

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

EL SALVADOR

DEVELOPMENT SUSTAINABILITY CONTINGENT CREDIT LINE TO PROVIDE TEMPORARY LIQUIDITY TO THE FINANCIAL SYSTEM

(ES-X1007)

LOAN PROPOSAL

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| ELECTRONIC LINKS | |
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| REQUIRED | |
| 1. | Monitoring and evaluation plan http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=38042347 |
| 2. | Conditionality matrix http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=38177943 |
| OPTIONAL | |
| 1. | Cost/benefit analysis (including ex ante evaluation) http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=38042349 |
| 2. | Arvind Krishnamurthy. 2010. American Economic Journal: Macroeconomics http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=38042314 |
| 3. | Andrew Berg and Eduardo Borensztein. 2000. The Pros and Cons of Full Dollarization. Working paper. http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=38042309 |
| 4. | McAndrews, James J. and Simon M. Potter. 2002. "Liquidity Effects of the Events of September 11, 2001." http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=38042316 |
| 5. | Javier Bolzico. 2011. Final consulting report: Development of the Financial System Liquidity Fund. IDB. http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=38042317 |
| 6. | Jose Berrospide. 2012. Liquidity Hoarding and the Financial Crisis: An Empirical Evaluation. http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=38042315 |
| 7. | Juan Antonio Osorio, 2009. "Impacto de la Crisis Económica Internacional y Respuestas de Política en El Salvador [Impact of the International Economic Crisis and Policy Responses in El Salvador]." http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=38042308 |
| 8. | IMF and World Bank. 2010. Safety Nets and Crisis Management Arrangements, Technical Note. Financial Sector Assessment Program, El Salvador. http://search.worldbank.org/all?qterm=technical%20note%2079192 |
| 9. | Mark Weisbrot et al., 2013. Ecuador's New Deal: Reforming and Regulating the Financial Sector. Center for Economic and Policy Research. http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=38042318 |
| 10. | Calculations corresponding to the economic analysis. http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=38042346 |
| 11. | Safeguard Policy Filter http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37950400 |

ABBREVIATIONS

| | |
|----------|-----------------------------------------------------------------------------------|
| BANDESAL | Banco de Desarrollo de El Salvador [Development Bank of El Salvador] |
| BCR | Central Reserve Bank of El Salvador |
| CAPDR | Central America, Panama, and the Dominican Republic |
| DSL | Development Sustainability Contingent Credit Line |
| EMBI | Emerging Markets Bond Index |
| FSAP | Financial Sector Assessment Program |
| GCI-9 | Ninth General Capital Increase |
| IMA | Independent macroeconomic assessment |
| IMF | International Monetary Fund |
| LIBOR | London Interbank Offered Rate |
| SSF | Superintendencia del Sistema Financiero [Superintendency of the Financial System] |

PROJECT SUMMARY

EL SALVADOR DEVELOPMENT SUSTAINABILITY CONTINGENT CREDIT LINE TO PROVIDE TEMPORARY LIQUIDITY TO THE FINANCIAL SYSTEM (ES-X1007)

| Financial Terms and Conditions | | | |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------|---------------------------------------------------|----------------------------------------------------------|
| Borrower: Central Reserve Bank of El Salvador (BCR) | | Flexible Financing Facility¹ | |
| | | Amortization period: | 6 years |
| Executing agency: Central Reserve Bank of El Salvador | | Original weighted average life: | 4.5 years |
| | | Drawdown period:² | 3 years |
| Source | Amount (US\$ million) | Grace period: | 3 years |
| IDB (Ordinary Capital) | Up to 100 | Interest rate: | LIBOR-based + 165 basis points |
| | | Front-end fee: | 50 basis points |
| Local | 0 | Standby fee: | 50 basis points |
| | | Inspection and supervision fee³ | |
| Total | Up to 100 | Currency: | U.S. dollars from the Ordinary Capital |
| Project at a Glance | | | |
| Project objective/description: The objective of the program is to mitigate the effects that exogenous macroeconomic and financial shocks, whether systemic or specific, can have on vulnerable populations by causing temporary liquidity contractions in the financial system, dampening the supply of credit and, through this channel, activity in the real sector. | | | |
| Special conditions precedent to the first disbursement: (i) signature and entry into effect of an agreement between the BCR and the Development Bank of El Salvador (BANDESAL) for the purposes of compliance with the conditionality matrix referenced in paragraph 4.1; (ii) approval of the Credit Regulations agreed upon with the IDB for use of the loan proceeds, including <i>inter alia</i> : (a) the eligibility and selection criteria for eligible financial institutions; (b) the negative list of environmental activities and the applicable environmental procedures; and (c) a detailed description of how the program will be executed, including the functions of the BCR; (iii) presentation of a legal opinion from the borrower confirming its authority to sign a loan contract with the IDB, effective at the time of signature, and confirming the authority of the borrower to fulfill the obligations set forth in the program; ⁴ (iv) presentation of a legal opinion from BANDESAL confirming its authority to fulfill its obligations under the program; (v) verification by the Bank, through an independent macroeconomic assessment (IMA) that the borrowing country has an adequate macroeconomic framework. In the event that the IMA shows a significant deterioration in the economic situation, the Bank may consider making the disbursement if the country has a borrowing arrangement with the IMF; (vi) the Bank has verified the occurrence of one or more eligible events (one of the triggers listed in paragraph 3.2); and (vii) the borrower, through BANDESAL, continues to fulfill the conditions set in the conditionality matrix, demonstrating that the social programs and investment expenditures from the Economic Development Fund aimed at financing micro, small, and medium-sized enterprises that are to be protected have the appropriate financing at the time of the corresponding disbursement request. | | | |
| Exceptions to Bank policies: None. | | | |
| Project consistent with country strategy: | | Yes [X] | No [] |
| Project qualifies as: | | SEQ [] | PTI [] Sector [] Geographic [] Headcount [] |

¹ The loan will benefit from the options offered under the Flexible Financing Facility (currency and interest rate conversions), except for the flexibility to change the amortization schedule. The amortization schedule for the loan will be one of consecutive, semiannual and, insofar as possible, equal installments at the end of the grace period.

² The loan will use the Development Sustainability Contingent Credit Line modality (document GN-2667-2) which establishes a drawdown period of three years as from the eligibility date for disbursements, without the option of renewal.

³ The inspection and supervision fee will be established periodically by the Board of Executive Directors as part of its review of the Bank's lending charges, in accordance with the corresponding policies.

⁴ The borrower has already fulfilled this condition precedent.

I. DESCRIPTION AND RESULTS MONITORING

A. Frame of reference, problem, and rationale

1. Macroeconomic and financial context

- 1.1 **Macroeconomic context.** Following negative GDP growth (-3.1%) in 2009, El Salvador experienced a recovery in growth of 1.4% in 2010, 2.2% in 2011, and 1.9% in 2012, surpassing pre-crisis levels. However, economic growth remained below the historic averages for the country and below the growth rates achieved by the CAPDR countries,¹ which had averages near 4%.² Growth has held steady in El Salvador in 2013.
- 1.2 The Comprehensive Crisis Plan³ weakened the fiscal situation, driving up the deficit to nearly 6% of GDP in 2009. The country embarked on a process to consolidate the public accounts, which brought down the deficit to around 4% of GDP in 2012. The government's financing needs are estimated at around 8% of GDP for 2013, including the amount needed to finance the deficit. Public debt came to 56.7% of GDP, counting the funds from the last Eurobond issue, in December 2012.
- 1.3 The country's current account deficit came to 5.25% of GDP in 2012, an increase of 25 basis points since end-2011. Inflation has remained below 1%, a relatively low rate compared with inflation in the CAPDR countries, which stands at 5%.⁴
- 1.4 In short, economic growth has been relatively sluggish, with an expanding fiscal deficit and a negative current account. In monetary terms, the country has a relatively low rate of inflation compared with the countries of Central America.
- 1.5 **El Salvador's financial system.** As of June 2013, El Salvador's financial system has a total of 43 entities, of which 22 are deposit-taking institutions, including banks (13), cooperatives (7), and credit unions (2), all supervised and inspected by the Superintendency of the Financial System of El Salvador (SSF).
- 1.6 As of June 2013,⁵ El Salvador's financial system⁶ had total assets of US\$14.546 billion, equivalent to 61.1% of GDP at current prices, which is high compared with the other countries in Central America (46.5%).⁷ The institutions comprising the banking subsector have a 94% share of the total assets, equivalent to US\$13.656 billion. It is important to note that 80% of the banking subsector's total

¹ Central America, Panama, and the Dominican Republic.

² IMF, 2013. 2013 Article IV Consultation, Country Report 13/132. Washington, D.C.

³ This plan was introduced by the government in June 2009 to mitigate the effects of the international financial crisis on the economy while supporting continued economic growth. For more information, see Ministry of Finance, Budget Division, 2009. Budget Bulletin 4, Year XIII.

⁴ IMF, 2013.

⁵ All figures correspond to this date unless otherwise indicated.

⁶ Understood as all 22 deposit-taking institutions.

⁷ <http://fas.imf.org/>, with 2011 figures for Central America.

assets are held by five foreign-based institutions: Banco Agrícola (Colombia, 28%), Scotiabank (Canada, 14%), Banco Davivienda (Colombia, 14%), Citibank (United States, 13%), and Banco de América Central (Colombia, 11%).

- 1.7 Credit is the largest asset category in the banking system, totaling US\$9.168 billion, or 67% of total assets. As of end-2012, the ratio of private sector bank credit to GDP had remained virtually unchanged for four years, shifting only slightly from 43% in 2008 to 38.6% in 2012.⁸
- 1.8 The banks have total liabilities of US\$11.270 billion (47.3% of GDP) concentrated mainly in retail deposits, which total US\$9.868 billion (84% of total liabilities).⁹ Of this amount, \$5.704 billion corresponds to retail demand deposits. Based on end-2012 data, deposits grew on average by just 1.6% in the period 2008-2012.¹⁰ The banking subsector has total equity of US\$1.876 billion.
- 1.9 In the context of Central America, including Panama and the Dominican Republic (CAPDR), El Salvador holds 7.6% of the total assets of the region's banks, which stood at US\$180.396 billion as of December 2012. As of the same date, the equity to assets ratio was 13.67% for El Salvador, compared with 10.71% for CAPDR. The nonperforming to total loan portfolio ratio was 2.94% for El Salvador, compared with 1.65% for CAPDR.¹¹
- 1.10 As instructed by the authorities, the financial institutions have been depositing their cash reserves in the Central Reserve Bank of El Salvador (BCR) or in foreign banks (in lesser amounts).¹² As of June 2013, there were cash reserves totaling US\$2.397 billion in the system, equivalent to 25% of total bank deposits or 42% of total demand deposits.^{13,14}
- 1.11 As concluded from the figures above, in the aggregate, El Salvador's financial system is adequately capitalized, if its capital is measured against total assets. Based on its asset position, the conclusion is that bank lending to the private sector, after falling in 2008, has remained virtually unchanged, with the slowest growth in the CAPDR region.¹⁵
- 1.12 In terms of liabilities, annual growth in deposits has been modest since 2008, remaining below 2%. The country's financial institutions have high levels of cash

⁸ Data from the World Bank's Global Financial Development Database (www.worldbank.org/financialdevelopment) and the BCR (www.bcr.gob.sv).

⁹ Average growth in deposits for the period 2008-2012 was 1.6%.

¹⁰ Data from the BCR: www.bcr.gob.sv.

¹¹ Data from the Secretariat of the Central American Monetary Council: <http://www.secmca.org/>.

¹² At this time, no financial institution is in a situation that would compromise its liquidity.

¹³ Data from the BCR: www.bcr.gob.sv.

¹⁴ This figure may be regarded as relatively high, taking into consideration that for CAPDR, according to figures from the Central American Monetary Council, the ratio of cash reserves to total retail deposits, a proxy, is 20.82%.

¹⁵ IMF, 2013.

reserves, which is primarily due to the prudential requirements imposed by the BCR and the SSF.

2. Institutional framework for liquidity in the financial system

- 1.13 **Institutional framework for liquidity in the financial system.** In January 2001, El Salvador's legislature signed the Monetary Integration Act,¹⁶ which established, *inter alia*: (i) the dollar as unrestricted legal tender that could be used for the payment of monetary obligations throughout the country, thereby dollarizing its economy; (ii) that all BCR obligations would be assumed by the State through the Ministry of Finance, which would be able to settle them with active obligations in its favor; (iii) an amendment to the BCR Act prohibiting the entity from issuing credit, avals, bonds, or guarantees to banks, nonbank financial intermediaries, or official credit institutions; and (iv) authorization for the BCR to carry out repurchase operations as a means of liquidity protection.
- 1.14 Dollarization was pursued as a mechanism for incentivizing fiscal adjustments that were needed in the country, and it had a number of beneficial effects, such as lowering interest and inflation rates, facilitating long-term corporate lending, and reducing uncertainty for businesses and consumers.¹⁷ Under the Monetary Integration Act, the SSF must set up a liquidity reserve proportional to bank deposits and obligations, to be administered by the BCR or a top-tier foreign bank, in dollars or dollar instruments. The reserve could be used provisionally by any bank to meet its liquidity needs.¹⁸
- 1.15 As a result of these changes, the functions of the BCR were circumscribed: (i) its authority to issue money was removed; (ii) it was prohibited from issuing credit to bank institutions; and (iii) it became the depository institution for the financial system's cash reserves, with limited responsibility and functions for maintaining system stability. These changes curtailed the ability to use monetary and exchange policies and meant the loss of seignorage, all while limiting the capacity of the BCR to serve as lender of last resort.
- 1.16 **Regulatory changes.** In the wake of the 2008 international financial crisis and the uncertainty in advance of the 2009 elections, and as a result of the findings of the evaluation conducted by the International Monetary Fund (IMF) and the World Bank through the Financial Sector Assessment Program in 2010,¹⁹ amendments

¹⁶ Legislative Assembly of El Salvador: Monetary Integration Act, Republic of El Salvador, San Salvador, January 2001.

¹⁷ Osorio (2009) provides support for this assertion. Berg and Borensztein (2000) discuss the advantages and disadvantages of dollarization.

¹⁸ The liquidity reserve would have three tranches: a first tranche for 25% of the demand deposits at the BCR, with automatic access provided to every bank; a second tranche for 25%, with withdrawal fees for every bank; and a final tranche for 50%, with withdrawal fees and prior authorization of the SSF and obligation to carry out a clean-up plan. Recently, in July 2013, the reserve requirement was increased by an additional 2% of total deposits through document CN-8/2013.

¹⁹ IMF, World Bank, 2010. FSAP El Salvador, Safety Nets and Crisis Management Arrangements. Technical Note.

were made to the BCR Act and the Banking Act, and the Financial System Supervision and Regulation Act was passed. These were intended to improve the instruments that were needed to prevent, mitigate, and control liquidity risks, among other objectives.

- 1.17 Amendments to the BCR Act authorized the entity to provide temporary liquidity support to financial institutions by issuing credit or any other type of liquidity financing to banks using resources from international or regional financial institutions, central banks, or other States.²⁰ This change resolved one of the main obstacles to the ability of the BCR to act as lender of last resort, mitigate liquidity risk, and preserve financial stability.
- 1.18 The fact that the country no longer had an entity with full monetary authority necessitated the introduction of prudential tools that would help establish a first line of defense against situations involving liquidity risk. In 2010, the SSF governing board published “Rules for integrated risk management in financial entities,”²¹ which included the obligation to identify, measure, control, and monitor the various risks and relationships between risks to supervised entities. Subsequently, in 2012, the BCR, in accordance with its regulatory functions, issued “Technical rules for managing liquidity risk,”²² including the minimum elements of risk management. These rules require financial institutions to report on their liquid assets by maturity and to provide analyses of simulated stress scenarios.
- 1.19 Along these lines, in 2012, amendments were made to the BCR Act to regulate operations in which BCR liquidity credit is issued to banking institutions²³ and an investment portfolio is purchased temporarily to protect bank liquidity²⁴ (both types of operation are temporary liquidity supports) and repurchase operations to protect bank liquidity.²⁵ Although these regulatory amendments give the BCR more tools to fulfill its role as lender of last resort, it needs complementary resources that will allow it to perform its functions. This is important inasmuch as El Salvador does not yet have a financial system stabilization liquidity fund²⁶ to help mitigate

²⁰ BCR Act, 2012. Article 49-A.

²¹ SSF, 2010. “NPB4-47: Rules for integrated risk management in financial entities,” San Salvador, El Salvador

²² BCR, 2012. “NRP-05: Technical rules for managing liquidity risk,” San Salvador, El Salvador.

²³ BCR, “Technical rules for issuing liquidity credit to the banking system,” San Salvador, El Salvador.

²⁴ BCR, “Technical rules for temporarily purchasing an investment portfolio to protect bank liquidity,” San Salvador, El Salvador.

²⁵ BCR, “Technical rules for repurchase operations to protect bank liquidity,” San Salvador, El Salvador.

²⁶ In countries with dollarized monetary systems, these types of permanent funds are administered by the central banks to provide resources in addition to bank reserves. A financial system stabilization liquidity fund in El Salvador would give the BCR resources to draw on to fulfill its mission as lender of last resort. The BCR expects the stabilization fund to begin operating in January 2015, a timeline that takes into account the need for an executive order to legally establish the fund. This process began in 2011 with IDB support to study international experiences and prepare preliminary designs for a stabilization fund for the country.

liquidity risks in the financial system, moderating the expectations of the various economic agents with respect to liquidity gaps and the attendant effects on credit and financing for the productive sector.

3. The problem and its causes

- 1.20 **The problem: exogenous shocks and liquidity.** Exogenous macroeconomic and financial shocks, whether systemic or specific, can cause temporary liquidity contractions in the financial system, dampening the supply of credit and, through this channel, activity in the real sector.
- 1.21 The BCR does not have a financial system stabilization liquidity fund to accompany the temporary liquidity supports authorized by law to distribute liquid resources to solvent financial institutions in need of liquidity in these situations, which would help mitigate their effects on the supply of credit.
- 1.22 **Liquidity risk.** A “lack of liquidity” or a “temporary liquidity contraction” is the manifestation of idiosyncratic (one institution) or systemic liquidity risk. This is an event or a series of events that are usually temporary and short-lived but can have longer-term effects on the supply of credit and thus on real sector growth.²⁷ In the financial literature, a “lack of liquidity” usually describes a crisis that originates in two markets—the financial assets market and the money market—and involves two types of liquidity risk.
- 1.23 **Market liquidity risk.** In the first case, a “market liquidity risk”²⁸ manifests idiosyncratically, at a microfinancial level, when a financial institution has difficulty selling an asset or assets that can be converted into a liquid medium, such as cash or bank reserves.²⁹
- 1.24 At the macrofinancial level, in a systemic exogenous financial crisis, financial institutions encounter market liquidity risk from various causes, such as loss of confidence in an institution, group of institutions, or the system, or the materialization of other risks such as credit or market risk. This type of liquidity risk can manifest in market failures,³⁰ such as the difficulty of institutions in a financial system to find counterparts to be able to execute sales of assets, a drop in trading volumes of assets that were formerly “liquid,” and rising price volatility.³¹

²⁷ The Bank for International Settlements (2012) shows how a decline in market liquidity weakens credit and exerts a drag on GDP.

²⁸ The literature also refers to this risk as a “trading liquidity risk.” For more information, see: John Hull (2012), *Risk Management and Financial Institutions*, 3rd edition. Wiley, Chapter 21.

²⁹ Specifically, the ability to sell an asset depends on its price, which in turn is affected by factors such as: (i) the market valuation of the asset (represented in bid and offer prices); (ii) the amount that needs to be sold; (iii) how quickly the asset must be sold; and (iv) the economic climate. These factors are identified in Hull (2012), as reference.

³⁰ Xavier Freixas, 2010, *The Lender of Last Resort in Today’s Financial Environment*, Els Opuscles del CREI, No. 4, Generalitat de Catalunya. The lack of a market is considered a failure per se.

³¹ Krishnamurthy (2010) reviews the causes of market liquidity risk.

- 1.25 **Funding liquidity risk.** In the second case, which originates in the money market, a microfinancial “funding liquidity risk” materializes, defined as the ability of a financial institution to resolve its cash needs as they arise at a reasonable price, in order to fulfill contractual and noncontractual commitments.³²
- 1.26 From a macrofinancial perspective, in a systemic exogenous financial crisis, funding liquidity risk is caused by market failures such as a deterioration in the conditions of external financing, whether from national or international funding sources,³³ a reduction in volumes in local repo³⁴ markets, an inability to obtain unsecured funding (interbank market), etc. The risk materializes when the system is unable to ensure that its institutions can obtain short-term funds at a reasonable price.
- 1.27 **Liquidity and solvency.** Solvency, at the most basic level, means that a company has more assets than liabilities, i.e., that it has a positive equity position.³⁵ A financial institution can be illiquid but solvent. However, solvency and liquidity are related inasmuch as solvency concerns can trigger a liquidity problem and vice versa.³⁶
- 1.28 **Market failure.** During a liquidity crisis, the supply of liquid assets available to a financial institution, or even to the financial system, dries up. In response, public intervention becomes necessary through the central banks, institutions that have intervention mechanisms to fully or partially correct market failures derived from the materialization of liquidity risks. This intervention generates what is known as macroeconomic or monetary liquidity,³⁷ which is usually short term and is used after a third party has verified that the financial institutions with liquidity problems do not also have solvency problems.
- 1.29 **Intervention mechanisms: Reserve requirement and liquidity reserves.** A reserve requirement is a minimum percentage of retail deposits and cash that financial institutions deposit, usually on a statutory basis, with the central bank, which administers it. The central bank can use the liquidity reserves deposited with it by the financial institutions to issue liquidity to illiquid but solvent institutions.
- 1.30 **Intervention mechanisms: Temporary liquidity supports.** These are mechanisms that the central bank can use to provide liquidity to financial

³² For this definition, see Jöel Bessis (2010), *Risk Management in Banking*, 3rd edition, Wiley.

³³ McAndrews (2002) and more recently Berrospide (2012) show how in episodes of systemic crisis, banks end up holding on to extra reserves, which has a procyclical effect that reduces system liquidity even further in a phenomenon known as hoarding.

³⁴ Adrian and Shin (2008) document how the repo markets contract substantially during crises.

³⁵ At a more technical level, solvency is related to the “capital adequacy” referred to by regulators, which establishes a minimum amount of capital that will allow financial institutions to sustain potential losses deriving from the risks to which they are exposed.

³⁶ For more references, Bessis (2010) explains the empirical interrelationship between liquidity and solvency, and invokes Northern Rock as an example of how an illiquid institution can become insolvent.

³⁷ Krishnamurthy (2010).

institutions. They include the temporary purchase of assets (portfolio and investments) or direct credit from the central bank to the financial institutions. In order to benefit from these operations, which, *inter alia*, are usually short-term transactions, the financial institution in question must be solvent and must provide guarantees of the highest quality.

- 1.31 **Intervention mechanisms: Financial stabilization liquidity fund.**³⁸ The basic objective of the financial stabilization liquidity fund is to promote the stability of the system through financial assistance—with public or private funds—for solvent institutions facing temporary liquidity problems,³⁹ using temporary liquidity supports. These funds also have the effect of reducing the self-insurance levels of banks, i.e., the precautionary reserves that banks set aside.⁴⁰
- 1.32 **Money market operations.** The central bank can intervene in the interbank market or the repo market to reduce volatility, using own resources, government resources, or the financial stabilization liquidity fund to temporarily repurchase bonds issued by the country's sovereign treasury.
- 1.33 **Rationale for IDB intervention in El Salvador.** In addition to the liquidity reserves, the BCR, in its financial system stabilization role, has legally established mechanisms to carry out the temporary liquidity support operations mentioned above. However, in order to execute these operations, it needs resources in addition to the liquidity reserves, which would usually be provided in a financial stabilization liquidity fund in the case of a dollarized economy.
- 1.34 **Liquidity fund.** In line with international best practices,⁴¹ the IMF and the World Bank (2010), as a result of the Financial Sector Assessment Program, recommended that El Salvador should establish a financial stabilization liquidity fund to serve as the vehicle for collecting and accumulating reserves that could be used to distribute liquidity to illiquid but solvent institutions, supplementing the temporary liquidity supports.⁴² The IMF ratified this request in its report for the Article IV consultation issued in May 2013.⁴³
- 1.35 Because El Salvador does not have a financial stabilization liquidity fund, it needs contingent resources on a provisional basis and supplementary to its liquidity reserves that can be offered to financial institutions during times of elevated liquidity risk, in order to mitigate the risk and support the BCR in its function of

³⁸ The BCR has been working with the IDB to design and prepare a financial stabilization liquidity fund for El Salvador.

³⁹ Definition taken from Bolzico (2011).

⁴⁰ See IMF, World Bank, 2010.

⁴¹ The liquidity fund is recommended as part of a comprehensive liquidity policy for a dollarized economy such as El Salvador's.

⁴² *Ibid.*

⁴³ IMF, 2013.

stabilizing the financial system. This will help mitigate the effects that a temporary liquidity contraction could have on the supply of credit to the real sector.

- 1.36 **Contingent credit line.** The objective will be achieved by authorizing a Development Sustainability Contingent Credit Line (DSL) for the country, which will serve as a first step towards establishing a financial stabilization liquidity fund and as support for the BCR so it can execute its role as lender of last resort through temporary liquidity supports, while moderating the expectations of the various economic agents with respect to potential liquidity shortages. The operation is consistent with the 2010-2015 lending targets of the GCI-9 under the category of lending to small and vulnerable countries, as well as with the IDB country strategy with El Salvador for 2010-2014 (document GN-2575).⁴⁴

B. Program objective

- 1.37 The objective of the program is to mitigate the effects that exogenous macroeconomic and financial shocks, whether systemic or specific, can have on vulnerable populations by causing temporary liquidity contractions in the financial system, dampening the supply of credit and, through this channel, activity in the real sector.

II. STRUCTURE OF THE OPERATION

A. Structure of the operation

- 2.1 **Financing instrument.** This operation will be implemented under the Development Sustainability Contingent Credit Line (DSL) in accordance with the “Proposal to Establish Contingent Lending Instruments of the IDB” (document GN-2667-2). The DSL enables the IDB to carry out contingent loan operations to provide individual support to countries that meet eligibility criteria and are able to take appropriate action to reduce systemic crisis risks deriving from temporary liquidity problems. Resources from the contingent credit line will enable the BCR to finance temporary liquidity supports to offer short-term liquid resources to sound financial institutions in specific situations.
- 2.2 **Program amount.** The program amount is for up to US\$100 million. This is below the maximum total amount that could be granted to El Salvador under this line (US\$300 million) pursuant to paragraph 4.15 of document GN-2667-2. The program amount is equivalent to 1% of total bank deposits, or 1.75% of demand deposits. Although the percentage of deposits covered by the program does not at first glance seem significant, the evidence shows that countries with a financial stabilization liquidity fund began with amounts equivalent to 1% of bank deposits

⁴⁴ It corresponds to the priority area of macrofiscal sustainability, which stresses that “one of the central elements of the Bank’s strategy is to support the country in achieving fiscal sustainability.” This project helps to mitigate this macrofiscal risk.

to finance these facilities, so one of the purposes of the fund would be met.^{45,46} Meanwhile, the liquidity fund would have a positive effect on the expectations of economic agents, including banks, by reducing the amount of self-insurance set aside by each financial institution,⁴⁷ which could then use the freed-up resources to issue credit to the productive sector. The resources used under the credit line and their cost will be repaid by each financial institution to the BCR in its capacity as the borrower, which in turn will return the funds to the IDB in accordance with the financing terms of this operation. Alternatively, in the event that the BCR requests resources but does not transfer them to a financial institution, the BCR will be responsible for repaying the amount to the IDB.

B. Main risks

- 2.3 In terms of social and environmental risks, pursuant to the Environment and Safeguards Compliance Policy (section OP-703, Directive B.13), this operation does not require classification. Furthermore, it will not have any significant or direct negative social effects or any such effects on the country's environment or natural resources.

1. Risks and mitigating factors

- 2.4 **Development risks.** (i) There is a possibility that financing would go to a solvency problem instead of a liquidity problem, in a possible adverse selection risk. This risk is mitigated by the no objection of the SSF, in which it declares that the eligible institution or institutions do not have a risk of insolvency. Low risk. (ii) There is a possibility of nonfulfillment of the conditionality matrix, in which case the disbursement would not be processed. Low risk.
- 2.5 **Public management and governance risks.** There is a risk that the BCR may not be able to identify and resolve potential liquidity problems. The Credit Regulations for the program will establish guidelines to ensure that the BCR is able to anticipate and resolve illiquidity situations. The BCR is a sound institution with proven technical capacity. Low risk.
- 2.6 **Macroeconomic and fiscal risks.** The country's economic growth is trailing that of other countries in the Central American region, and although its public finances have improved, they need to be further consolidated. There is a risk of delays in the implementation of fiscal measures, which would weaken the country's fiscal position and debt dynamics. The IDB maintains an ongoing dialogue with the country and other multilateral lending institutions to monitor the evolution of the Salvadoran economy and provide assistance in this regard. Medium risk.

⁴⁵ According to the project completion report for operation ES-L1029, in the experience with El Salvador, "The portfolio purchased from the financial institutions consists of 1,915 loans totaling US\$289.9 million."

⁴⁶ Mark Weisbrot, Jake Johnston, and Stephan Lefebvre. 2012. Ecuador's New Deal: Reforming and Regulating the Financial Sector. Center for Economic and Policy Research, Washington, D.C.

⁴⁷ See IMF, World Bank, 2010.

- 2.7 **Reputational risks.** The amount of the operation could turn out to be insufficient, in which case the system's liquidity problems would not be resolved and the risks of systemic crisis would require additional mitigating factors. Empirical experience⁴⁸ suggests that the amount is sufficient, so this risk is considered to be controlled and is categorized as low.
- 2.8 **Fiduciary risk.** Any imprecision, intentional or unintentional error, and in general any event that could affect the quality, timeliness, or transparency of the data that lead to execution of the triggers could create a fiduciary risk. This will be mitigated by identifying data sources that are official and specific. These sources will be included in the Credit Regulations for the program. Low risk.

III. IMPLEMENTATION AND MANAGEMENT PLAN

A. Summary of implementation arrangements

- 3.1 **Borrower and executing agency.** The Central Reserve Bank (BCR) will be the borrower and executing agency for this operation. The BCR is an autonomous technical public institution established by law with its own resources. It has a permanent mandate to maintain the liquidity and stability of the financial system, promote the development of an efficient, competitive, and solvent financial system, and regulate the expansion of credit in the financial system. In order to exercise these powers, the BCR must receive all relevant information in a timely manner, which it will require of the financial institutions and the SSF in the form and by the means determined by its board. The financial institutions will be required to provide to the BCR all information requested of them for such purposes. The BCR is known for the technical capacity and competence of its officials. The Development Bank of El Salvador (BANDESAL) will work⁴⁹ with the borrower only for the effects of fulfilling the following affirmative obligations: work with the IDB to identify and protect the social programs and investment expenditures to be listed in the conditionality matrix,⁵⁰ in accordance with the DSL objectives established in document GN-2667-2, in order to ensure that those programs continue to be funded during the DSL drawdown period.

⁴⁸ The experience with operation ES-L1029 suggests that the resources are more than sufficient, despite the fact that when the instrument was applied, it constituted a reactive, not preventive, action in that case. Among the lessons learned, the project completion report mentions that: "Making the Liquidity Program for Growth Sustainability available for a limited time, both in terms of the period of access to the product and the period of disbursement, proved wise because it was consistent with the temporary and emergency nature of the product and allowed for efficient use of the Bank's lending capacity." For more information, see: Mark Weisbrot, Jake Johnston, and Stephan Lefebvre, 2012.

⁴⁹ The BCR is not permitted to assume affirmative obligations in the conditionality matrix, so these will be fulfilled by BANDESAL, which has the legal capacity to do so.

⁵⁰ The ex ante evaluation of how the selected investment expenditures and programs would benefit poor and vulnerable populations during a crisis is set forth in the optional electronic link, [Cost-benefit analysis](#).

- 3.2 **Triggers.** As stipulated in document GN-2667-2, in the case of El Salvador, there will be a specific trigger for systemic shocks and specific triggers for nonsystemic exogenous shocks, as described below.⁵¹
- a. **Specific trigger for systemic shocks: EMBI spreads.** In accordance with document GN-2667-2, Emerging Markets Bond Index (EMBI) spreads will serve as the specific trigger for identifying systemic shocks. A systemic crisis is defined as an episode in which the EMBI spreads of at least one third of the countries in the sample comprising the IDB's 26 borrowing member countries are two standard deviations from the mean value during a rolling period of five years.
 - b. **Specific trigger for nonsystemic exogenous shocks 1: Interest rates.**⁵² This trigger is executed when the level of the interest rates that are effectively agreed upon at any given moment of the day in the 1- to 7-day repo market is more than two standard deviations above the mean value during a rolling period of 240 observations⁵³ of the weighted average rates in the 1- to 7-day repo market for every day until the last business day for which figures are available. The data source will be the BCR and the intraday trading system for monitoring.
 - c. **Specific trigger for nonsystemic exogenous shocks 2: Deposit levels.**⁵⁴ This trigger is executed when: (i) in the financial sector as a whole, the value of the total deposits at any given moment is more than two standard deviations below the mean value during a rolling period of 120 observations;⁵⁵ (ii) an individual institution that possesses less than 10% of the total consolidated deposits in the financial system has total deposits more than two standard deviations below the mean value during a rolling period of 120 observations for one or more days; (iii) an individual institution that possesses more than 10% of the total consolidated deposits in the financial system has total deposits more than two standard deviations below the mean value during a rolling period of 120 observations for five or more days.
 - d. **Specific trigger for nonsystemic exogenous shocks 3: Second tranche of reserves.**⁵⁶ This trigger is executed when a financial institution is using the second tranche of the liquidity reserves deposited with the BCR.

⁵¹ The individual, i.e. independent, occurrence of any of the triggers may prompt the country to exercise the option of requesting credit under the line.

⁵² As of August 2013, interest rates on repurchase agreements were at 1%. Source: BCR.

⁵³ These are daily observations made on every business day of the year. The rule was calibrated to obtain the full effect of one year.

⁵⁴ As of August 2013, total deposits in the system stood at US\$9.942 billion. Source: BCR.

⁵⁵ These are daily observations made on every business day of the year. The rule was calibrated taking into account that deposit terms are short and in any case less than one year.

⁵⁶ As of August 2013, no institution has requested access.

- 3.3 **Specific macroeconomic requirements for approval and drawdown in the event of a shock.** In accordance with document GN-2667-2, the macroeconomic requirements for approving an operation in the framework of the DSL will be the independent macroeconomic assessment (IMA) and an Article IV consultation report issued within the previous six months, or a request for a comfort letter from the IMF in the event that the consultation report was issued over six months prior or the country does not have arrangements in place for Article IV consultations. For each drawdown of resources, aside from verification of the triggers (eligible events) and compliance with the conditionality matrix, an IMA will need to be distributed verifying that macroeconomic conditions are acceptable. In the event that the IMA shows a significant deterioration in the economic situation, it may be considered wise to proceed with the disbursement if the country has a borrowing arrangement with the IMF.
- 3.4 **Credit Regulations.** As a condition precedent to the first disbursement, Credit Regulations agreed upon with the IDB and approved by the BCR governing board will be established (see paragraph 3.7(ii)).
- 3.5 **Use of operation resources.** In accordance with its establishing legislation and the rules protecting bank liquidity, the BCR may fulfill its role as lender of last resort through temporary liquidity supports to financial institutions that request assistance.
- 3.6 **Eligibility criteria for institutions.** Financial institutions eligible to receive liquidity support must secure the loans in accordance with the conditions stipulated in the technical rules governing operations in which BCR liquidity credit is issued to banking institutions and an investment portfolio is purchased temporarily to protect bank liquidity. This is without prejudice to the other conditions stipulated in the Credit Regulations.
- 3.7 **Special conditions precedent to the first disbursement:** (i) signature and entry into effect of an agreement between the BCR and the Development Bank of El Salvador (BANDESAL) for the purposes of compliance with the conditionality matrix referenced in paragraph 4.1; (ii) approval of the Credit Regulations agreed upon with the IDB for use of the loan proceeds, including *inter alia*: (a) the eligibility and selection criteria for eligible financial institutions; (b) the negative list of environmental activities and the applicable environmental procedures; and (c) a detailed description of how the program will be executed, including the functions of the BCR; (iii) presentation of a legal opinion from the borrower confirming its authority to sign a loan contract with the IDB, effective at the time of signature, and confirming the authority of the borrower to fulfill the obligations set forth in the program;⁵⁷ (iv) presentation of a legal opinion from BANDESAL confirming its authority to fulfill its obligations under the program; (v) verification by the Bank, through an independent macroeconomic assessment (IMA) that the borrowing country has an adequate macroeconomic framework. In the event that the

⁵⁷ The borrower has already fulfilled this condition precedent.

IMA shows a significant deterioration in the economic situation, the Bank may consider making the disbursement if the country has a borrowing arrangement with the IMF; (vi) the Bank has verified the occurrence of one or more eligible events (one of the triggers listed in paragraph 3.2); and (vii) the borrower, through BANDESAL, continues to fulfill the conditions set in the conditionality matrix, demonstrating that the social programs and investment expenditures from the Economic Development Fund aimed at financing micro, small, and medium-sized enterprises that are to be protected have the appropriate financing at the time of the corresponding disbursement request.⁵⁸

- 3.8 In order for the BCR to carry out the activities required for implementation, the administrative units that will participate in applying these conditions are the following: Financial System Office, Financial Operations Office, Department for the Stability of the Financial System, Payments and Securities Department, and the Legal Department.
- 3.9 The BCR will execute the operations authorized by law in accordance with the technical rules governing each one. The execution of operations authorized by the technical rules, in particular the guarantees issued under those operations, and monitoring of the financial situation of the participating financial institutions will receive support from the the SSF, in accordance with the applicable laws and regulations and the provisions of the Credit Regulations.
- 3.10 Funds drawn from the contingent credit line will be deposited into an account at the BCR that is separate from the one that will be used to field requests from the financial institutions for temporary liquidity supports. Unused funds from drawdowns may be invested by the BCR using the same reserves policy.

B. Monitoring and evaluation arrangements

- 3.11 **Requirements subsequent to approval of the credit line.** The IDB and the BCR will remain in close communication throughout the drawdown period. During this period, the IDB will conduct monitoring of the country's macroeconomic framework, in order to ensure that a set of consistent macroeconomic policies is in place, as well as the conditionality matrix, on a schedule that meets the institution's reporting needs, but at least every six months.
- 3.12 **Nonfulfillment of conditions.** The IDB will quickly notify the borrowers if any of the conditions are not being fulfilled and will set a date for subsequent review to confirm that the condition has been fulfilled.

⁵⁸ The conditions set forth in subparagraphs (v), (vi), and (vii) are conditions precedent to each disbursement (see paragraph 3.3).

IV. CONDITIONALITY MATRIX

- 4.1 The conditionality matrix⁵⁹ identifies the list, agreed on with the IDB, of programs and investment expenditures from the Economic Development Fund aimed at financing micro, small, and medium-sized enterprises that the borrower pledges to protect, through BANDESAL, at the onset of an economic shock, so that programs helping the vulnerable population have the appropriate financing during the DSL drawdown period. The prior written consent of the borrower, the IDB, and BANDESAL will be required in order to make any amendments to the conditionality matrix (see required link #2).

⁵⁹ BANDESAL will be responsible for complying with the provisions of paragraph 3.1.

| Development Effectiveness Matrix | | | |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------|
| Summary | | | |
| I. Strategic Alignment | | | |
| 1. IDB Strategic Development Objectives | Aligned | | |
| Lending Program | Lending to small and vulnerable countries. | | |
| Regional Development Goals | | | |
| Bank Output Contribution (as defined in Results Framework of IDB-9) | | | |
| 2. Country Strategy Development Objectives | Not Aligned | | |
| Country Strategy Results Matrix | | | |
| Country Program Results Matrix | GN-2696 | The intervention is not included in the 2013 Country Program Document. | |
| Relevance of this project to country development challenges (If not aligned to country strategy or country program) | GN-2575 | Although this project is not aligned with the Country Strategy objectives, it contributes to the mitigation of the macro-fiscal risk, which, according to the Country Strategy, is one of the principal risks to its implementation. | |
| II. Development Outcomes - Evaluability | Highly Evaluable | Weight | Maximum Score |
| | 7.5 | | 10 |
| 3. Evidence-based Assessment & Solution | 8.4 | 33.33% | 10 |
| 4. Ex ante Economic Analysis | 7.0 | 33.33% | 10 |
| 5. Monitoring and Evaluation | 7.1 | 33.33% | 10 |
| III. Risks & Mitigation Monitoring Matrix | | | |
| Overall risks rate = magnitude of risks*likelihood | Low | | |
| Identified risks have been rated for magnitude and likelihood | | | |
| Mitigation measures have been identified for major risks | Yes | | |
| Mitigation measures have indicators for tracking their implementation | | | |
| Environmental & social risk classification | B.13 | | |
| IV. IDB's Role - Additionality | | | |
| The project relies on the use of country systems (VPC/PDP criteria) | | | |
| The project uses another country system different from the ones above for implementing the program | | | |
| The IDB's involvement promotes improvements of the intended beneficiaries and/or public sector entity in the following dimensions: | | | |
| Gender Equality | | | |
| Labor | | | |
| Environment | | | |
| Additional (to project preparation) technical assistance was provided to the public sector entity prior to approval to increase the likelihood of success of the project | | | |
| The ex-post impact evaluation of the project will produce evidence to close knowledge gaps in the sector that were identified in the project document and/or in the evaluation plan | | | |

The objective of the operation is to mitigate the effects that an exogenous macroeconomic or financial shock, systemic or specific, may have in the economy through a temporal reduction in liquidity. The operation is aligned to the strategic development goal of financing for small and vulnerable countries.

The diagnosis presents adequate information on the macroeconomic situation and the financial system. The vertical logic is adequate and indicators allow measuring the expected results. The document presents a cost benefit analysis which compares the benefit in terms of the credit that IFIs would grant to the total cost of the operation. The Monitoring and Evaluation Plan is adequate, there will be permanent monitoring of the triggers and a before-after evaluation.

The loan identifies the risks. The most important ones are to fund a solvency problem instead a liquidity problem and the magnitude is not enough. Both were classified as low.

RESULTS MATRIX

| Program objective | The objective of the program is to mitigate the effects that exogenous macroeconomic and financial shocks, whether systemic or specific, can have on vulnerable populations by causing temporary liquidity contractions in the financial system, dampening the supply of credit and, through this channel, activity in the real sector. | | | | | | |
|-----------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------|--|--|--|---------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Indicators | Unit | Baseline | | | | Target ¹ | Description |
| IMPACTS | | | | | | | |
| Consolidated annual variation in lending to the private sector after one year of a systemic or specific exogenous macroeconomic and financial shock | % | -6.3% ² | | | | -5.0% | The figure reflects consolidated annual data for the banking subsector in El Salvador for the purpose of identifying the effects, over a one-year horizon, of a systemic or specific exogenous macroeconomic and financial shock on the supply of credit. Source: Central Reserve Bank of El Salvador (BCR) |
| OUTCOMES | | | | | | | |
| Change in average daily lending rates | bp | 200 bp ³ | | | | 100 bp | The effects of an exogenous shock influence supply and demand for credit. In the first case, a liquidity shortage can increase the cost of lending. Source: BCR |
| Excess liquidity reserves relative to what is needed | % | 123.9% ⁴ | | | | 120% | An excess of liquidity reserves is indicative of action by financial institutions to “self-insure.” The program seeks to reduce excess reserves so the freed-up funds can be used to extend credit. |
| OUTPUTS | | | | | | | |
| Contingent financing by the IDB to provide liquidity to regulated financial institutions | US\$ | 300 million | | | | 300 million | Up to US\$300 million may be issued under the Development Sustainability Contingent Credit Line to mitigate the direct effects of exogenous economic shocks by providing liquidity to regulated financial institutions. |

¹ One year after drawdown of the credit line is requested.

² The figure corresponds to the steepest decline in deposits during the macroeconomic and financial shock of 2008.

³ Due to the exogenous macroeconomic and financial shock of 2008 and the uncertainty ahead of elections, lending rates rose by 200 basis points between September 2008 and December 2009.

⁴ The percentage corresponds to the largest excess of consolidated bank reserves, observed in July 2009 in El Salvador.

FIDUCIARY AGREEMENTS AND REQUIREMENTS

Country: El Salvador
Project number: ES-X1007
Name: Development Sustainability Contingent Credit Line to Provide Temporary Liquidity to the Financial System
Executing agency: Central Reserve Bank of El Salvador (BCR)
Prepared by: Mario Castaneda (FMP/CES); Marco Alemán (FMP/CES)

I. SUMMARY

- 1.1 This report has been prepared based on the fiduciary context of the executing agency and the financial management and procurement policies for IDB-financed projects.¹ It establishes the agreements and requirements for financial management that have been agreed upon with the executing agency. It should be noted that given the nature of the program, program resources will not be used to procure goods, works, or consulting services subject to the IDB's procurement policies.
- 1.2 For fiduciary administration of the program, the Central Reserve Bank of El Salvador (BCR) will use its current administrative structure, establishing the different roles, responsibilities, and procedures needed for program execution in an operating manual. For financial management, the IDB's financial management policy will apply, supplemented by BCR rules and regulations. Program resources will be disbursed to the BCR, which will channel them to the intermediary financial institutions that are declared eligible in accordance with the technical rules governing temporary liquidity support operations.

II. THE EXECUTING AGENCY'S FIDUCIARY CONTEXT

- 2.1 Under its establishing legislation, the BCR has institutional autonomy, and its primary functions are to ensure the normal functioning of the system of payments and to create the right conditions for a financial system that is competitive and solvent.
- 2.2 The legislation establishing the BCR authorizes it to use resources from international or regional financial institutions, central banks, or other States to issue credit or any other form of liquidity financing to banks in the event of structural deterioration in the liquidity of one or more institutions, to prevent situations of

¹ OP-273-2 and OP-274-2: Financial Management Policy and Operational Guidelines; and documents GN-2349-9, GN-2350-9, and OP-272-1: Procurement Policies and Operational Guidelines.

general illiquidity in the financial system; to restore liquidity in the event of a crisis caused by a strong contraction in the market, and in cases of force majeure or public calamity that cause the banks to become illiquid.

- 2.3 In turn, the Development Bank of El Salvador (BANDESAL) is an autonomous, permanent public credit institution established by law with its own resources that launched operations in January 2012 when the Financial System Law for the Promotion of Development entered into effect. Its mission is to promote the competitive development of El Salvador's economy and society, offering financial instruments and technical support, directly and through strategic partners, to productive sectors and other economic actors. BANDESAL will work² with the borrower for the sole purpose of fulfilling the following affirmative obligations: work with the IDB to identify and protect the social programs and investment expenditures to be listed in the conditionality matrix,³ in accordance with the objectives of the Development Sustainability Contingent Credit Line (DSL) as established in document GN-2667-2, in order to ensure that those programs continue to be funded during the DSL drawdown period.

III. FIDUCIARY RISK EVALUATION AND MITIGATION ACTIONS

- 3.1 The fiduciary risk associated with the operation is regarded as low, considering the effective and efficient management observed during execution of loan 2104/OC-ES, the purposes and characteristics of which were similar to this operation's. However, because the same structure will be used for administration of the program, the measures described in the table below are proposed to mitigate the fiduciary risks:

Table 1: Identified risks and proposed mitigation actions

| Risks/weaknesses | Preventive/corrective action | Deadline |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------|
| Lack of clarity among the different administrative structures of the BCR on the roles, responsibilities, and procedures for program administration in relation to the IDB. This risk is primarily associated with purely operational aspects related to reporting. | The Operating Manual for the program will contain a chapter on the organizational structure for program execution, clearly defining the roles, responsibilities, and procedures of the various BCR offices and departments that will be involved in the operation. | Condition precedent. |

² The BCR is not permitted to assume affirmative obligations with respect to the conditionality matrix; accordingly they will be fulfilled through BANDESAL, which confirmed its legal capacity to do so.

³ Optional electronic link 1 establishes the ex ante evaluation of how the selected programs and investment expenditures will, during a crisis, benefit poor and vulnerable populations.

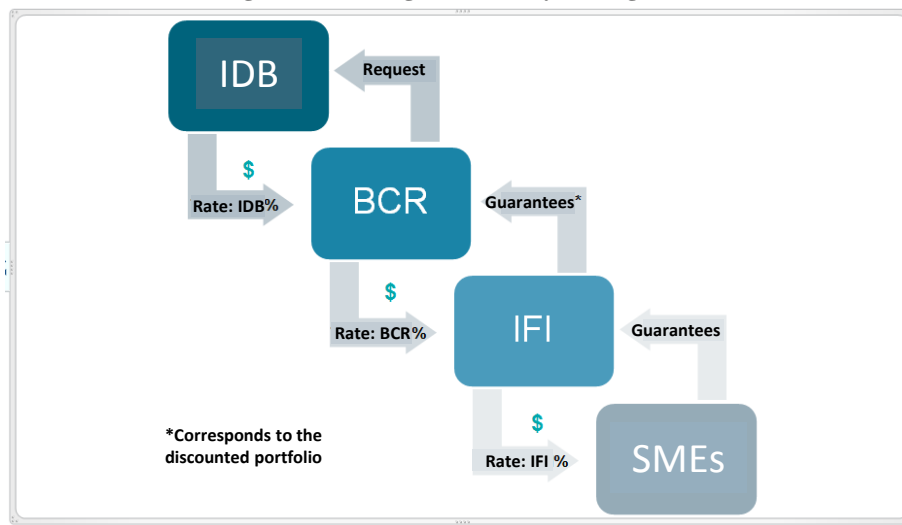
IV. CONSIDERATIONS FOR THE SPECIAL CONDITIONS OF THE CONTRACT

- 4.1 The following agreements and requirements will be included in the Special Conditions of the loan contract:
- (i) Presentation for IDB approval of Credit Regulations that contain an Operating Manual as an independent chapter within the Credit Manual for the program, defining the procedures as well as the mechanisms for institutional and interagency coordination with the participating entities, together with their roles and responsibilities in the context of program execution.

V. FINANCIAL MANAGEMENT AGREEMENTS

- 5.1 **Accounting and financial reports.** The administrative/financial/accounting systems of the BCR will be used to record transactions and produce reports for this operation. The BCR will also ensure that it maintains any auxiliary records that are deemed necessary to support the financial reporting requirements established in the loan contract.
- 5.2 **Internal control.** The rules and regulations of the BCR will apply, together with the controls established in the Operating Manual for program execution. The BCR has an audit, risk management, and self-evaluation committee with rules and regulations that have been approved by the BCR governing board. These include: (i) technical rules on internal control; (ii) rules for the functioning of the audit committee; (iii) internal audit regulations; (iv) guidelines for risk management; and (v) guidelines for monitoring of internal control.
- 5.3 **Execution mechanism: Disbursements and cash flow.** Funds will be disbursed directly to the BCR on a contingency basis according to demand among the participating financial institutions. This demand will be in the form of direct requests for credit by those institutions, or agreements for the temporary purchase of investment portfolios, as illustrated in Figure 1.

Figure 1: Contingent fiduciary arrangement



- 5.4 **Conditionality.** BANDESAL will come to an agreement with the BCR and the IDB on the means of verification of compliance with the conditionality matrix. In addition, BANDESAL will:
- (i) Deliver to the IDB, prior to the first disbursement, a historical series on the evolution of new loans from the Economic Development Fund, classified, if possible, by use of proceeds and sector, the current availability of resources, and usage projections for the next three years.
 - (ii) Present regular monthly reports with the amounts of all new loans, with the same classifications used in the series in the previous subparagraph.
- 5.5 **Internal audit.** The BCR has an internal audit unit with suitable human and technical resources, and that unit is expected to include a review of the activities under this operation as part of its annual supervision planning.
- 5.6 **External control and reports.** External control of the program will be the responsibility of the external auditor hired for this purpose by the BCR.⁴ Annual financial statements will be prepared in accordance with the IDB's Guidelines for Financial Reporting and Audits.
- 5.7 **Supervision.** For financial monitoring of the program, (unaudited) financial reports generated by the BCR's institutional information systems will be used, and the necessary disaggregation will be provided in the corresponding notes and supplemental financial information prepared for that purpose.

⁴ Paragraph 3.7 of the "Guidelines for Financial Reporting and External Audits of Operations Financed by the Inter-American Development Bank" states: It is recommended that audits of the executing agency and the borrower or co-executing agencies (as applicable) for the project should be conducted by the same independent auditor or as the case may be, if eligible for the Bank, an auditor that is already providing this type of service. In some exceptional cases, the loan contracts may stipulate that audits of the project and the borrower or executing agency are to be conducted by different independent auditors.

- 5.8 Initially, these reports will be delivered quarterly; the reporting frequency may be adjusted subsequently. These quarterly reports will be presented no later than 45 days after the end of each calendar quarter. In the first six months of execution, the IDB will conduct on-site reviews of the financial information presented. The fiduciary risks will be reevaluated and a determination will be made as to whether ongoing on-site reviews, versus desk reviews, are needed.
- 5.9 **Operating Manual.** The aspects presented in these fiduciary agreements and requirements will be described in detail in an Operating Manual, which will have to be cleared by the undersigned fiduciary specialists.

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE-____/13

El Salvador. Loan ES-X1007 to the Banco Central de Reserva de El Salvador
Development Sustainability Contingent Credit Line
to Provide Temporary Liquidity
to the Financial System

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 Banco Central de Reserva de El Salvador, as Borrower, for the purpose of granting it a Development Sustainability Contingent Credit Line to Provide Temporary Liquidity to the Financial System. Such financing will be for the amount of up to US\$100,000,000, from the resources of the Bank's Ordinary Capital, which may be utilized for the approval and financing of individual operations within the Development Sustainability Contingent Credit Line, and will be subject to the Financial Terms and Conditions and the Special Contractual Conditions of the Project Summary of the Loan Proposal.

(Adopted on ____ 2013)