

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

EL SALVADOR

GLOBAL CREDIT LOAN FOR FINANCING PRODUCTIVE DEVELOPMENT IN EL SALVADOR

(ES-L1089)

LOAN PROPOSAL

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ELECTRONIC LINKS	
REQUIRED	
1.	Monitoring and evaluation plan http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=38810745
2.	Environmental and social management plan http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=38805556
OPTIONAL	
1.	Economic analysis http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=38810818
2.	Project risk management (PRM) http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=38806032
3.	Structure and recent performance of El Salvador's financial system http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=38806066
4.	Analysis of demand for investment credit http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=38805523
5.	BANDESAL: Origin, institutional mandate, objectives, and recent financial performance http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=38793993
6.	Risk management and control at BANDESAL http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=38793856
7.	Program operational flow http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=38806046
8.	Credit Regulations http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=38797639
9.	Administrative activities http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=38808117
10.	Safeguard policy filter report http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=38810745
11.	Institutional capacity analysis http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=38811744

ABBREVIATIONS

BANDESAL	Banco de Desarrollo de El Salvador [El Salvador Development Bank]
BCR	Banco Central de la Reserva de El Salvador [Central Reserve Bank of El Salvador]
GCI-9	Ninth General Capital Increase, or Ninth General Increase in the Resources of the Inter-American Development Bank
IFIs	Intermediary financial institutions
MSMEs	Micro, small, and medium-sized enterprises
OC	Ordinary Capital
PCR	Project completion report
PRM	Project risk management
SSF	Superintendencia del Sistema Financiero de El Salvador [Financial System Superintendency of El Salvador]
TFP	Total factor productivity
WB-IFC	World Bank–International Financial Corporation
WEF	World Economic Forum

PROJECT SUMMARY

EL SALVADOR GLOBAL CREDIT LOAN FOR FINANCING PRODUCTIVE DEVELOPMENT IN EL SALVADOR (ES-L1089)

Financial Terms and Conditions			
Borrower and executing agency: Banco de Desarrollo de El Salvador [El Salvador Development Bank] (BANDESAL) Guarantor: Republic of El Salvador		Flexible Financing Facility*	
		Amortization period:	25 years
		Original WAL:	15.25 years
		Disbursement period:	48 months
		Grace period:	5.5 years
Source	Amount	Inspection and supervision fee:	**
IDB (Ordinary Capital)	US\$100 million	Interest rate:	LIBOR-based, US\$
		Credit fee:	**
Total	US\$100 million	Currency:	U.S. dollars from the Ordinary Capital
Project at a Glance			
Project objective/description: The program's objective is to support productivity growth at micro, small, and medium-sized enterprises (MSMEs) by improving their access to medium- and long-term credit for productive investment and restructuring projects.			
Special contractual conditions precedent to the first disbursement: Approval of the Credit Regulations by BANDESAL, with the Bank's prior no objection, will be the condition precedent to the first disbursement (see paragraph 3.7).			
Exceptions to Bank policies: The Board of Executive Directors is asked to approve a partial waiver to the Bank's Operational Policy OP-303, "Guarantees required from the borrower," for the Republic of El Salvador to guarantee only the financial obligations stemming from this operation (see paragraph 3.1).			
Project qualifies as: SEQ [] PTI [] Sector [] Geographic [] Headcount []			

* Under the terms of the Flexible Financing Facility (document FN-655-1), the borrower has the option of requesting changes to the amortization schedule, as well as currency and interest rate conversions. The Bank will take operational and risk management considerations into account when reviewing such requests.

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

I. DESCRIPTION AND RESULTS MONITORING

A. Frame of reference, problem to be addressed, and rationale for the Bank's support

- 1.1 El Salvador has a small, open, and dollarized economy with a productive structure geared toward services and consumption, and heavy trade dependence on the United States economy. Following a 3.1% contraction in gross domestic product (GDP) in 2009, the economy has recovered gradually to expand at an average of 1.8% per year since then.¹ Although its annual growth rate is still relatively low compared to both its own historical averages and those of other countries of similar development level in Central America and the Caribbean, the economy is expected to grow at annual rates of between 2%² and 3%³ in the medium term.
- 1.2 El Salvador's productive structure has changed over the last two decades as a result of the structural reforms implemented in the early 1990s, heavy migration to the United States, the relative development of its financial system, and the dollarization adopted in 2001, among other reasons. In 1990 the agriculture sector generated 17.1% of GDP, but by 2013 its share had fallen to 12.19%, while sectors such as commerce, restaurants and hotels, and financial establishments and insurance increased their GDP shares in the same period (from 18.1% to 20.1% and from 2.2% to 3.6%, respectively).⁴
- 1.3 **Low productivity.** Like other countries in the region, El Salvador lags in terms of productivity. This problem is particularly important for tradable sectors such as agriculture and manufacturing. Total factor productivity (TFP) in agriculture has been growing at roughly 0.31% per year in El Salvador, one of the lowest rates in Latin America.⁵ In manufacturing, TFP grew at a good pace until 2005, but since then it has faltered as investment levels have dropped compared to other countries in the region. In addition to the adverse impact that Dutch disease⁶ has exerted on TFP through the tradable sectors of the economy, El Salvador's particular pattern of production and employment, heavily concentrated in low-productivity small businesses mostly operating informally, has exacerbated the country's productivity problem. At the aggregate level productivity has performed poorly in recent years, as shown in Figure 1.

¹ Following a 3.1% drop in GDP in 2009, El Salvador recovered with positive growth figures of 1.4% in 2010, 2.2% in 2011, and 1.9% in 2012, thereby surpassing the precrisis level.

² International Monetary Fund, [World Economic Outlook, October 2013](#).

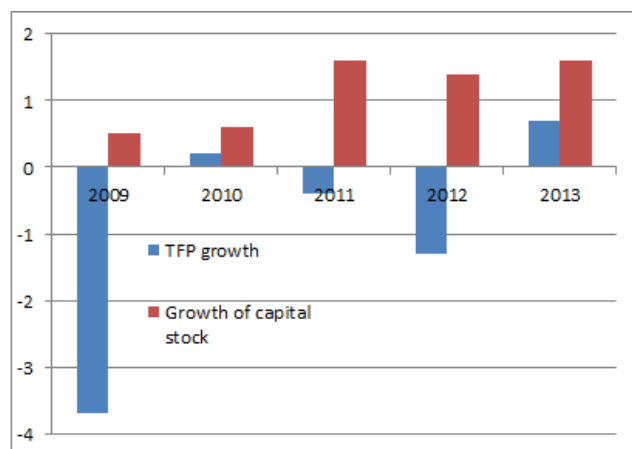
³ For further details, see the annex, "[Brief macroeconomic analysis of El Salvador](#)," IDB-CID, April 2014.

⁴ "[Balance económico para El Salvador](#)" [Economic balance sheet for El Salvador], ECLAC, 2013.

⁵ Pages, C., ed., *The age of productivity: Transforming economies from the bottom up*, IDB, 2010.

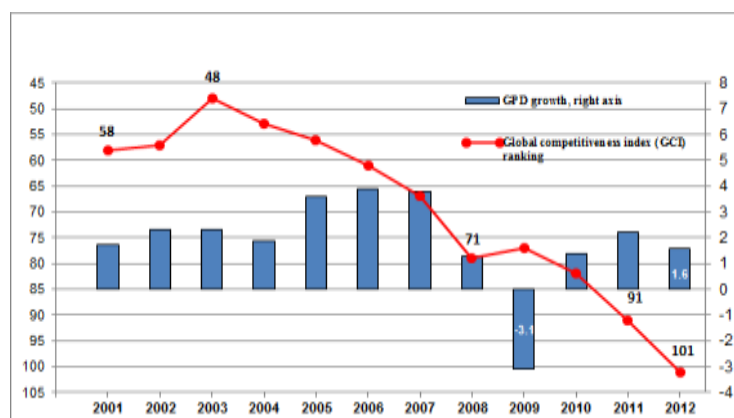
⁶ Acosta et al. (2009) find that remittance flows induce a reallocation of factors towards nontradable sectors, a phenomenon known as "Dutch disease," which could potentially be an additional factor contributing to low productivity growth in El Salvador (see Acosta, P., E. Lartey, and F. Mandelman, "Remittances and the Dutch disease," Working Paper 2007-8^a, Federal Reserve of Atlanta, August 2009).

Figure 1. TFP in El Salvador



Source: [Economist Intelligence Unit](#), April 2014.

Figure 2. El Salvador: Competitiveness, Deterioration, and GDP Stagnation



Source: World Economic Forum (WEF) and Central Reserve Bank of El Salvador (BCR), 2013.

- 1.4 **Deteriorating competitiveness.** Slower TFP growth in El Salvador has gone hand-in-hand with a loss of competitiveness and a deterioration in the ease of doing business.⁷ As shown in Figure 2, from 2012 to 2013 El Salvador fell 10 notches (from 91 to 101) in the WEF Global Competitiveness Index. Similarly, the 2013 Ease of Doing Business Index published by the World Bank–International Finance Corporation (WB-IFC) ranked the country 113th out of 185 countries (down one notch from 2012).
- 1.5 These indexes rank countries according to their macroeconomic management, regulatory environments, institutions, and development plans, as well as the ability of their firms to integrate, innovate, adopt new technologies, and adapt to markets. Table 1 reports the performance of each of the component indicators of El Salvador’s WEF Global Competitiveness Index, which show that, in addition to basic requirements of environment and efficiency enhancements in its markets, competitiveness challenges relate directly to factors of innovation, technological readiness, and business sophistication, which are evaluated at the firm level. As can be seen in the table, these factors have a strong influence on the country’s competitiveness, and over the last year have deteriorated quite sharply, particularly in terms of the readiness to adopt new technologies and innovate.

⁷ [Global Competitiveness Index 2013-2014](#), prepared by the WEF, and 2014 [Ease of Doing Business Index](#) prepared by the World Bank–International Finance Corporation (WB-IFC).

Table 1. Pillars of Competitiveness

Factor	Rank 2012-2013	Rank 2011-2012	Rank 2010-2011	Change in rank 2012-2013 / 2011-2012
Number of countries	144	142	139	NA
Overall position	101	91	82	-10
Basic requirements	99	87	71	-12
Institutions	134	118	101	-16
Infrastructure	72	65	59	-7
Macroeconomic environment	103	80	64	-23
Health and primary education	90	90	81	0
Efficiency enhancers	103	96	87	-7
Higher education and training	105	105	101	0
Goods market efficiency	74	69	53	-5
Labor market efficiency	121	108	88	-13
Financial market development	81	72	78	-9
Technological readiness	102	90	81	-12
Market size	83	86	87	3
Innovation and sophistication factors	107	106	96	-1
Business sophistication	82	74	68	-8
Innovation	128	127	126	-1

Source: WEF, *Global Competitiveness Report*, 2010-2011, 2011-2012 and 2012-2013. The report draws on statistics obtained from recognized international agencies (such as the United Nations Educational, Scientific and Cultural Organization (UNESCO), the International Monetary Fund (IMF), and the World Health Organization (WHO)), in conjunction with subjective data obtained from the [World Economic Forum's Annual Executive Opinion Survey](#).

- 1.6 In recent years, Salvadoran firms have been under pressure to improve their productive performance, in order to stay competitive in the dollarized economy and to meet the challenges and exploit the opportunities of the more open trading arrangements arising from free trade agreements, particularly the Dominican Republic–Central America–United States Free Trade Agreement (DR-CAFTA). For a given level of demand, outperforming local or foreign competitors means becoming more competitive by producing at lower costs or offering products of superior value that justify a premium price (Porter and van der Linde).⁸ To achieve that, firms need to improve and innovate continuously in terms of how they produce, how they design products, and the market segments they serve. This means making investments, which requires access to credit on terms adapted to the firms' cash flows and the amortization period of their projects.

⁸ Porter, M., and C. van der Linde, "Towards a new conception of the environment competitiveness relationship," *Journal of Economic Perspectives*, vol. 9, issue 4, 1995.

- 1.7 **Problems facing MSMEs.**⁹ Salvadoran firms generally have a limited ability to innovate owing to the obsolescence of their equipment and the prevalence of outdated business models.¹⁰ Their inability to gain access to more modern technologies and migrate towards more productive business models is due largely to low levels of investment, resulting from limited access to medium- and long-term credit.^{11 12} Often, most of them have to make use of short-term supplier and/or bank credit to undertake their investments, which limits their possibilities for expansion. Irrespective of the various factors that may undermine their productivity and competitiveness, access to investment credit should ease their transition to technologically more efficient and better capitalized firms that are also much more productive and integrated into global value chains.¹³
- 1.8 These problems of low levels of investment and limited access to medium- and long-term credit are particularly acute among MSMEs,¹⁴ which play a crucial role in El Salvador's economic growth and in its productive diversification, competitiveness, job creation, and income generation. The most recent census¹⁵ shows that this business segment accounts for 99.6% of the country's enterprises, generating 58.5% of employment and 30% of GDP.¹⁶
- 1.9 In general, there are numerous demand-side factors that explain the difficulties many MSMEs face in gaining access to credit, the most well-known being:¹⁷ (i) the lack of behavioral track records and internal procedures for generating quality information on their activities and operations, as well as strong resistance to sharing information; (ii) limited administrative and financial management capacity; and (iii) lower levels of capitalization and capacity to offer collateral.
- 1.10 Moreover, medium- and long-term financing is so scarce in El Salvador, that even MSMEs which are already borrowers in the local financial system, particularly for short-term credit, find it hard to access on terms and conditions suited to their investment projects. This shortage of credit for investment makes it difficult for many MSMEs to scale their operations to optimal levels. This state of affairs does

⁹ This operation will use the definition of MSMEs provided by the Central Reserve Bank of El Salvador (BCR): firms with fewer than 99 employees and assets not exceeding US\$228,571.41. See *Manual de Cuentas Nacionales* [Manual of National Accounts], BCR, 2005.

¹⁰ [Encuesta de competitividad empresarial](#) [Business competitiveness survey], FUSADES, 2013.

¹¹ [“Doing business in a more transparent world 2012 – economy profile: El Salvador,”](#) WB-IFC, 2012.

¹² As shown in the [Analysis of demand for investment credit](#), in recent years El Salvador's credit-to-GDP ratio has been lower than for other Central American countries and the Dominican Republic (9 points below) and for countries with a similar per capita income, adjusted for purchasing power parity (PPP): Algeria, Armenia, Belize, Bhutan, Egypt, Jordan, Namibia, Paraguay, and Sri Lanka (1.9 points lower).

¹³ See the supplier financing trends of reported in the annex on [Analysis of demand for investment credit](#).

¹⁴ [Business competitiveness survey](#), FUSADES, 2013.

¹⁵ [National Census of El Salvador, 2005.](#)

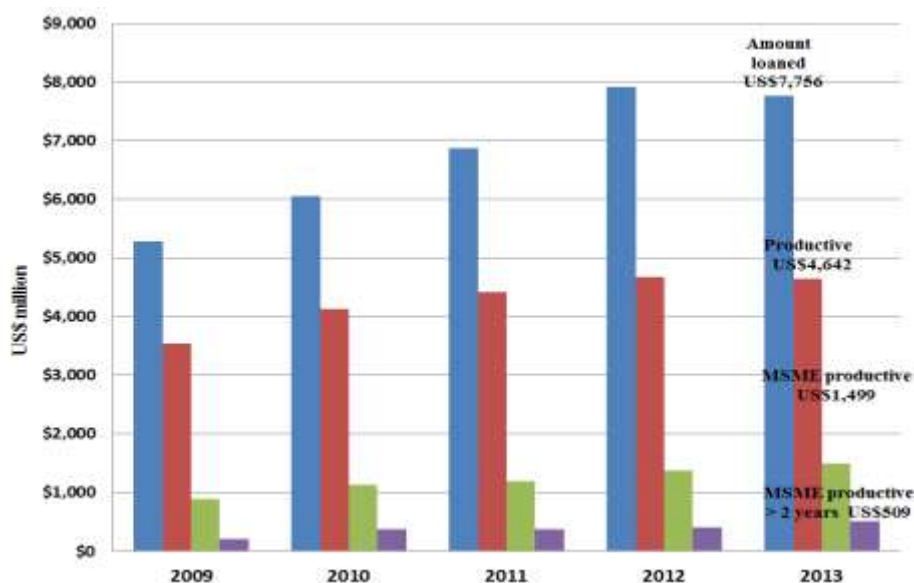
¹⁶ More recent unofficial estimates (Chorros, 2010) show that the GDP share of this type of firm could be as high as 43%, generating 65% of all jobs.

¹⁷ IDB, *Unlocking credit: the quest for deep and stable bank lending*, Washington, D.C., 2005.

nothing to foster structural change and efficient allocation of factors to the most productive activities and projects, because it is the large firms with higher levels of capitalization that gain the lion's share of such financing. In contrast, projects developed by smaller-scale entrepreneurs with capabilities or ideas, which can obtain short-term credit, still face major constraints in accessing medium and long-term lending.¹⁸

- 1.11 These difficulties in access to bank lending have been reported in the most recent business survey of El Salvador undertaken by WB-IFC.¹⁹ Its findings show that access to financing, particularly for investment, is the third greatest obstacle that firms face and, as explained in paragraph 1.7 is particularly acute for MSMEs.
- 1.12 MSMEs' limited access to credit, particularly for investment, is evidenced by the fact that, as of end-November 2013, lending to this market segment accounted for just 19% (US\$1,498 million) of total lending by the financial system; and just 7% (US\$509 million) of this credit was extended to MSMEs for terms longer than two years (medium- and long-term credit). Figure 3 clearly illustrates the recent trend in lending in El Salvador.

Figure 3. El Salvador: Lending, 2009-2013



Source: El Salvador Development Bank (BANDESAL), Financial System Superintendency of El Salvador (SSF), authors' calculations, 2013.

¹⁸ Albuquerque, R., and H. Hopenhayn. "Optimal Lending Contracts and Firm Dynamics," *Review of Economic Studies* 71(2), 285-315, 2004.

¹⁹ The three main obstacles identified are informality, crime/security, and access to credit. See [Enterprise Survey, El Salvador Country Profile](#), WB-IFC, 2010.

- 1.13 The figure shows that long- and medium-term productive lending to MSMEs is a small proportion of total lending, and also small in comparison to potential demand. An [analysis of demand for investment credit](#) by MSMEs, conducted as part of the preparation of this operation, found that at least 13% of the demand for medium- and long-term credit by MSMEs went unmet in 2013, and estimates that the volume of credit applications from MSMEs turned down by intermediary financial institutions (IFIs) could grow to 14.3% by 2015. Lastly, the study projects that MSME demand for medium- and long-term credit will grow in the next five years, as shown in Table 2.

Table 2. Projected MSME Credit Demand and Sensitivity Analysis
(current US\$ millions)

	2014	2015	2016	2017	2018
Base projection	1,552	1,644	1,743	1,852	1,972
Econ. growth 25% below expectations	1,552	1,635	1,724	1,821	1,927
Econ. growth 50% below expectations	1,552	1,626	1,706	1,790	1,882
Inflationary shock 1%	1,568	1,674	1,790	1,917	2,059
Inflationary shock 2%	1,583	1,704	1,837	1,984	2,149
25% lower growth and 1% inflationary shock	1,568	1,665	1,770	1,885	2,012
50% lower growth and 1% inflationary shock	1,568	1,656	1,751	1,854	1,965
25% lower growth and 2% inflationary shock	1,583	1,695	1,817	1,951	2,099
50% lower growth and 2% inflationary shock	1,583	1,686	1,797	1,918	2,050

Source: [Analysis of demand for investment credit](#).

- 1.14 As will be analyzed in greater depth in the paragraphs that follow, a critical factor restricting the availability of medium- and long-term credit in the Salvadoran financial system is the fact that IFIs are funded by a very short-term deposits base, which limits their ability to make medium- and long-term loans. Given this financial constraint, and the lower risk perception that IFIs have of well-capitalized large firms, the small amount of medium- and long-term financing available in the system tends to be allocated to those firms. Moreover, available financing has been increasingly channeled towards consumer credit, rather than lending for productive investment.²⁰
- 1.15 **The situation of IFIs and key factors affecting the availability of medium- and long-term funding for MSMEs.** In summary, Salvadoran IFIs remain well capitalized²¹ and continue to show comfortable levels of profitability and liquidity.²²

²⁰ Miguel Chorro, *Financiamiento a la inversión de las pequeñas y medianas empresas: el caso de El Salvador* [Financing the investment of small and medium-sized enterprises: the case of El Salvador], ECLAC and AECID, 2010.

²¹ The regulatory capital ratio, which measures capital as a percentage of risk-weighted assets, is 550 basis points above the regulatory requirement, which points to a good level of capitalization among the banks on aggregate.

²² See [Structure and recent performance of El Salvador's financial system](#).

As of December 2013, the indicators reported: (i) an increase in their capital ratios, to 550 basis points above the 12% regulatory minimum; (ii) a liability/asset ratio of 85.4%, which is two percentage points below the level recorded at the end of 2008, suggesting that value creation in assets has been less and less associated with increases in short- or long-term debt; (iii) returns on assets and equity above 1.6% and 12%, respectively; (iv) a sustained reduction in the nonperforming portfolio as a percentage of the gross portfolio since 2010, from 4.01% in December of that year to 2.4% at the end of 2013; (v) adequate liquidity levels, with short-term financial investments amounting to 20% of total investments in December 2013; and (vi) a recent trend towards faster credit growth in real terms.

- 1.16 This recovery in real credit growth is associated with more vigorous growth in the Salvadoran economy in response to the expansion of the United States economy since the 2008 global financial crisis. Lending to the private sector fell from a precrisis level of 43.6% of GDP in December 2007 to 36.9% at its lowest point, in March 2011, before recovering to 41.6% of GDP in December 2013.²³ It is important to note that the ability of the Central Reserve Bank of El Salvador (BCR) to use monetary policy as a countercyclical policy tool is heavily constrained by the dollarization of the economy.
- 1.17 Despite the recovery in real credit since the global financial crisis of 2008, there has been less financial deepening in El Salvador than in other countries of the region, including those with similar or lower development levels.²⁴ According to the International Monetary Fund (IMF), El Salvador could increase its potential growth by between 1% and 1.5% by implementing reforms to deepen the financial system.²⁵
- 1.18 Moreover, not only is the domestic financial market relatively shallow, but most of the credit extended by IFIs is of very short maturities.²⁶ This is largely because their deposits are also concentrated in very short-term instruments. At end-December 2013, 96% of their deposits were for terms of less than one year, and 60% were demand deposits.^{27 28} With this funding structure, IFIs have little appetite for lending in the medium and long term, given the extent of the mismatch between assets and liabilities, thus reducing their potential for financing growth through investment lending.

²³ Central American Monetary Council (2014).

²⁴ See [Analysis of demand for investment credit](#).

²⁵ IMF, “El Salvador, 2013 Article IV Consultation,” *IMF Country Report* 13/132, May 2013.

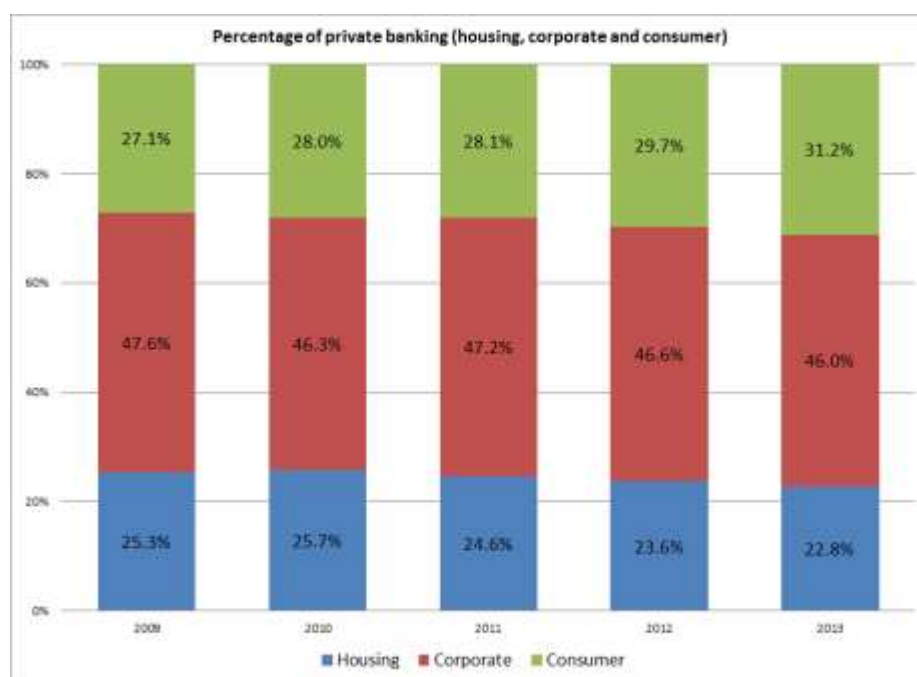
²⁶ Over 66% of IFI lending to MSMEs is for less than two years.

²⁷ Central American Monetary Council (2014).

²⁸ It is important to note that, when comparing M1 (as a proxy for the most liquid assets) against lending to the private sector in Central American countries, this ratio for El Salvador is 28.6%, the third lowest in the Central American region, surpassing only Honduras (19.1%) and Nicaragua (26.8%). See link, “[Structure and recent performance of El Salvador’s financial system](#).”

- 1.19 In addition, as Figure 4 shows, IFIs have tended to favor consumer credit, rather than corporate lending and home loans. Corporate lending has been declining as a share of IFIs' total loan portfolio, shrinking from 47.6% in 2009 to 46.0% at the end of 2013.²⁹ If this trend continues, it is estimated that in the next two years alone, El Salvador's firms would require US\$544 million in additional credit, of which US\$98 million would be needed to serve MSMEs.³⁰

Figure 4. Portfolio Distribution of Private Sector Banking



Source: BANDESAL, SSF, authors' calculations, 2013.

- 1.20 **Government initiatives and the role of the El Salvador Development Bank (BANDESAL).**³¹ The national development strategy regards MSMEs as a key sector³² of the economy, and promotes their productive investments and access to

²⁹ SSF database, December 2013.

³⁰ See "[Analysis of demand for investment credit](#)."

³¹ BANDESAL was established as an autonomous public institution of indefinite duration with separate legal status and its own assets, under Decree 847 of 2011, issued by the Legislative Assembly of El Salvador. BANDESAL has continued activities that were being conducted by the Multisector Investment Bank (BMI), founded in 1994. For further information, see [BANDESAL: Origin, institutional mandate, objectives, and recent financial performance](#).

³² Cabal, M. (2010), "Políticas e instituciones de apoyo a las micro, pequeñas y medianas empresas: la experiencia de El Salvador" [Policies and institutions to support micro, small, and medium-sized enterprises: the experience of El Salvador], in C. Ferraro and G. Stumpo (comps.), *Políticas de apoyo a las PYMES en América Latina. Entre avances innovadores y desafíos institucionales* [Policies to support SMEs in Latin America. Innovative advances and institutional challenges], ECLAC, (LC/G. 2421-P), Santiago, Chile.

credit.³³ Institutionally, this priority has been reflected in the creation of an institution devoted to MSME promotion and support (the National Micro and Small Enterprise Commission ([CONAMYPE](#)) and the Financial System to Promote Development, in which BANDESAL participates along with two development funds under its administration: the Economic Development Fund (FDE) and the Salvadoran Guarantee Fund (FSG).

- 1.21 BANDESAL's mission is to "provide financial and technical support to promote the development of viable and profitable investment projects in the country's productive sectors, to help: (i) promote the growth and development of all productive sectors; (ii) promote business development and competitiveness; (iii) foster the development of MSMEs; (iv) promote development of the country's exports; (v) create jobs...."³⁴
- 1.22 At December 2013, BANDESAL had capital of US\$215 million, whereas its assets, generated through first- and second-tier lending operations, stood at US\$540 million. Its second-tier portfolio as of that date was US\$326 million, US\$210 million of which (64% of the total) consisted of loans to MSMEs. Of this amount, US\$153 million (73%) were credits for longer than two years (medium- and long-term), equivalent to 17% of total medium- and long-term lending by the financial system to MSMEs in that year.³⁵ It should be noted that BANDESAL's second-tier portfolio for MSMEs has grown by an average of 14% per year in the last four years. In 2013 alone, the outstanding balance of its second-tier credit for MSME investment projects grew by US\$42 million.³⁶
- 1.23 Although in recent years the government has been prioritizing productivity growth in MSMEs through its public policy programs, both financial and nonfinancial, enterprises of this type are expected to continue facing major productivity and competitiveness challenges in the future, owing to a more competitive business climate. In this context, the promotion of medium- and long-term credit for investment projects that lead to the adoption of new technologies, productive restructuring, and business and export development, is seen as a key strategy for achieving sustained growth in productivity and competitiveness for Salvadoran MSMEs.

B. Rationale of the Bank program

- 1.24 By offering long-term funding, the proposed program will help to address the problem of low MSME productivity and competitiveness, caused by the obsolescence of their equipment and outdated business models, by promoting medium- and long-term credit for productive investment and restructuring projects.

³³ [El Salvador Five-year Plan, 2010-2014](#) (see paragraphs 130 and 131).

³⁴ Law on the Financial System for Development Promotion.

³⁵ For further information on BANDESAL's second-tier line, see <https://www.bandesal.gob.sv>.

³⁶ See link, "[Institutional presentation: BANDESAL](#)."

- 1.25 The proposed operation will provide BANDESAL with additional medium- and long-term resources, to continue financing investment projects of MSMEs borrowers of IFIs, thereby expanding the supply of financing on terms suitable to those firms' investment, productive restructuring, and business and export development projects.³⁷ It is estimated that the proposed program could support about 1,000 eligible MSMEs³⁸ and supply 6% of MSME demand for credit for productive investments in a single year.³⁹
- 1.26 Importantly, similar programs promoted by development banks in other countries of the region show that the beneficiary MSMEs, compared to comparable nonbeneficiary firms, not only obtained lower interest rates, larger credits, and longer maturities,⁴⁰ but also achieved substantial increases in their production, employment, investment, and productivity.⁴¹
- 1.27 Lastly, the need to expand medium- and long-term credit offerings to MSMEs for productive investment is also justified by diagnostic studies of other Bank operations in El Salvador and lessons learned from them. In particular, the operation benefitted from: (i) diagnostic studies of the financial system, conducted for the preparation of operation ES-X1007; (ii) the efforts to enhance MSME competitiveness and export capacity under operations ES-L1057, ES-L1058, and ES-L1075; and (iii) operations of the Multilateral Investment Fund (MIF) and the Salvadoran Economic and Social Development Foundation (FUSADES) to facilitate MSME access to credit.
- 1.28 **The country's sector strategy.** The program is aligned with the productive development strategy contained in El Salvador's Five-year Plan, which emphasizes the need to promote new forms of financing that enable access to financial resources and quality management to promote more dynamic entrepreneurship among MSMEs.⁴²
- 1.29 **Alignment with GCI-9 and the Bank's country strategy.** Under the Bank's Ninth General Capital Increase (GCI-9) (document AB-2764), this project contributes to the priority of supporting small and vulnerable countries (the Group

³⁷ As specified in paragraph 1.38, all investment and productive restructuring projects of borrower MSMEs in any sector of the economy will be eligible for this program, provided that they meet the requirements specified in the program's socioenvironmental management plan.

³⁸ Based on the average amount of medium- and long-term (more than two years) investment loans extended by BANDESAL (i.e. US\$97,876), an estimated 1,017 firms will obtain credit through the program.

³⁹ The percentage mentioned takes account of rejection rates in MSME demand for productive investment credit, the potential growth in the demand for credit over the next five years, and the increasing tendency of IFIs to prioritize consumer credit over productive lending. For further details, see [Analysis of demand for investment credit](#).

⁴⁰ See Marcela Eslava, Alessandro Maffioli, and Marcela Melendez (2012), "Second-tier government banks and access to credit: micro-evidence from Colombia," IDB Working Paper Series No. IDB-WP-308.

⁴¹ See Marcela Eslava, Alessandro Maffioli, and Marcela Melendez (2011), "Government-owned banks and firm performance: micro-evidence from Colombia," working paper, IDB.

⁴² [El Salvador Five-year Plan, 2010-2014](#) (see paragraphs 130 and 131).

C and D countries). It also contributes to the regional development goal of increasing the percentage of firms using banks to finance investments and increasing the number of productive MSMEs financed. In addition, the operation is aligned with the “Sector framework document on support for SMEs and financial access and supervision” (document GN-2768), particularly in relation to resource targeting and allocation criteria.

- 1.30 The program is included in the update to the 2014 Operational Program Report (document GN-2756-2), and is aligned with the first pillar of the Bank’s country strategy with El Salvador (2010-2014) (document GN-2575) in a broader context and dialogue related to supporting economic growth and the productive sector. In particular, the country strategy emphasizes that the Bank may support productive development, the nurturing of MSMEs, and technological innovation. This operation’s activities will foreseeably complement other Bank operations, as mentioned in paragraph 1.27. In addition, the Bank will provide nonreimbursable technical cooperation funding to support BANDESAL in learning from other development banks in the region about the monitoring and evaluation of MSME financing programs (operation ES-T1231).

C. Objective, components, and features

- 1.31 The program’s objective is to support productivity growth at micro, small, and medium-sized enterprises (MSMEs)⁴³ by improving their access to medium- and long-term credit⁴⁴ for productive investment and restructuring projects.
- 1.32 The program for BANDESAL is structured through a credit component that, via the capillarity of the institution’s second-tier window, will provide medium- and long-term funding to eligible intermediary financial institutions (IFIs), for them to onlend to MSMEs to finance eligible productive investment and restructuring projects (see [Program operational flow](#)). Specifically, the program will have a single credit component of US\$99.5 million, to fund the IFIs. A portion of the program’s resources (US\$500,000) will be used to support its administration, promotion, monitoring, and evaluation. An [execution plan](#) for such activities is attached.
- 1.33 The features of the program’s financing for eligible IFIs, and the terms on which the latter will onlend to eligible MSME projects, are described in the program [Credit Regulations](#).
- 1.34 In principle, productive investment and restructuring projects of eligible borrower MSMEs from all sectors of the economy will be eligible, provided that they meet the requirements specified in the program’s socioenvironmental management plan. The fact that the businesses eligible for the program are already borrowers is evidence of their greater balance sheet strength and operational maturity, and

⁴³ Eligible MSMEs will include persons and corporations regarded as MSMEs under the BCR definition (i.e., firms with fewer than 99 employees and assets not exceeding US\$228,571.41) from all sectors of the economy, which are borrowers.

⁴⁴ Medium- and long-term financing is understood as loans with a maturity of two years or more.

therefore greater growth potential, in keeping with the sector framework document (see paragraph 1.29).

D. Key results indicators

- 1.35 The program's main impact will be the percentage increase in real sales per worker of the beneficiary firms, compared to those of comparable nonbeneficiary enterprises. The outcomes will be increases in investment, better access to financing for the beneficiary firms, measured by the trend in the average maturity of loans made using program resources, and an improvement in the quality of the subloan portfolio. The expected output will be the number of firms that obtain medium- and long-term credit for investments through the program, differentiated by gender and by the amounts of funding granted (see Annex II).

E. Economic analysis

- 1.36 The [economic analysis](#) characterizes the expected typical beneficiary firm on the basis of the historical information on BANDESAL credit operations and the features of the project, and estimates the benefits of the investment for them. The expected outcomes have been subjected to sensitivity analysis in multiple dimensions (costs, revenues, and other factors), which indicates that the project is sustainable and beneficial for El Salvador.

II. FINANCING STRUCTURE AND MAIN RISKS

A. Financing instruments

- 2.1 **Origin and use of resources.** The global credit loan program will be financed in United States dollars from the Bank's Ordinary Capital (OC) resources. Under the rules of the Flexible Financing Facility (FFF), the borrower has the option of requesting changes to the amortization schedule, as well as currency and interest rate conversions, as permitted by market conditions and the country's regulatory framework.
- 2.2 BANDESAL will onlend the funds destined for the program's sole component to the IFIs on the terms specified in the [Credit Regulations](#). In accordance with IFI lending practices in El Salvador, their financing requires capital contributions or cofinancing from potential subborrowers.

B. Fiduciary risks

- 2.3 An analysis of BANDESAL's delivery capacity (see Annex III) found that it has the capability to perform the program's financial management activities. Fiduciary risk has been determined to be medium-low, mainly because this is the first time BANDESAL will be responsible for executing a Bank-financed program of this type. This risk will be mitigated with a program of training and advisory support (see [Risk matrix](#) and [Project risk management \(PRM\)](#)).

C. Environmental and social safeguard risks

- 2.4 Since the program provides BANDESAL with funding for second-tier lending operations, its environmental and social impacts and risks will occur at the level of the subloans and are not predictable ex ante. According to Directive B.13 of the Bank's Environment and Safeguards Compliance Policy (Operational Policy OP-703), the operation does not require classification. Nonetheless, for purposes of the program, BANDESAL will have a [socioenvironmental management plan](#) that contains an exclusion list, previously agreed upon with the Bank and incorporated into the Credit Regulations.

D. Execution risks

- 2.5 Although the demand for investment project financing may be a risk, is considered low given the relatively small size of the program in relation to potential [projected demand](#).
- 2.6 In terms of program sustainability, once the IDB line of financing is repaid, the program is expected to maintain continuity and exert a long-term effect on how IFIs act to meet demand for longer maturities in the target market, for the following reasons: (i) the program is based on a long-term commitment by the Salvadoran government, to strengthen a line of credit to MSMEs that BANDESAL is already operating; (ii) the economic analysis projects that the program will have a positive return; and (iii) according to the Credit Regulations, the funds from subloan recoveries will be used to make additional loans in activities of the same type.

III. IMPLEMENTATION AND MANAGEMENT PLAN

A. Summary of implementation arrangements

- 3.1 **Guarantor, borrower, and executing agency.** The Republic of El Salvador will act as guarantor of the loan, guaranteeing only the financial obligations⁴⁵ stemming from the loan contract to be entered into by the borrower and the Bank. The Board of Executive Directors is therefore asked to approve a partial waiver to the Bank's Operational Policy OP-303, "Guarantees required from the borrower," which calls for a joint and several guarantee (financial and execution obligations).
- 3.2 The borrower and executing agency will be BANDESAL, an institution that: (i) is supervised by the Financial System Superintendency of El Salvador (SSF); (ii) has the fiduciary and operational capacity required for successful implementation of the program; and (iii) is creditworthy, with excellent risk management practices. BANDESAL operates as a second-tier bank that uses a previously authorized network of intermediary financial institutions (IFIs) (supervised by the SSF) to meet credit needs in all sectors of the economy (see Annex III and [Institutional presentation: BANDESAL](#)). BANDESAL also has a clear mandate and solid

⁴⁵ The authorities have stated that the execution obligations are outside their legal mandate.

technical capacity, and is strengthening its impact evaluation systems, which should enable it to execute the loan without substantial difficulty.

- 3.3 **Execution and administration.** For the purposes of this program, BANDESAL will be responsible for: (i) execution and supervision of proper use of the loan proceeds; (ii) provision of the human, technological, and budgetary resources necessary for implementation, as planned and on schedule; and (iii) delivery to the Bank of the documentation required to satisfy the disbursement conditions, and the fulfillment of other operational conditions required for execution.
- 3.4 The requirements for execution will be for the system to be established by BANDESAL to authorize its IFIs (see [Risk management and control at BANDESAL](#)), and for the Credit Regulations to be agreed upon between the parties, to be in effect. In the case of the present program:
- a. **System to authorize IFIs.**⁴⁶ Participation is open to first-tier IFIs subject to inspection and supervision by the SSF (regulated), or unregulated IFIs that satisfy the conditions set by the BANDESAL risk management system (see [Risk management and control at BANDESAL](#)), according to the guidelines of the Credit Regulations. The IFIs will responsible for: (i) evaluating the risk of subborrowers and making the financing decision, pursuant to the Credit Regulations and BANDESAL's rules of operation; and (ii) assuming responsibility, with respect to BANDESAL, for the servicing and repayment of subloans, regardless of whether the subborrowers fulfill their obligations.
 - b. The [Credit Regulations](#) will: (i) be consistent with the policies and rules of operation of both BANDESAL and the IDB, as well as the country's financial laws and practices; (ii) specify the main features of the program; (iii) stipulate that noncompliance with its provisions will prevent access to financing; (iv) specify that approval of the Credit Regulations by BANDESAL, subject to the Bank's prior no objection, will be a condition precedent to the first disbursement; and (v) that its amendment will require the Bank's no objection.
 - c. Work plan. Since this is a financial intermediation program, no annual work plan or procurement plan is required. An [execution plan](#) for the activities described in paragraph 1.32. is attached.
- 3.5 **Disbursement conditions and schedule.** The demand from IFIs will determine the pace of disbursements, which will be made in accordance with Bank policy. The execution and disbursement periods will be 48 months.
- 3.6 The program financial statements will be audited annually by a firm acceptable to the Bank, to be engaged and paid by BANDESAL. The firm will report on the eligibility of expenditures and payments to BANDESAL. The program's audited financial statements will be delivered to the Bank no later than four months after the

⁴⁶ For further details on the definition and performance of regulated and unregulated IFIs in El Salvador, see link, "[Structure and recent performance of El Salvador's financial system](#)."

end of the executing agency's fiscal year, pursuant to procedures and terms of reference previously agreed upon with the Bank.

- 3.7 **Approval of the Credit Regulations by BANDESAL, subject to the Bank's prior no objection, will be a special contractual condition precedent to the first disbursement.**

B. Summary of arrangements for monitoring results

- 3.8 The program will be monitored via six-monthly reports prepared by the executing agency and delivered to the Bank no later than 60 days after the end of each six-month period. These will reflect progress made in terms of the output indicators and intermediate outcomes, and fulfillment of the subloan eligibility criteria.
- 3.9 The executing agency and the Bank will perform a midterm evaluation of the program 24 months after the first disbursement, or once 50% of the loan proceeds have been committed, whichever occurs first. Progress toward the outcomes specified in the Results Matrix will be evaluated to identify corrective actions as necessary. The executing agency will provide the information necessary for the Bank to produce a project completion report (PCR) 90 days after the end of the execution period or the date of the last disbursement. Regular monitoring meetings will also be scheduled. The [monitoring and evaluation plan](#) also includes a strategy for performing an impact evaluation beginning in the last year of program implementation. This will be financed from the program execution support funds described in paragraph 1.32.
- 3.10 The evaluation plan calls for a quasi-experimental assessment, through statistical matching and a differences-in-differences estimator to compare the credit beneficiary firms with similar nonbeneficiary firms.
- 3.11 BANDESAL will gather and retain all information, indicators, and any other documentation required to prepare the PCR and/or any other ex post evaluation that the IDB may wish to conduct.

Development Effectiveness Matrix				
Summary				
I. Strategic Alignment				
1. IDB Strategic Development Objectives		Aligned		
Lending Program		Lending to small and vulnerable countries.		
Regional Development Goals		Percent of firms using banks to finance investments.		
Bank Output Contribution (as defined in Results Framework of IDB-9)		Micro/small/Medium productive enterprises financed.		
2. Country Strategy Development Objectives		Aligned		
Country Strategy Results Matrix				
Country Program Results Matrix		GN-2756-2 *	The intervention is included in the 2014 Operational Program.	
Relevance of this project to country development challenges (If not aligned to country strategy or country program)		GN-2575	Productive development and support to MSMEs is included as a dialogue area in the Country Strategy.	
II. Development Outcomes - Evaluability		Highly Evaluable	Weight	Maximum Score
		9.7		10
3. Evidence-based Assessment & Solution		9.6	33.33%	10
3.1 Program Diagnosis		3.0		
3.2 Proposed Interventions or Solutions		3.6		
3.3 Results Matrix Quality		3.0		
4. Ex ante Economic Analysis		10.0	33.33%	10
4.1 The program has an ERR/NPV, a Cost-Effectiveness Analysis or a General Economic Analysis		4.0		
4.2 Identified and Quantified Benefits		1.5		
4.3 Identified and Quantified Costs		1.5		
4.4 Reasonable Assumptions		1.5		
4.5 Sensitivity Analysis		1.5		
5. Monitoring and Evaluation		9.5	33.33%	10
5.1 Monitoring Mechanisms		2.5		
5.2 Evaluation Plan		7.0		
III. Risks & Mitigation Monitoring Matrix				
Overall risks rate = magnitude of risks*likelihood		Low		
Identified risks have been rated for magnitude and likelihood		Yes		
Mitigation measures have been identified for major risks		Yes		
Mitigation measures have indicators for tracking their implementation		Yes		
Environmental & social risk classification		B.13		
IV. IDB's Role - Additionality				
The project relies on the use of country systems				
Fiduciary (VPC/PDP Criteria)		Yes	Financial Management: i) Accounting and Reporting; and ii) Internal Audit.	
Non-Fiduciary				
The IDB's involvement promotes improvements of the intended beneficiaries and/or public sector entity in the following dimensions:				
Gender Equality				
Labor		Yes	Judging from previous evaluations of similar interventions with other national development banks, it is expected that Bandedal 's financing to beneficiary MSMEs with program resources will have a positive impact on employment in relation to comparable, non-beneficiary firms.	
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		Yes	A TC intra is being prepared to allow BANDESAL to visit other national development banks in the region (namely, Bancoldex in Colombia and NAFIN in Mexico) to learn about their particular experiences on monitoring and evaluating the outcomes and impacts of second-tier financing programs geared to enhance the productivity of MSMEs.	
The ex-post impact evaluation of the project will produce evidence to close knowledge gaps in the sector that were identified in the project document and/or in the evaluation plan		Yes	To the extent that the impact evaluation determines that firms improve their productivity, then the proposed impact evaluation of the program would confirm that: i) investments in technology, innovation and improved business models enhance the productivity and competitiveness of firms; and ii) that improving the access to medium- and long-term finance at adequate terms and conditions stimulate private sector investments in those areas.	

* 2014 Operational Program Report Update under revision.

The project document amply substantiates the lack of financing in the longer term for MSMEs in El Salvador and it presents an analysis of the demand that provides evidence for the excess demand and the lack of supply in this area. Evidence is cited from the last enterprise survey realized, where the difficulty in access to finance for investment is documented as one of the main obstacles to growth by Salvadorian MSMEs. The project is linked to the Country Strategy in the wider context and dialogue of facilitating growth and supporting the productive sector. The intervention described seeks to support MSMEs' productivity and the proposed solution is helping them bridge the gap in the available financing.

The results matrix reflects the project's objectives and activities and has a clear vertical logic. In general, the indicators reflected are SMART and at the highest impact level are supported by the project's quasi-experimental evaluation.

The cost benefit analysis is consistent with the program logic and is supported in the experience of BANDESAL, the country's development bank and executing agency, which has provided assumptions as to the characteristics of a typical beneficiary firm and proceeds to estimate benefits. These benefits are also reflected in the results matrix. The assumptions are presented with clarity and substantiated in the best way possible with estimations formulated in conjunction with the executor given a lack of richness in available information in the country context.

The documentation includes a monitoring and evaluation plan that describes the implementation of a quasi-experimental evaluation via propensity score matching to compare beneficiary firms with similar firms that did not partake of the loans. The value added of this evaluation is that it will provide a richness in knowledge on this type of intervention specifically in the case of small, open economies with fixed exchange rate regimes as is the case of El Salvador.

RESULTS MATRIX

Project Objective:	The program's objective is to support productivity growth at micro, small, and medium-sized enterprises (MSMEs) by improving their access to medium- and long-term credit for productive investment and restructuring projects.
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Impact indicators	Unit of measure	Baseline	Targets	Comments
Percentage increase in sales per worker of the beneficiary firms, compared to nonbeneficiary firms, by the fifth year after program start.	Percentages	0	11	<p>The indicator is equal to the average real sales per worker at beneficiary firms over the same indicator at comparable nonbeneficiary firms, minus 1, multiplied by 100.</p> <p>Real sales per worker at beneficiary firms are expected to increase in relation to comparable nonbeneficiary firms by 2018.</p> <p>The value of real sales per worker at the firm is US\$16,113 (see Table 2 of the cost-benefit analysis).</p> <p><i>Source of verification: Ex post impact evaluation, as described in the monitoring and evaluation plan in the corresponding annex.</i></p>

Sole component	Unit of measure	Base year	Year 1	Year 2	Year 3	Year 4	Target	Comments
Outputs:								
1. MSMEs financed with program funds.	Number	0	306	306	203	202	1,017	<p>The target is given by dividing the program amount (US\$99.5 million) by the average size of the medium- and long-term loans that BANDESAL projects it will make to MSMEs (US\$97,876), based on the institution's information systems.</p> <p>Number of eligible firms that obtain investment financing through the program during its execution period.</p> <p><i>Source of verification: BANDESAL information systems.</i></p>

Sole component	Unit of measure	Base year	Year 1	Year 2	Year 3	Year 4	Target	Comments
2. Amount of resources loaned by the program.	US\$ millions	0	29.9	29.9	19.9	19.8	99.5	<p>The target is given by multiplying the number of firms benefitted by the program in the first two years, by the projected average amount of each investment loan to MSMEs (US\$97,876) to be financed with program resources.</p> <p>Dollar amount of medium- and long-term loans made by the program to eligible firms for investment during the execution period.</p> <p><i>Source of verification: BANDESAL information systems.</i></p>
3. Share of indirect investment loans made to MSMEs led by women.	Number of credits	116	117	118	119	120	474	<p>The number of loans to women is calculated on the basis of the total number of credits allocated by the program each year.</p> <p>Although the operation does not have a specific gender impact objective, as BANDESAL has previous experience of monitoring the gender impact of its portfolio, it is proposed here to also monitor this program. Given the track record of BANDESAL's second-tier portfolio, the program is expected to at least maintain the share of women in that second-tier portfolio, with a potential marginal increase.</p> <p><i>Source of verification: BANDESAL information systems.</i></p>

Sole component	Unit of measure	Base year	Year 1	Year 2	Year 3	Year 4	Target	Comments
Outcomes								
1. MSME investments made with the program.	US\$ millions	0	39	39	25.9	25.8	129.7	<p>This indicator corresponds to total investments that can be made, based on the program financing. Based on an assumed typical MSME investment (see economic analysis), BANDESAL financing is estimated to represent about 76.7% of the total investment.</p> <p>This indicator is intended to measure the program's total investment flow, including the equity invested by project promoters.</p> <p><i>Source of verification: BANDESAL information systems.</i></p>
2. Average maturity of loans made.	Years	System 2.88 years	4	4	4	4	4	<p>This indicator shows the change in the average maturity of loans made with program resources, year by year. The indicator is expected to be above the system-average maturity for loans targeting productive activity, which would indicate the program's success in offering better financing terms to MSMEs.</p> <p><i>Source of verification: BANDESAL information systems.</i></p>
3. Program portfolio quality index measured by the percentage of nonperforming subloans.	Percentages	System 3.00	1.5	1.4	1.3	1.1	1.1	<p>This indicator shows the expected behavior of the program subloan portfolio quality. It is expected to be better than the system-average for loans targeting productive activity, year by year.</p> <p>The portfolio quality index will be calculated using the following formula: (Total amount of nonperforming loan portfolio financed with program resources / Total amount of loan portfolio financed with program resources) x 100.</p> <p><i>Source of verification: BANDESAL information systems.</i></p>

FIDUCIARY AGREEMENTS AND REQUIREMENTS

Country:	El Salvador
Program:	Global Credit Loan for Financing Productive Development in El Salvador (ES-L1089)
Executing agency:	Banco de Desarrollo de El Salvador (BANDESAL)
Prepared by:	Lilena Martínez de Soto, Financial Management Specialist, and Marco Alemán, Senior Procurement Specialist (FMP/CES)

I. SUMMARY

- 1.1 The fiduciary evaluation of Banco de Desarrollo de El Salvador [El Salvador Development Bank] (BANDESAL), which will serve as borrower and executing agency for the program, was based on the assessment of institutional capacity and the program's fiduciary risks. BANDESAL has experience managing IDB operations in the private sector window, and is currently responsible for one component of loan 2373/OC-ES, "Program for Housing and Comprehensive Improvements for Informal Urban Neighborhoods." The evaluation concludes that BANDESAL has the capacity to conduct the activities involved in financial management and administration of the loan proceeds. Fiduciary risk in financial management is rated medium-low.
- 1.2 BANDESAL was established as an autonomous public lending institution of indefinite duration with separate legal status and its own assets, under the Financial System Law for Development Promotion, Legislative Decree 847 of 11 October 2011. It grew out of the transformation of the Multisector Investment Bank to give it broader and more inclusive authority and jurisdiction as a development bank, enabling it to support sector public policies with financial resources in order to promote the development of micro, small, and medium-sized enterprises (MSMEs), exports, job creation, and consequently the country's economic and social development. BANDESAL is subject to inspection and supervision by the Financial System Superintendency, and oversight by the Office of the Auditor General, as well as by an external auditor and a tax auditor, who certify the entity's financial position and the fulfillment of its tax obligations.
- 1.3 Given its nature, BANDESAL is not covered by the Financial Administration Act, nor is it part of the General Budget or required to maintain its budget, cash management, and accounting records in the SAFI Integrated Financial Administration System. However, it has reliable procedures, mechanisms, and systems for institutional financial management, as described in the institutional capacity assessment report.

- 1.4 The total amount of the program is US\$100.0 million, wholly financed by the Bank. The program does not involve financing from other multilateral agencies.

II. FIDUCIARY CONTEXT OF THE EXECUTING AGENCY

- 2.1 BANDESAL's budget is reviewed during its preparation by the Finance Division, the Management Department, and the Risk Committee before being submitted to the Executive Board, for subsequent approval by the Board of Governors. Projections are monitored monthly and compared against actual performance in a report submitted to the Executive Board. Once BANDESAL's budget has been approved by its Board of Governors, appropriations are frozen and entries are made in the cash management and accounting modules of Sistema Banca 2000. This system allows each executed budget item to be recorded and booked, and can also be used as a tool to control credit lines, and allocate quotas and actuals under them. Sistema Banca 2000 is an institutional enterprise resource planning (ERP) system purchased from an external supplier, used to manage all BANDESAL operations, with banking, investment, and debt modules fully integrated with accounting and cash management. The system allows specific credit lines to be created in order to record and track project resources, facilitating their identification and control.
- 2.2 BANDESAL policies, procedures, and processes are clearly defined, and it has skilled professional staff, supported by functional and reliable information systems, as well as clear work procedures for the performance of their duties.

III. FIDUCIARY RISK EVALUATION AND MITIGATION MEASURES

- 3.1 Fiduciary risk in financial management has been rated as medium-low, mainly because this is the first time that BANDESAL will be responsible for executing an IDB-financed program of this type under IDB policies. This risk will be mitigated through an intensive training and advisory support program that began at the program preparation stage. It will also be necessary to establish clear procedures and mechanisms in the Credit Regulations, in order to ensure that information on budget formulation and accounting and cash management records are integrated for the program, and that credit lines meeting the program's conditions are properly identified, making it possible to identify, record, track, and control the IDB loan proceeds at any time. The executing agency is not expected to conduct any procurements, since it will operate as a second-tier bank with private sector subborrowers.

IV. CONSIDERATIONS FOR THE SPECIAL CONDITIONS OF THE CONTRACTS

- 4.1 Approval of the Credit Regulations by BANDESAL's Executive Board, with the Bank's prior no objection, will be a condition precedent to the first disbursement of the loan.

- 4.2 Given the nature of the operation, the Bank will disburse the program resources in the form of reimbursements. Nonetheless, another disbursement modality may be used by mutual agreement with the Bank.
- 4.3 This program's financial statements will be audited annually by an IDB-eligible firm. In addition, the executing agency undertakes to deliver unaudited financial information on a quarterly basis.

V. PROCUREMENT MANAGEMENT

- 5.1 Given that the program has the characteristic structure of a global credit loan, whereby funds are provided to BANDESAL for transfer to intermediary financial institutions (IFIs) that lend to individuals or corporations engaged in economic activities, paragraph 3.2 of the document GN-2349-9, "Policies for the procurement of works and goods financed by the Inter-American Development Bank" is applicable. In cases of this type, the policies require procurements to adhere to current private sector or commercial practices.
- 5.2 **Records and files.** The documentation for the subloans financed by the operation will be kept at the IFIs that review and approve the credit application, and therefore fully assume the credit risk and will be solely responsible for monitoring the portfolio.
- 5.3 BANDESAL's Institutional Operations and Guarantees Department will be responsible for keeping program records and files. The official formats for disbursement requests will be used to prepare and file program reports, recording the list of subloans subject to reimbursement of expenditures.

VI. FINANCIAL MANAGEMENT

- 6.1 **Programming and budget.** The program budget will be managed by BANDESAL, applying the mechanisms and procedures used for its own budget, which is prepared annually for the fiscal/financial year beginning on 1 January and ending on 31 December, and includes projections of portfolio investment, both first-tier and second-tier, to identify financing requirements or liquidity surpluses. The programming is reviewed each week on a rolling 12-month forward basis, and projections are monitored each month for submission to the Executive Board, compared with actuals. There is an established process for their preparation, approval, and execution. Pursuant to the Financial System Law for Development Promotion, the budget must be submitted to the Executive Board for approval, and then submitted for approval by the Board of Governors. Although unusual at BANDESAL, if the budget requires amendment, the same procedure must be followed for approval.
- 6.2 Both the formulation and the execution of the BANDESAL budget will be processed in Excel. Nonetheless, a specific credit line will be created for the program, which will allow for the control and monitoring of quota allocations and

- actuals in Sistema Banca 2000, which is supplied with information from the approved budget and integrates accounting records with cash management operations.
- 6.3 **Accounting and information systems.** Program accounting will be the responsibility of BANDESAL, using its own accounting system, in which accounting and cash operations are integrated and referenced to information from the approved budget, together with supplemental records as deemed necessary to present information to the Bank. To prepare its financial statements, BANDESAL applies generally accepted accounting standards and regulations issued by the Financial System Superintendency. The program's audited financial statements will be prepared on a cash accounting basis, using information generated by Sistema Banca 2000, which will identify transactions involving the Bank loan proceeds. The accounts to be used for program execution and records must be identified, so that the relevant information is clearly and easily identifiable.
- 6.4 **Disbursements and cash flow.** The Bank will disburse the program resources in the form of reimbursements. Nonetheless, another disbursement modality may be used with the Bank's prior consent. Disbursement requests will be accompanied by the list of eligible credits as specified in the Credit Regulations.
- 6.5 BANDESAL will maintain a special account at the Central Reserve Bank, as well as a designated operational account at a commercial bank, from which the disbursements corresponding to the portfolio rediscounts required by the IFIs will be made. As indicated in the Bank's financial management policy (document OP-273-2), disbursements will be made on the basis of liquidity requirements, for which BANDESAL will prepare a financial plan as the basis for the advances of funds, or other disbursement modality as deemed appropriate. Additionally, BANDESAL undertakes to open an operating account at a commercial bank for making the payments resulting from execution of the program procurement plan.
- 6.6 **Internal control.** As a public institution, BANDESAL applies the technical standards of specific internal control, issued under general rules set by the Office of the Auditor General and based on the global COSO standard. It has an audit and control division that reports directly to the Executive Board. Additionally, as an autonomous public lending institution, it applies the International Standards for the Professional Practice of Internal Auditing (ISPPIA).
- 6.7 The methodology approved for the audit work includes a section on presenting reports, in which any findings must be followed up and resolved within a specified time frame. The results of each audit task are presented to the Audit Committee established by the BANDESAL Executive Board. The Government Ethics Law applies at the institutional level, and the entity has an Institutional Committee to ensure compliance.
- 6.8 BANDESAL has a risk division responsible for the evaluation, monitoring, and supervision of risks generated by its operations.

- 6.9 **External control and reports.** External control of the program will be performed by a firm of independent auditors acceptable to the Bank, to be engaged by BANDESAL. The firm may be the same one that audits the entity's financial statements, to gain a holistic control view of the executing agency and program management. In the event of a competitive process, it will follow the procedures of Bank guideline AF-200. The terms of reference will be previously agreed upon with the Bank, and the contracting process will be subject to ex ante review. The annual financial statements will be prepared in accordance with the Bank's guidelines on financial reports and external audits. To ensure the effectiveness of the audit work, the firm must be engaged no later than September of the fiscal year in execution that is to be audited.
- 6.10 The auditor will report on the eligibility of program expenditures, and will verify the existence of promissory notes endorsed to BANDESAL. It will also verify that the funds are being channeled through the IFIs to the end-beneficiaries on the terms stipulated in the program Credit Regulations. It will also make inspection visits both to the IFIs and to the end-beneficiaries. The program's audited financial statements will be delivered to the Bank no later than four months after the end of the corresponding BANDESAL fiscal year.
- 6.11 **Supervision.** For the financial monitoring of the program, the (unaudited) financial reports produced by the BANDESAL systems will be used, and the required breakdown will be shown in the corresponding notes and supplemental financial information. Initially, these reports will be required on a quarterly basis, although the frequency may be adjusted subsequently. It is estimated that these quarterly reports could be presented no later than 45 days after the end of each calendar quarter, or earlier. The explanatory notes to the financial statements will be designed to be consistent with the Bank's monitoring policy and tools.
- 6.12 The financial specialist may conduct onsite inspections and will perform desk reviews of the audited annual and final financial statements. The fiduciary supervision visits for financial management will include verification of the financial and accounting arrangements used to manage the program and monitor the implementation of recommendations issued either by the independent auditor of this program or by others. The auditor will verify the existence of promissory notes endorsed to BANDESAL, and that the funds are being channeled through the IFIs to the end-beneficiaries on the terms specified in the program Credit Regulations. It will also make inspection visits both to the IFIs and to the end-beneficiaries.
- 6.13 **Execution mechanism.** The borrower and executing agency will be BANDESAL, which will be legally accountable to the Bank for payment of the debt, with the sovereign guarantee of the Government of El Salvador, and for conduct of the program technical and financial activities. The Bank loan proceeds will be transferred by BANDESAL to the IFIs through its normal rediscount mechanism, or other mechanism agreed upon with the Bank, at a market rate reflecting its financial cost of funds plus a spread to cover its operating costs.

BANDESAL will be responsible for identifying and selecting the eligible IFIs to participate in the program, pursuant to the Credit Regulations and its own policies and processes. The IFIs will be free to set the amount of the subloans, the features of disbursements, interest rates and fees, maturities and frequency of repayment, and grace period, based on the characteristics of the lines operated by BANDESAL, a credit analysis of the subloans, and the useful life of the program. Financial management will be the responsibility of BANDESAL.

- 6.14 **Credit Regulations.** The points covered in these fiduciary agreements and requirements will be more fully described in the program Credit Regulations, which will require the concurrence of the undersigned fiduciary specialists.
- 6.15 **Other financial management agreements and requirements.** There are no agreements additional to those mentioned above. However the fiduciary agreements and requirements included in this annex may be adjusted as the program progresses, based on the risk analysis updates and institutional capacity assessment performed during program execution.

References

Institutional capacity analysis:

<http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=38811744>