2.11 The series of reorganizations reduced CORFO's staffing strength to only 482 employees by 1998. Of these, 17 are assigned to the GIF, as a reflection of two aspects: (i) making effective use of human resources, and (ii) contracting out various functions to specialized official bodies such as the SBIF and the Superintendency of Securities for monitoring the IFIs, to the CCR and the private rating agencies for evaluating the IFIs, and to external audit firms for the review of financial statements.

2. Financial considerations

2.12 The financial structure reflects the importance of the holding company function fulfilled by CORFO, which has served to build up its capital base through the ownership of a number of state enterprises. Many enterprises have been sold and the proceeds transferred to the National Treasury, reflecting the continued diminution in the institution's assets and holdings. The financial aspects of CORFO's current activities – enterprise holdings, financial intermediation; and technical assistance to SMEs – are administered independently, so that the profitability of one branch is not affected by that of the others. Technical assistance to SMEs is for the most part nonreimbursable, and relies on external donations and funding from the National Treasury.

2.13 Total assets at June 30, 1998, stood at the equivalent of US$3,201 billion. The largest assets fall under the heading of enterprise investments, accounting for 70% of the total. The second major component is the lending intermediation portfolio,

which stood at US$418 million (13%). That portfolio consists of bank and leasing company obligations and its default index is equal to 0. In third place is the receivables on loans granted directly by CORFO that are still outstanding and that could not be sold. These amount to the equivalent of US$321 million (10%). CORFO has continued its efforts to transfer some of these to private banks, and intends to take legal action to recover those in greatest difficulty. CORFO has sufficient reserves to cover any possible unrecoverable loans.

2.14 The financial intermediation portfolio includes the development finance programs in which the Bank is a participant, along with other international entities (KfW, USAID, etc.). A classification by intermediary shows the banks as the principal debtors, with 56% of the total, and the leasing companies, with 38%. The remaining 6% represents the low-income housing project, financed by the US Agency for International Development, which was channeled through real estate companies. The portfolio risk by institution is broadly distributed among 46 debtors, none of which has liabilities exceeding 10% of the total.

2.15 Because it has taken on no new loans in recent years, the institution's liabilities have been declining. At June 30, 1998, they stood at the equivalent of US$1,079 billion, of which the largest component was financial intermediation credits, at the equivalent of US$421 million (39%). Debt service on these loans over the next three years will reduce amounts available for financial intermediation programs by more than 36%. If CORFO is to continue providing financial support to the productive sector, it will need additional funds.

2.16 The significant equity component of CORFO's financial structure means that its indebtedness ratio is satisfactory (0.51:1). On the other hand, its operating returns are negative, recording a deficit of US$1.7 million at June 30, 1998, as a result of transfers to the Treasury and losses suffered through the sale of enterprises and loans. This situation will improve significantly once CORFO succeeds in clearing the last of its doubtful assets, either through sale or write-off of problem investments. In any case, the credit programs executed by CORFO are fully profitable (see paragraph 2.26).

3. Operational considerations

a. Financial support

2.17 In 1990, CORFO withdrew from direct lending to businesses in the producing sector and began to operate as a "second-tier" entity, using other intermediaries to channel its financial support. The institutions involved in this intermediation were primarily the private commercial banks and the leasing companies. The latter group played an important role, since most of its members involved

themselves and the leasing approach became increasingly popular as an alternative for financing SME investments in machinery and equipment.

2.18 At the same time, faced with the difficulty of obtaining an adequate price on medium and long-term loans, CORFO initiated the procedure of allocating funds at auction, awarding them to those institutions that offered the best rate. CORFO conducts the auctions, and decides on the term, the currency and the cutoff interest rate in consultation with the Central Bank. That cutoff rate is not published until after the bids are submitted, and represents the minimum rate at which CORFO will transfer the funds.

2.19 Experience over the eight years that the new procedures have been in force has been satisfactory. The most significant lesson has been the usefulness of using two different pricing procedures: one for leasing operations and another for discounting. Bidding has been conducted in a climate of competition: in the last eight auctions held during 1997 and 1998, the amounts awarded by CORFO represented only 39% of the offers submitted – in effect, CORFO put the equivalent of US$132 million to tender and received offers from leasing companies for US$377.4 million.

2.20 Between 1990 and 1998, CORFO has channeled a total of US$1.48 billion into financing for private business investments, distributed as follows: leasing companies US$856 million, private commercial banks US$590 million and others US$34 million (primarily real estate companies). The annual volume of placements over the last three years averaged US$206 million. If demand keeps to this pace, CORFO should have no difficulty in disbursing the proposed operation in its entirety.

b. Technical assistance

2.21 CORFO has used various instruments over the last four years to help improve the technical efficiency and competitiveness of SMEs. The major instruments are as follows:

(i) Fondo de Asistencia Técnica [Technical Assistance Fund] (FAT). Nonreimbursable financing of up to 50% or UF 450 per firm, to contract technical advisors and business management consulting services.

(ii) Proyecto de Fomento [Development Project] (PROFO). Nonreimbursable business modernization support for groups of no fewer than five SMEs that agree to work together on a program to develop their business and make themselves more competitive. The maximum amount of the CORFO grant is UF 2,700 or UF 360 per company.

(iii) Programa de Apoyo a la Gestión de Empresas Medianas [Management Support Program for Medium-sized

Enterprises] (PREMEX). Grants cover the cost of specialized consulting services for productivity and quality enhancement. CORFO can cover up to 60% of consulting costs.

(iv) Fondo de Desarrollo e Innovación [Development and Innovation Fund] (FDI). Promotes initiatives to generate and manage innovation and technological change, with nonreimbursable financing for up to 80% of costs.

(v) Fondo de Desarrollo Tecnológico y Productivo [Technology and Production Development Fund] (FONTEC). Grants to promote technological innovation, technological infrastructure, technology transfer and preinvestment studies.

(vi) Caucion solidaria [joint-and-several liability cover]. CORFO issues guarantees to private banks for financing investments in designated economic diversification zones, with a cap of UF 60,000.

(vii) Cupones de Bonificación [Bonus Coupons] (CUBOS). Financing of up to 50% of the credit insurance premiums charged by insurance companies to cover the repayment risk of small enterprises in their dealings with commercial banks, finance companies, leasing companies and suppliers of capital goods on credit terms.

(viii) Fondos de Inversión de Desarrollo de Empresas [Business Investment Development Funds] (FIDE). Encourages the supply of risk capital through long-term loans to SMEs for strengthening their capitalization by means of seed capital or quasi equity.

(ix) Fondos de Asistencia y Reconversión [Assistance and Diversification Funds] (FARCAR and FARARICA). Grants for employment creation in economically depressed zones, based on providing subsidies at different stages of investment.

2.22 CORFO is the national agency responsible for managing the majority of economic development plans. Until 1995, it extended funding directly to its client businesses. In that year it introduced a system of intermediation through private operators that could justify their participation on the basis of administration costs. The changes that have been made to CORFO's operating procedures have encouraged it to seek new forms of providing financial support to SMEs. At the present time it is considering the following approaches: (i) introducing an export insurance system; (ii) issuing securities for purchase by the AFPs (pension fund

associations), and (iii) support to landowners to promote reforestation in agriculture diversification zones.

2.23 To manage the enterprises, companies and businesses in which CORFO has shares, warrants and other ownership rights in a manner separate from its financial intermediation activities, the Sistema Administrador de Empresas [Business Administration System] (SAE) was established. It is currently responsible for 13 sanitation firms and nine service companies.

D. Intermediary Financial Institutions (IFIs)

2.24 IFIs eligible to participate in the program would be drawn from among the private commercial banks and leasing companies. The following selection criteria would be taken into account: (i) each eligible IFI's credit exposure with CORFO would be subject to a limit, relating to the amount of the financial intermediation portfolio and capital and reserves, in the case of banks, and of liabilities and net worth in the case of leasing companies; and (ii) the risk classification issue by the CCR, associated with a weighting factor related to the rating obtained by the entity. In this way, 20 of the 29 private banks could participate as IFIs in the program at the outset, and 16 of the 21 leasing companies would be eligible. A selection system of this kind would ensure that first-class institutions would be selected.

2.25 Only IFIs that achieve the highest CCR rating (between AAA and A-) will be allowed to take part in the program. The fact that all goods and services producing sectors will be eligible for financing under the program reflects prevailing economic conditions, where no activity in particular is either favored or at a disadvantage.

E. The previous program (loan 576/OC-CH)

2.26 The objectives of the program were fulfilled in their entirety. The involvement of the leasing companies and the adoption of the auction mechanism proved to be positive innovations. In December 1996, some 6,700 credit transactions had been formalized for an amount equal to US$999.3 million, including investments of recoveries (the original cost of the program was US$600 million, with a Bank contribution of US$360 million). The program was reasonably profitable for CORFO. In 1996, its net return on assets was 8.3%, and in 1997 it was 5.4%, a third of which was generated by exchange rate differentials. These rates of return are higher than those on commercial bank assets, which for the same two years were 1% and 1.1% respectively.

2.27 Of total placements, US$697.4 million (70%) went to 6,130 subloans intermediated by leasing companies, and US$301.9 million (30%) to commercial banks, in 244 transactions. The banks channeled most of their lending to medium-sized enterprises, while the leasing companies directed their credits to small businesses. This

participation by the leasing companies promoted growth in the sector and introduced an important alternative source for small enterprises in financing capital goods. Credit terms were between three and ten years, and lending was distributed by sector as follows: industry (29%), agro-industry (23%), and forestry and fisheries (10%).

2.28 The auction process was transparent, and the determination of cutoff rates and the subsequent recommendation of awards were performed by a technical committee made up of representatives of the Central Bank of Chile, the Ministry of Finance, CORFO, SBIF and the Superintendency of Securities. In principle, the auction procedure reduced participation by the banks, because: (i) pricing of the funds was inflated by bids from the leasing companies, which had fewer alternative sources of funding; (ii) there was a time lag between the date the funds were required to finance a project and the date of the auction; and (iii) banks were reluctant to commit themselves to finance a specific project in the face of uncertainty over costs, term, currency and the risk that they might be unsuccessful in the auction itself. Nonetheless, 17 commercial banks participated in the auctions.

2.29 Although the loan contract with the Bank allowed CORFO to lend up to 10% of program resources directly, it chose not to exercise this option, but rather to limit its activity to that of a second-tier entity. In the final stage of the program, in light of accumulated experience, CORFO refined the auction system by type of intermediary institution, and in special cases it awarded funds without bidding, particularly for export-oriented projects.

2.30 In order to determine the banks' spread on program resources, two representative samples were taken from transactions reported to September 15, 1998, by nine banks. In the first case, 67 transactions were selected, producing an average spread of 2.21%, within a range of 1.06% to 3.02%. In the second case, 51 transactions were reviewed, and the average spread was found to be 2.05%, within a range of 1.10% to 3.10%. In both samples, the spread was considered to be reasonable as a reflection of the risk to the IFIs.

2.31 The process of modernizing CORFO called for an in-depth redefinition of its role in promoting development of the financial system. CORFO abandoned its direct directed lending activities and delegated to the financial system the responsibility for allocating resources and assuming the risk on transactions. CORFO conducts a regular analysis of any shortcomings that might be apparent in the financial market, in particular those that might impede access to credit by certain business sectors.

F. Environmental considerations

2.32 In light of the CESI recommendations, CORFO hired an external consultant, who concluded that activities financed under the previous program (loan 576/OC-CH) had posed no environmental risks. In allocating resources, CORFO observes the following principles: (i) generic environmental protection standards are included in all financing lines; (ii) IFIs are required to declare on special forms that their beneficiaries are in compliance with environmental legislation; and compliance with environmental regulations is verified through inspections carried out by specialized institutions with the required technical competence.

2.33 The credit regulations for the proposed program will add to the rules already in force by requiring CORFO to provide the appropriate environmental authorities with a list of subloans granted under the program, so that they can ensure strict compliance with the respective environmental regulations. The IFIs will request the final users to submit documentation in support of their project's environmental classification and its compliance therewith. In the case of irregularities, CORFO and the IFIs will take all steps necessary to ensure that the subborrower corrects the situation, and may if necessary cancel the subloan.

III. PROGRAM EXECUTION

A. Borrower and executing agency

3.1 The borrower under the Bank loan will be the Republic of Chile, represented by the Ministry of Finance. Program resources will be transferred by the borrower to CORFO, with promulgation of the relevant legal measures, whereby CORFO will undertake to comply with the obligations incumbent upon it as executing agency. Submission of those legal documents will be a condition prior to the first disbursement of the loan.

3.2 The program will be executed by the Corporacion de Fomento de la Produccion (CORFO), acting as a second-tier entity. CORFO will channel program resources via financial intermediary institutions (IFIs) that meet the eligibility criteria established in the credit regulations.

B. Program execution

3.3 Basic responsibility for managing the program will lie with the Gerencia de Intermediación Financiera (GIF) of CORFO. The program will be multisectoral in nature. Funds will be used to discount loans or leasing transactions (hereafter referred to as "subloans") made by the IFIs to SMEs in the goods and services sector.

3.4 Program funds will be used to finance investments in machinery, equipment, installations, construction, civil works, plantations, engineering and assembly services and other services that eligible enterprises require in carrying out their productive activities; they will also be used to meet working capital needs associated with investment projects.

3.5 Program resources will be allocated to the IFIs in accordance with rules to be laid down in the credit regulations, which must be put into effect by CORFO as a condition precedent to the first disbursement of resources under the loan. Following is a description of the most important features of the credit regulations proposed for this operation.

1. IFI eligibility 4/

3.6 Banks and leasing companies will be eligible as financial intermediary institutions under the program if they fulfill the following conditions:

4/ At the outset of the program, 20 of the 29 banks now in operation would qualify to participate, and 16 of the 21 existing leasing companies would meet the eligibility requirements.

a. For the commercial banks

(i) They must be subject to supervision by the Superintendency of Banks and Financial Institutions, and they must be compliant with the Banking Law and relevant legal provisions.

(ii) At the time they submit a bid or application for funds, they must be rated by the Risk Classification Commission with a classification of at least category A (subcategory A-).

b. For leasing companies

3.7 They must be subject to supervision by the Superintendency of Banks and Financial Institutions or the Superintendency of Securities and Insurance, as appropriate. They must be constituted as corporations, and must be registered in the National Securities Registry maintained by the Superintendency of Securities and Insurance or the Superintendency of Banks and Financial Institutions, during the entire life of the loan.

1. Leasing companies that issue public debt instruments

They must be classified by the Risk Classification Commission in category A (subcategory A-) or higher, with respect to their solvency. For these companies, the solvency classification refers to the rating accorded their long-term debt instruments.

2. Leasing companies that do not issue public debt instruments

Their financial quality, management performance and solvency must have a rating of at least category A (subcategory A-) or higher, issued by the Risk Classification Commission.

3.8 CORFO may establish additional requirements for participation in the program, in light of the net worth and financial situation of each leasing company.

3.9 Leasing companies that meet the requirements set forth in the preceding paragraphs must provide surety to the satisfaction of CORFO, in a proportion of guarantees to debt that is consistent with the solvency risk classification of the company. Leasing companies classified in category A or higher must constitute surety in favor of CORFO in a guarantee-to-debt ratio of 1:1, and those classified in category A- must provide surety in a ratio of 1:1.2.

3.10 Notwithstanding the foregoing, leasing companies will be exempt from the obligation of constituting surety in favor of CORFO if they meet the following conditions:

- Their solvency classification is category AA or better;

- They have placed debentures with private institutional investors, issued without guarantees or endorsements of any kind.

3.11 This exemption will remain in effect as long as the leasing companies continue to comply with the above requirements.

2. <u>Allocation of funds</u>

3.12 The IFIs may access program funds through loans granted by CORFO under either of the following allocation procedures:

a. Discounting of subloans granted by the IFIs to eligible clients under the program, on the basis of pre-established market interest rates; and

b. Auctioning of funds for leasing operations to the highest bidder.

3.13 With both of these procedures, the funds will be passed on by the IFIs to the subborrowers at a term consistent with the maturity of the funds received from CORFO.

3. <u>Limitations</u>

3.14 The commercial banks may not receive funding from CORFO in an amount that exceeds their total capitalization (capital and reserves).

3.15 No IFI may receive more than 20% of the total of CORFO's financial intermediation funds. The individual limit will be established in accordance with the following weighting factors:

Risk classification	Weighting factor
AAA	1.00
AA+	0.95
AA	0.90
AA-	0.85
A+	0.80
A	0.75
A-	0.70

3.16 Leasing companies may not receive funding from CORFO under the program equivalent to more than 45% of their total liabilities and equity.

3.17 Moreover, the maximum loan limit per IFI will be determined by multiplying the total intermediation resource base of CORFO by the weighting factor of the individual IFI. The formula for this calculation is as follows:

Maximum limits		
(i)	LF (x)	= [0.20 * FT * FP (x)] < 1 * LK (x)
(ii)	LF (y)	= [0.20 * FT * FP (y)] < 0.45 * LP (y)
Where:		
	LF (x)	= Maximum limit for a bank (x) in relation to FT
	LF (y)	= Maximum limit for a leasing company (y) in relation to FT
	FT	= Total funds in the CORFO/GIF portfolio
	FP (x, y)	= Risk weighting factor for (x) or (y)
	LK (x)	= Limit for a bank in relation to its capital and reserves
	LP (y)	= Limit for a leasing company in relation to its liabilities and equity

3.18 The program will provide financing for:

- investments and working capital related to investment projects (the latter will be funded solely with local counterpart resources);

- exports of durable goods;

- equipment procured under leasing arrangements.

4. Amount and term

3.19 The maximum amount of subloans to final users may not exceed the equivalent of US$5 million in outstanding balances. The term may vary between one and 12 years.

5. Financing terms

3.20 Loan transactions may be expressed in UF-indexed local currency, or in U.S. dollars.

3.21 The auction method for allocating funds to the IFIs will be governed by special regulations concerning the formalities and conditions that such auctions must meet. These will be established by CORFO on the basis of those applicable to auctions generally. For each auction, specific ground rules will be established with respect to the amount to be tendered, the indexation alternatives, the terms and interest rates that the IFIs may offer in their bids, and any other aspects relating specifically to that particular auction. The auction cutoff rates for leasing transactions will be set so that they are no different from average market lending rates. The procedure for determining those rates will be reported

to the Bank prior to the first auction, and their application, as well as any subsequent amendment thereto, must have the Bank's concurrence.

6. Interest rates

3.22 Annual interest rates applicable to IFIs on loans granted in UFs or US dollars may be variable or fixed, and must be consistent with market rates. In the latter case, the procedure for determining the spread of fixed over variable rates will be reported to the Bank for its nonobjection, before any credits are granted under this procedure. The borrower and CORFO recognize that difficulties and risks may arise in the application of fixed rates. To eliminate such risks, CORFO will conduct a study to minimize any losses, and its findings and recommendations will be applied to the program, subject to Bank knowledge and analysis. None of the applicable rates may be below a level sufficient to cover the cost of the funds provided by the IDB, plus CORFO's administrative costs.

3.23 The rediscount rates for subloans denominated in UFs may not be lower than the rates applicable to Adjustable Promissory Notes (PRCs) of the Central Bank of Chile, with coupons payable at the respective maturity (bids) and at the Average Interest Rate (TIP) of the system for raising 90 to 365-day funds in that currency. In all cases, rates applicable to the loans must include a spread that increases according to the term of the subloans. The IFIs will be free to set the rates charged to the final user in each subloan.

7. Non-eligible expenditures

3.24 Program resources may not be used to finance the following:

- lands and buildings and real estate projects, as well as investments in constructions or facilities of a primarily commercial use. This prohibition does not include the purchase of lands or buildings that businesses may require in order to move their producing facilities for environmental reasons from a non-industrial to an industrial zone or from the Metropolitan Region to other regions of the country;

- vehicles for personal use;

- capital goods that make use of polluting technologies;

- used capital goods, except in the case of goods located outside the country or where the purchasing subborrower is a business with annual sales not exceeding UF 25,000;

- debt, except in the case of refinancing of short-term liabilities acquired for financing projects that will subsequently be brought under this program;

- the purchase of shares or interests in businesses or companies, or their securities;

- payment of taxes, except those related to the purchase of goods or services, which will be financed with local counterpart resources;

- weapons or other military articles.

8. Responsibility of the IFIs

3.25 The IFIs will have the sole responsibility for assessing the risk of the subloans they make, and for deciding whether to provide financing. Such financing must be consistent with the conditions established in the regulations and in the rules governing the respective procedure. Subloans will not require the prior approval of CORFO or the IDB. The IFIs will be responsible to CORFO for servicing and repaying the subloans, regardless of the performance of the subborrowers in servicing their obligations to the IFI. Debt service and prepayments by users to the IFIs will be transferred to CORFO on the date they are received or due, so as to ensure that funds deriving from loan repayments are used for the purposes of the program.

9. Approval and formalization

3.26 Loans granted by CORFO to the IFIs under the program will be approved by the Executive Credit Committee of CORFO.

3.27 The IFIs will sign participation contracts with CORFO for each of the funding allocation procedures they intend to use; these contracts will cover the general obligations and conditions governing the loans received by the IFIs under the respective procedure.

3.28 In the absence of an umbrella contract of this kind, a separate contract may be signed for each subloan received under the program.

3.29 The IFIs will issue promissory notes to CORFO for disbursements received.

10. External audit

3.30 Participating IFIs will submit their financial statements each year to CORFO, audited by a private firm of reputable independent auditors.

11. Environmental considerations

3.31 CORFO will notify and submit periodically to the respective environmental authority a listing of subloans granted under the program. Each authority will be responsible for ensuring

compliance with environmental standards. The IFIs will request final users to submit documentation in support of the environmental classification of their project and its compliance therewith. They will report any irregularities in this regard to CORFO. CORFO and the IFIs will take all necessary measures to have the final beneficiaries remedy the situation. Otherwise, they may proceed to cancel the subloan.

3.32 In order to ensure adequate compliance with environmental aspects, the loan contract will include the following contractual provisions:

a. The borrower, in cooperation with the entities participating in the program, must perform an annual review of a representative sample of activities financed with resources of the program, to determine the degree of compliance with measures recommended for mitigating environmental impact.

b. During the program execution period, the borrower must submit to the Bank each year, together with the progress reports, an evaluation of compliance with the measures recommended to mitigate any negative environmental impacts of activities financed by the program. If this evaluation reveals significant noncompliance with the measures recommended, the Bank may require that such activities no longer receive financing under the program.

12. <u>Information on subborrowers</u>

3.33 The rules applicable to each financing procedure must indicate the information to be supplied to CORFO by the IFIs with respect to the subloans they have financed, as well as the timing of such reports. Those reports must also include any background information that CORFO may request with respect to the destination and use of the resources, both for each individual operation and for the program as a whole.

3.34 CORFO and the Bank reserve the right to review operations financed under the program, on the basis of selective sampling, in order to ensure full compliance with the provisions of the regulations and the respective procedure. Without prejudice to the foregoing, CORFO may review individual operations at any time. The IFIs must undertake to keep available supporting documentation for use in such reviews, and to verify the use of the funds.

3.35 Without prejudice to any general requirements that the supervisory authorities may establish with respect to borrowers in general, operations under the program must be evaluated for their financial viability, and must have certificates indicating the country of origin of goods and services purchased with resources of the subloan.

C. Cost and financing

3.36 The cost and financing of the program will be as follows:

Cost and financing (in US$000)			
Category	IDB	Local counterpart contribution	Total
1. Credit operations	237,600	160,000	397,600
2. Inspection and supervision	2,400	-	2,400
TOTAL	240,000	160,000	400,000
%	60%	40%	100%

D. Disbursement schedule

3.37 With a view to ensuring continuity for the multisector facility, and in light of the current level of CORFO's financial intermediation resources and the likely demand for funds, a disbursement schedule has been prepared, including the revolving fund and retroactive disbursements.

3.38 The borrower and the Bank have agreed to limit disbursements to an amount not exceeding 34% of total resources by December 31, 1999, and 75% of total by December 31, 2000, with the balance to be disbursed in the course of 2001. The estimated disbursement schedule is as follows:

Financing commitments and disbursements (In US$00)				
IDB loan	Year 1	Year 2	Year 3	TOTAL
Commitments	100,000	100,000	37,600	237,600
Disbursements	81,600	96,400	60,000	237,600

E. Periodic program reviews

3.39 During execution of the program, the borrower and the executing agency, together with the Bank, will keep the interest rates applied to subloans under periodic review. The borrower and the executing agency will take all necessary measures, consistent with national economic policies, to harmonize interest rates on the subloans with the policy objective pursued by the Bank.

3.40 Within 12 months after the first disbursement under the program, the borrower, CORFO and the Bank will conduct a review of compliance with program objectives, and the results obtained. If it is found that the program is not substantially achieving its objectives, remedial measures must be agreed, before any further

financing commitments are made, whereby the borrower will resolve the problems detected. Following this first review, further reviews will be connected annually until all program resources are disbursed.

F. Ex post evaluation

3.41 Consistent with Bank policy, and after consultation between the borrower and the executing agency, the latter has decided that an ex post evaluation will not be conducted as part of the program. CORFO bases this decision on the grounds that the periodic program evaluations to be conducted during execution will provide sufficient information on progress and results. Nonetheless, it should be noted that an ex post evaluation could eventually be conducted without difficulty, since the necessary information will already be available.

G. Internal audit

3.42 The administration of the program will be subject to control by the Internal Audit Service of CORFO, which will be responsible for establishing and maintaining administrative, accounting and internal control procedures appropriate to the needs of the program, in accordance with generally accepted practices in these areas.

1. External audit

3.43 The external audit of the program will be conducted by the Comptroller General of the Republic, during the program execution period and for five years following the date of the last disbursement.

H. Revolving fund and retroactive disbursements

3.44 The program may establish a revolving fund of up to 10% of the Bank's financing; the resources of that revolving fund will be subject to Bank rules. This percentage is considered necessary in light of the fact that CORFO has historically offered amounts ranging between US$16 million and US$18 million in each funding auction, and has disbursed between US$10 million and US$12 million in discount operations.

3.45 The borrower has requested the Bank to recognize disbursements made after October 27, 1998, and those that it expects to make prior to approval of the financing. The amounts committed and the procedures used are those of the previous program, and have served to cover the resource gap so that those operations could continue until approval of the program proposed here. The project team considers that the Bank could recognize up to US$41.6 million of such funding in this regard.

IV. PROGRAM VIABILITY

A. Economic viability

4.1 The program will complement the flow of financial resources for expanding and consolidating the development of private sector projects, by facilitating the capital formation essential to promoting growth in output and employment. Using the market to set interest rates and intermediation spreads will promote additionality of funding and will encourage the use of domestic savings in providing credit to SMEs. The country's current macroeconomic and financial policies have established the basic conditions for the economic feasibility of the projects to be financed by the proposed program.

4.2 The design of the program will help to provide more equitable access for SMEs to credit through the financial system. Financing will be directed towards all economic activities of the private sector, both in goods production and in services. The cost of program resources will be market-based, and will be compatible with the structure of interest rates now prevailing within the country for medium and long-term transactions. The flexibility that the IFIs will have in setting their intermediation spreads will encourage the more conservative banks to expand the supply of their funding to meet the credit needs of small and medium-scale clients.

B. Institutional viability

1. Executing agency: CORFO

4.3 As the executing agency, CORFO has the organizational and functional capacity necessary to ensure effective administration of program resources, in a manner consistent with the guidelines established in the credit regulations. CORFO has acquired extensive experience and expertise in executing this type of operation, and has established appropriate relationships with the IFIs and with the supervisory and rating agencies involved.

4.4 The Financial Intermediation Division (GIF), which is responsible for operations of this type within CORFO, has an adequate level of efficiency and suitably experienced and qualified technical and administrative personnel to fulfill the functions demanded of it under the program. The involvement of the Central Bank of Chile, the Ministry of Finance and the Superintendencies of Banks and Financial Institutions and of Securities and Insurance in the setting of cutoff rates and the conduct of funding auctions provides reasonable confidence that these procedures will be planned and conducted in an appropriate manner.

4.5 The ratings to be issued by the Risk Classification Commission will provide additional support for CORFO in selecting IFIs with the best qualifications and the lowest risk.

2. Intermediary financial institutions (IFIs)

4.6 The eligibility criteria for selecting IFIs, as set out in the credit regulations, require that participating entities must have a rating classification no lower than A-. The intention is to ensure the selection of those with the soundest financial structure. Similarly, as part of the analytical process, visits were made to various banks and leasing companies, during which it was confirmed that they have the operational capacity and the professional teams necessary to evaluate the economic and financial feasibility of projects, and the experience to appreciate the risks involved in each transaction. In the case of projects that require specialized handling, these entities will contract external consultants with expertise in the appropriate area.

4.7 The laws and regulations governing operations of the banking sector and the activities of leasing companies provide a favorable framework for the further development of those entities. Moreover, the submission to CORFO of IFI financial statements audited by reputable independent firms will facilitate periodic reviews of the situation of each entity, and allow for monitoring and control of IFI borrowers.

C. Financial viability

4.8 The proposed program is financially viable, since it calls for total recovery of administrative and financial costs, by applying interest rates consistent with the level of those expenses. CORFO will also undertake regular analytical reviews of the behavior of the UF and the US dollar, the currencies in which the subloans will be denominated, to determine the effects of possible exchange rate movements on the program's profitability.

D. Justification of the proposed program

4.9 From the description contained in the preceding chapters, it may be concluded that domestic markets have not yet succeeded in extending the maturity structure of their deposits. The IFIs rely on short-term instruments, in most cases no longer than six months, to finance investment projects that require considerably longer maturities. This situation, which in fact extends to the entire spectrum of credit demand, has a major impact on SMEs, which find themselves consistently displaced by large companies in the competition for commercial bank financing. This provides justification for the financial support that CORFO has been providing to the sector in recent decades, and which has rendered it possible for SMEs to make steady progress on their investment plans.

E. Benefits and risks

1. Benefits

4.10 The additional credit resources to be provided under the program will facilitate financing by CORFO for SME investment projects, and this will have a significant impact on increasing output and employment. The availability of medium and long-term funds will encourage the financial system to grant credit to SMEs, thereby allowing them to strengthen and expand their operating capacity and to introduce modern technologies into their productive processes. In addition, it will help the IFIs to reduce the current mismatch in terms between sources and applications of funds.

4.11 The program assumes particular importance in the current economic situation, where the supply of loanable funds for SMEs at appropriate terms is declining. By bringing the allocation of credit more closely into line with the operating realities of participating IFIs, and adopting new IFI selection criteria, the program will help make better use of financial resources in fulfilling program objectives.

2. Risks

4.12 Any disruption of the current macroeconomic context of price stability, as a result of exogenous factors, could discourage investment and the demand for credit, and could reduce the willingness of the financial system to grant loans to the target group. Nevertheless, the national government's commitment to the principles of a free market and an open economy, and its determination to maintain current policies, should considerably reduce the prospects for any such change, even under the pressure of external economic events.

PROPOSED RESOLUTION

CHILE. LOAN /OC-CH. TO THE REPUBLIC OF CHILE
Global Multisectoral FinancingProgram

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with the Republic of Chile, as Borrower, for the purpose of granting a financing to cooperate in the execution of a global multisectoral financing program. Such financing will be for the amount of up to two hundred forty million dollars of the United States of America (US$240,000,000) from the Single Currency Facility of the Ordinary Capital resources of the Bank and it will be subject to the "Terms and Financial Conditions" and the "Special Contractual Conditions" of the Executive Summary of the Loan Proposal.