

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

EL SALVADOR

SOCIAL ENTREPRENEURSHIP PROGRAM

EXECUTIVE SUMMARY

EXPANDING ACCESS TO MICROFINANCE FOR THE POOR IN EL SALVADOR

(ES-S1009)

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I. BASIC PROJECT INFORMATION

A. Executing agency

- 1.1 Fideicomiso para el Desarrollo para la Micro y Pequeña Empresa [Micro and Small Enterprise Development Trust Fund] (FIDEMYPE).

B. Amount and source of financing

	IDB US\$	FIDEMYPE US\$	Total US\$
Reimbursable financing	1,000,000	300,000	1,300,000
Technical-cooperation funding	<u>250,000</u>	<u>202,000</u>	<u>452,000</u>
Total:	1,250,000	502,000	1,752,000

Source: Net income of the Fund for Special Operations (FSO)

C. Terms and Conditions

Amortization period:	10 years
Grace period:	3 years for principal
Interest rate:	2% annually
Currency:	U.S. dollars

- 1.2 The grace period will apply only to the repayment of principal, not to payment of interest. The loan will be denominated, disbursed, and repaid in United States dollars.

D. Statement of no objection

- 1.3 In a communication dated 22 May 2006, the Technical Secretariat of the Office of the President of the Republic of El Salvador has indicated its no objection to the Bank financing for the project.

E. The problem to be addressed

- 1.4 **Rural poverty:** El Salvador has a population of 6.76 million,¹ 43% of whom live in poverty. At least 2.66 million people, or 28% of the population, have left the country. In El Salvador, there are over 515,000 microenterprises;² 90.6% of which are subsistence operations and 65% are located outside the metropolitan area. Most of the inhabitants of rural communities earn their living from small-scale agricultural activities or from productive or commercial microenterprises. The government's *Plan Oportunidades* [Opportunities Plan] uses a comprehensive

¹ Multipurpose household survey, 2004.

² *Revista Microenfoque*, April-June 2005.

- strategy for providing greater opportunities to the most economically and socially disadvantaged sectors of the population in 100 mostly rural municipios with high levels of extreme and severe poverty. One of the plan's priority components is the development of instruments for broadening access to credit through the use of microfinance as a key tool in support of the economic development of the poor.
- 1.5 ***Limited supply of credit in rural areas.*** In addition to problems with infrastructure, entrepreneurial shortcomings, and limited market access that interfere with economic activity in these areas, small-scale producers and rural microenterprises lack access to the credit to meet their investment and working capital needs. This is partly because financial services for rural microenterprises are in short supply. In fact, only 15% of the country's microenterprises have access to such services. At the national level, financial services are furnished by 160 banks and nonbank institutions. Their nationwide market penetration rate is 40% (measured as a percentage of GDP); 66% of their activities target business, industry, and services, while only 6% are devoted to agriculture, the sector employing most of El Salvador's poor. Although some banks, nonbank financial institutions, and other informal agencies lend to rural microenterprises, their coverage is still sparse, and most of these microenterprises have nowhere to turn. For regulated institutions, the rural credit market is not perceived as a priority since the market is considered too risky and unprofitable, borrowers are unable to provide real guarantees, and operations have little chance of success and entail high transaction costs—the risks inherent in rural activities and typical of many of the poor. As a result, coverage of this market is shrinking as lenders choose to work with urban borrowers instead. The products offered by commercial banks, the credit technologies used, and the collateral requirements are not suited to successfully channeling credit to small-scale rural borrowers. The shortage of credit on attractive terms and conditions for these producers and microentrepreneurs diminishes their ability to develop productive and commercial activities and to generate income.
 - 1.6 ***The demand for credit in areas of extreme poverty.*** The demand for credit in these areas is marked by: (i) geographic dispersion, which raises the operating costs for intermediary financial institutions (IFIs); (ii) the seasonality associated with the various stages of agricultural production; (iii) the high potential risk of geographic mobility (emigration), exposure to changeable weather conditions and natural disasters, the volatility of farm prices, and the lack of diversification in production activities; and (iv) limited availability of traditional bank guarantees, credit histories, and accounting records.
 - 1.7 Rural microentrepreneurs have recourse to two main types of lenders that are able to cover part of the demand for credit in rural areas: (i) informal sources; and (ii) IFIs. Informal sources (suppliers, household savings, or lenders who charge usurious rates) do not provide sufficient financing and generally charge excessively high rates. In contrast, IFIs serving low-income groups in remote areas provide microfinance programs and other services, charge more reasonable rates, and offer

microfinance products specifically designed to meet the needs of people who usually lack access to credit. About 40 IFIs scattered across most of El Salvador's extremely, severely, and moderately poor departments now offer rural microfinance programs. Most of them are small institutions with loan portfolios of less than US\$2 million and fewer than 500 customers. Under Salvadoran law, only savings and loan cooperatives can accept deposits from the general public to finance their operations. The funding for their microfinance operations is sourced from loans and/or grants from international aid agencies or national second-tier funds as well as from capitalization of earnings, which is generally minimal.

- 1.8 ***Major problems hindering IFI rural microfinance operations:*** (i) portfolios are too small to meet rural credit demand; (ii) operational and management shortcomings place constraints on their productivity, management, and efficiency that limit their growth potential; and (iii) alternative financing mechanisms are lacking. The Fideicomiso para el Desarrollo para la Micro y Pequeña Empresa [Micro and Small Enterprises Development Trust Fund] (FIDEMYPE), founded in 2000, is the only second-tier institution in El Salvador that funds unregulated microfinance institutions. The Banco Multilateral de Inversiones [Multilateral Investment Bank] (BMI) serves as its trustee.³ As of the end of March 2006, it had US\$8.7 million in assets and US\$8.5 million in equity, served 23 organizations with lines of credit, and had a portfolio of US\$7.5 million consisting of over 10,000 loans to micro and small enterprises across the country, but primarily in urban and semiurban areas. FIDEMYPE thus needs financial resources to support unregulated IFIs that are prepared to target microenterprises in extremely poor rural areas.
- 1.9 ***Potential IFI weaknesses:*** Microfinance institutions serving the rural sector vary widely in terms of specialization, size, sophistication, and market penetration strategy. Some specialize in channeling financial services through village banks or solidarity lending in a number of different departments, while others are multiple service institutions with small individual or group lending programs targeting very specific areas. These marked differences notwithstanding, the vast majority of IFIs suffer from technical, operational, administrative, and management shortcomings that limit their potential coverage, sustainability, and impact. If specialized technical assistance and advisory services can be provided to help such institutions address these problems, their clients will have access to a wider array of more sustainable, higher-quality financial services at lower rates over the medium term. DOC 4 in the technical files provides a representative group of IFIs with rural credit programs, together with a description of each one and their main indicators.
- 1.10 ***Strengthening a permanent mechanism for channeling resources to IFIs having rural microfinance programs:*** Due to their institutional limitations, relatively small size, and the additional risk associated with operations in rural areas, IFIs have

³ The BMI's charter states that it may lend funds only through institutions supervised by the Superintendency of the Financial System. The FIDEMYPE is not subject to this requirement.

difficulty in securing sufficient funds to expand their portfolios. They cannot obtain loans from the financial system or other local funds because these lenders are unwilling to work with small, rural, unregulated intermediaries or because they lack the types of collateral these sources require. FIDEMYPE is the country's only viable financial arm for these institutions, since under the BMI's founding charter, it may place loans only via institutions supervised by the Superintendency of the Financial System. Moreover, the best way to channel any substantial volume of funds to a number of small intermediary institutions is by using a second-tier, business-oriented "wholesaler" having the specialized, local capabilities necessary to backstop these IFIs' technical and management operations. FIDEMYPE has shown itself to be just such an institution.

- 1.11 **Beneficiaries:** The project's end users will be around 5,500 low-income microentrepreneurs and small producers in rural departments with high levels of extreme and severe poverty. Their estimated individual borrowing requirements are less than US\$500, with an estimated average loan amount of US\$300. The main economic activities of the beneficiaries are agriculture, small animal husbandry and livestock raising, services, marketing, and other production activities such as craftwork. These households currently live below the poverty line, with a variety of unmet basic needs.

II. THE PROJECT

A. Objective and purpose

- 2.1 The project's main objective is to help raise the incomes of rural microentrepreneurs by expanding and strengthening the supply of financial services in municipios with extreme, severe, and moderate poverty in El Salvador.⁴ Its purpose is to ensure that participating financial institutions strengthen and expand their credit services for microentrepreneurs in these municipios.

B. Description

- 2.2 Two components will be financed: US\$1.3 million in reimbursable financing (IDB: US\$1 million; FIDEMYPE: US\$300,000), and US\$452,000 in nonreimbursable technical-cooperation funding (IDB: US\$250,000; FIDEMYPE: US\$202,000). Both will be executed by FIDEMYPE.

⁴ The poverty categories set out in El Salvador's poverty map have been used for this project.

- 2.3 The **reimbursable financing component** will provide funds to FIDEMYPE, as the project executing agency, which will channel the resources in their entirety to IFIs⁵ that qualify for the present project, to form part of a rural microfinance line. FIDEMYPE will function as a second-tier banking institution and extend loans to selected IFIs that run rural credit programs. The aim is to increase the supply of resources available to these institutions so that they can meet the growing demand for credit in the rural areas where they operate. FIDEMYPE's contribution for this component will include US\$300,000 in cash.
- 2.4 FIDEMYPE will lend funds to the IFIs at an average annual rate of 6.5%⁶ for a maximum term of 24 months, with the possibility of rolling the debt over for a similar term. Grace periods for payment of principal and interest may be offered in some cases. A ceiling of US\$130,000 will be set on lending to each IFI; with average expected to be around US\$100,000. To qualify for a loan, a lending institution must have acceptable indicators of portfolio quality, financial viability, internal controls, auditing, and borrowing, as well as loans with customers in areas of extreme, severe, or moderate poverty. A draft version of the Credit Regulations is available in the project's technical files.
- 2.5 The **technical cooperation component** will support the institutional strengthening of all IFI project beneficiaries. These funds will be used primarily to provide external advisory services and technical assistance in the following areas: (i) technical assistance and strengthening of 15 IFIs to help them administer their financial services efficiently and overcome weaknesses in their credit operations or overall management; (ii) environmental consulting services to facilitate the implementation of suitable environmental policies and procedures; and (iii) support for project monitoring and evaluation. Technical assistance will be provided primarily to complement the funding received by IFIs. IFIs that do not qualify for financing may also have access to these services, however, as a way of helping them to rectify problems that have prevented them from qualifying. The technical cooperation plan of operations that outlines these support measures is available in the project technical files.
- 2.6 In order to manage the IFI strengthening and technical assistance component, FIDEMYPE will sign a partnership agreement with the Fundación en Asesoría y

⁵ The criteria for IFI eligibility are as follows: they must offer services to municipios with high, severe, and moderate poverty, have separate loan programs and staff that work only in that area, have been in operation for at least two years, have a full-time loan manager and specialized staff for this purpose, be legally registered in El Salvador, and have an outside auditor and/or an in-house auditor who works at least half-time.

⁶ FIDEMYPE uses differing rates (ranging from 5.5% to 7.0%) per annum depending on each IFI's risk rating at the time a loan is approved. The rates to be used in this program are estimated at between 6.5% and 7.0% in view of the segment of institutions concerned. Accordingly, increased loan provisioning will be required. When the time comes to renew these lines, however, a lower rate may be applied if the IFI's financial and performance indicators have improved.

Capacitación en Microfinanzas [Microfinance Advisory and Training Foundation] (FUNDAMICRO). Since its inception, FIDEMYPE has worked with this institution in order to help deliver these services to IFIs. The aim is to assist IFIs in improving their financial and operational indicators so that they can obtain access to financing. FUNDAMICRO will undertake the requisite baseline assessments of each IFI and will engage, in accordance with Bank policies and standards, any necessary technical assistance services.

C. Sustainability and financial analysis

- 2.7 The Bank regards FIDEMYPE as the most suitable and prudent choice of borrower and executing agency for this project because it will manage the loan funds properly and minimize the credit risk. FIDEMYPE has a great deal of financial and administrative experience and capacity, as well as proven experience in managing international cooperation programs. It has a well-established track record and is knowledgeable about the different types of microfinance providers found in El Salvador and about the financial market and banking sector in general. It also has a sound asset structure, and its loan portfolio is fully backed with own resources and a minimal liability portfolio. Given its experience in the sector, it is willing to join the Bank in assuming the risk associated with this loan operation. For further information on FIDEMYPE's financial condition, see the institutional analysis and financial statements in the project technical files.
- 2.8 This project's financial viability is based on FIDEMYPE's financial and management performance as executing agency and the sustainability of the IFIs that receive project loans. It will also depend on the IFIs' operational efficiency and management and on their ability to set the interest rates charged to final users at levels that are high enough to cover their costs and generate earnings to finance growth, consolidation, and repayment of debt.
- 2.9 Projections (see the technical files) based on the financial standards and conditions proposed under this project indicate that, taking into account the sum total of FIDEMYPE's available portfolio resources, it will generate a positive revenue stream starting in the initial year.⁷ The project is also expected to yield rising levels of profits from its first year on. These earnings will generate a return on equity (ROE) and a return on assets (ROA) of over 2.25% for a 10-year period from commencement of the project. Also, total assets are projected to increase by nearly US\$3 million during this period thanks to the institution's policy of capitalizing earnings from the funds it administers. This will assure FIDEMYPE's long-term potential growth and sustainability. Only IFIs whose performance indicators demonstrate their financial viability will be selected as beneficiaries for the financing component and their performance will be closely monitored. Based on

⁷ The projections for this project, which are based on very conservative assumptions, point to continued good profitability.

FIDEMYPE's previous experience, the IFIs receiving specialized technical assistance are expected to become profitable enterprises upon completion of the project, with an 8% delinquency rate and an average operating efficiency ratio of under 50 (operating expenses/financial spread).

D. The Bank's credit risk

- 2.10 The credit risk entailed by this operation is determined by FIDEMYPE's capacity to repay the loan to the IDB. This, in turn, depends on its ability to correctly identify and select (balancing risk against return) IFIs for the project. This risk is mitigated by the following factors: (i) FIDEMYPE's track record in terms of growth, profitability, and the high quality of its portfolio since its inception (arrears under 1% and no nonperforming loans); (ii) 100% of FIDEMYPE's portfolio is leveraged with its equity, and the institution will continue with its policy of capitalized earnings; (iii) by virtue of its operational and institutional ties with the BMI, it will benefit continuously from improvements in its risk-analysis and IFI-selection capacity and processes during the consolidation and loan placement stage; and (iv) beneficiary IFIs will also receive technical assistance in improving their management, efficiency, and profitability.

E. Expected outputs and benefits

- 2.11 The project will benefit its end users (rural microentrepreneurs) and the participating IFIs. It will provide sustainable access to new and better microfinance services to an estimated 5,500 rural microentrepreneurs and small-scale producers in municipios of high, severe, and moderate poverty in El Salvador that are largely not being served by any other formal or informal microfinance institutions. Bank resources will provide these microentrepreneurs and small-scale producers with an immediate and ongoing means of obtaining the credit they need for their economic activities and with a projected increase in their net incomes of 20% over the life of the project. In addition, approximately 15 IFIs with rural lending programs are expected to benefit from: (i) access to additional resources for financing their loan portfolios, which would be very difficult for them to obtain elsewhere; and (ii) specialized technical assistance in such areas as management, credit technology, operating capacity, and new products that will give them greater reach and improve their performance indicators. These indicators include a portfolio at risk over 30 days < 8%, an average financial sustainability ratio of 1.20, and an average operating efficiency level of 50% or less. Upon project completion, FIDEMYPE will have a total portfolio of around US\$10 million, a portfolio at risk $\leq 3\%$, an operating efficiency > 100, financial sustainability ≥ 1.5 , and coverage of its risk portfolio > 100%. These indicators are included in the project table of indicators (see the technical files).

F. The Bank's strategy

- 2.12 The project's activities are in keeping with the priorities set forth in the Bank's new country strategy with El Salvador (BCS-ES), whose core objective is to reduce poverty in the country. The project will also support the government's efforts through the Opportunities Plan and the Tu Crédito [Your Credit] Program under way since September 2005, with a view to expanding financial services for poor regions in the country. The project addresses, in particular, the first objective of the Bank's strategy, which is to promote sustainable economic growth by increasing competitiveness, especially in rural areas and targeting vulnerable groups. It will do so by: (i) expanding financial services for the production activities of small-scale producers and microentrepreneurs in rural areas, thereby creating opportunities for raising the incomes of campesino families living in municipios with high, severe, and moderate poverty; and (ii) supporting efforts to reduce poverty by furnishing sustainable financial services to low-income groups in virtually all of the country's departments.

G. Joint efforts with other international cooperation agencies

- 2.13 In analyzing and designing this operation, the project team consulted with the local team of the United States Agency for International Development (USAID) which is in charge of the financial services project for micro, small, and medium-sized enterprises. During these coordination meetings it was confirmed that over the next four years the USAID project would target technical assistance primarily at strengthening sources of credit for small and medium-sized enterprises and three microfinance institutions that will be channeling resources to the rural sector. The two teams shared information on the various efforts in support of these institutions and agreed that their local offices would continue to work closely together in coordinating the activities of both projects.

H. Environmental and social review

- 2.14 On 17 March 2006 (meeting 11-06), the Committee on Environment and Social Impact (CESI) reviewed this operation and suggested that: (i) information on the location of indigenous groups in El Salvador be shared with FIDEMYPE, and the possibility be explored of FIDEMYPE and the relevant nonbank financial institutions identifying which of their customers belong to these groups; and (ii) FIDEMYPE's lending policies be reviewed, and a request be made to integrate into these policies the established guidelines for analyzing environmental and social impacts of IDB microenterprise operations. To address these points, the project will include consulting services for environmental training to FIDEMYPE and participating IFIs.

I. Special terms and conditions

- 2.15 As a condition precedent to the first disbursement of the **reimbursable financing**, FIDEMYPE will submit the following items to the Bank's satisfaction: (i) the definitive version of the FIDEMYPE Credit Regulations⁸ for the project as approved by its Management Board; and (ii) evidence that it has designated a staff member to administer project operations.
- 2.16 As a condition precedent to the first disbursement of the **technical-cooperation** funding, FIDEMYPE is to submit the following items to the Bank's satisfaction: (i) a work plan for the first 12 months of the project, including timetables for project activities and for attainment of performance indicators that can be used to oversee the operation and monitor its progress; and (ii) a signed agreement with FUNDAMICRO for administration of the nonreimbursable technical-cooperation component.
- 2.17 As a condition precedent to disbursement of more than 40% of the technical-cooperation funding, FIDEMYPE must demonstrate that at least 30% of the reimbursable financing has been disbursed. As a condition precedent to disbursement of more than 60% of the reimbursable financing, FIDEMYPE must demonstrate that it is furnishing technical assistance to at least nine (9) IFIs.

J. Reports, evaluations, procurements, and revolving fund

- 2.18 **Reports.** FIDEMYPE will submit progress reports to the Bank's Country Office in El Salvador within 60 days after each six-month period. These reports will include an analysis of the extent to which the performance indicators have been reached, any problems encountered, the steps taken to correct them, and projections for the following six-month period. It will also include at least: (a) for the **reimbursable financing component**: (i) information on completed and ongoing FIDEMYPE operations (clients, amounts, terms and conditions, etc.); (ii) information on the procedures used to analyze and select clients and the results; (iii) a narrative description, together with financial and statistical information, of existing onlending operations using a format established in advance with the Bank; (iv) statistical and financial information on FIDEMYPE, to include portfolio quality, efficiency, productivity, profitability, and other indicators; (v) information on the effective annual rate charged on loans made by participating IFIs to their clients and how the rates compare with the average rate charged to microenterprises by banks and nonbank institutions; and (vi) a summary of FIDEMYPE's cash contributions to the project; and (b) for the **technical cooperation component**: (i) a summary of the work done in providing technical assistance to the IFIs and its results; (ii) a summary of the results of the training and in-service training provided for IFI members; (iii) statistical data on improvements in the performance indicators of

⁸ The basic terms and conditions set out in the Credit Regulations are listed in DOC 2 in the project's technical files.

- IFIs that have received technical assistance and/or advisory services under the program; (iv) a summary of the progress made in providing environmental consultancy services and their results, including the IFIs' application of new environmental policies ; and (v) statistical data on end users generated by the program monitoring and baseline analysis system. The last of these reports will serve as the final project report and summarize the extent to which the original objectives have been achieved. The Bank will review the results and recommendations discussed in these reports. If any significant shortcomings are detected, the Bank will not stop all further disbursements until FIDEMYPE has taken satisfactory steps to correct the shortcomings.
- 2.19 **Evaluations.** Two project evaluations will be performed by individual consultants to be selected and engaged by the Bank's Country Office in El Salvador. The cost of these services is to be covered out of the technical-cooperation component. A midterm evaluation will be conducted 18 months after the effective date of the contract or when 50% of the funds have been disbursed, whichever comes first. Another midterm evaluation will be carried out 36 months after the effective date of the contract. The first evaluation will measure, as a minimum: (i) the progress made in raising the incomes of participating microentrepreneurs; (ii) the extent to which the project's performance indicators have been achieved; (iii) lessons learned and recommendations for improving the project; and (iv) the executing agency's institutional capacity.
- 2.20 In addition to the items to be included in the first evaluation, the final evaluation will measure and document: (i) the extent to which the project objectives have been fulfilled; (ii) lessons learned; and (iii) project sustainability.
- 2.21 **Audits.** During the operation and within 120 days after the close of its fiscal year, FIDEMYPE will submit annual audited financial statements of the organization and the loan component. The executing agency will use counterpart funds to defray the cost of these audits. Funds will be drawn on the Bank's contribution to pay for a final audit of the technical-cooperation component once it is completed.
- 2.22 **Procurement.** All procurement will be conducted in accordance with Bank policy. Individual contracts will be issued in the case of consulting services. Given the amounts envisaged for the consulting contracts, a short list composed entirely of national consultants may be used to select these services. Since the procurement of goods, services, and consulting services will not entail international competitive bidding, post reviews may be used to assess these transactions as specified in documents GN-2350-6 and GN-2349-6 of February 2006.
- 2.23 **Revolving fund.** A revolving fund of up to 20% of the project amount will be established for project disbursements, since the average disbursement per IFI will be US\$100,000, and a number of potential IFI beneficiaries have been identified in advance. FIDEMYPE is a sound institution that has experience in allocating funds to microfinance agencies.

K. Project risks and mitigating factors

- 2.24 The project is faced with the following potential risks: (i) the quality of the FIDEMYPE's portfolio could be diminished if any of the IFIs falls into arrears as a result of shortcomings in liquidity management, maturity mismatches, inappropriate process applications, or inadequate information technology support for operations monitoring, etc. This risk will be mitigated by: (a) a rigorous selection of IFIs based on best practices in risk analysis derived from the BMI's experiences with its various programs; (b) careful monitoring of the portfolio by BMI risk-analysis personnel; and (c) technical assistance for IFIs to help them build their management capacity; and (ii) the impact of natural phenomena could adversely affect portfolio quality. As IFI exposure to such risks is quite high, mitigating actions will include: (a) helping IFIs to diversify and deconcentrate their portfolios; and (b) ensuring that the technical assistance services include the possibility of agricultural insurance and natural disaster insurance for credit operations; and (iii) participating IFIs may find cheaper sources of financing and not rediscount FIDEMYPE lines of credit. This risk will be mitigated by FIDEMYPE's capacity, under the Credit Regulations, to modify interest rates based on market conditions.

L. Exceptions to Bank policy

- 2.25 None.