

MULTISECTOR GLOBAL CREDIT PROGRAM

(ME-0117)

EXECUTIVE SUMMARY

Borrower:	Nacional Financiera, S.N.C. (NAFIN)	
Guarantor:	United Mexican States	
Executing agency:	Nacional Financiera, S.N.C. (NAFIN)	
Amount and source:	IDB (dollar window):	US\$300 million
	Local counterpart:	US\$300 million
	Total:	US\$600 million
Financial terms and conditions:	Amortization period:	12 years
	Disbursement period:	3 years
	Interest rate:	variable
	Inspection and supervision:	1 %
	Credit fee:	0.75%
	Currency:	U.S. dollar
Objectives:	<p>The objective of the program is to assist with the development of micro-, small-, and medium-sized enterprises (MSME) by expanding the supply of formal credit services geared to this sector. To accomplish its objective, the program will make resources available to NAFIN to fund loans that financial intermediaries make to MSME. It will also provide resources for developing specialized lending technologies tailored to meet this sector's needs efficiently.</p>	
Description:	<p>The proposed program will have two components: a multisector credit component (US\$586.75 million) that will provide resources to expand NAFIN's roll-over programs for loans that eligible financial intermediaries make to MSME. This component will be instrumental in funneling medium- and long-term resources through auction and rediscount programs and, on a short-term, more limited scale under a supplier credit program. A technical assistance component (US\$8 million) whose specific objective is to expand the institutional capacity of the financial intermediaries and of NAFIN to serve the MSME sector and make the products offered more competitive. This component will have three subcomponents: (1) technology transfer and competitiveness; (2) upgrading specialized providers and</p>	

developing new distribution channels, and (3) improving MSME competitiveness.

**The Bank's
country and
sector strategy:**

The Bank's strategy for the financial sector has focused on support for the government in its efforts to reform and modernize the system of existing public development banks in Mexico. The Bank has financed modernization programs for NAFIN and Banobras (two of the leading development banks) and has at the same time kept up an ongoing dialogue with authorities on the future role that development banks will play as tools of government economic policy.

The Bank's strategy is fully consistent with the country's strategy for the sector, which is why the present operation was included in the country paper that the Bank's Programming Committee approved last October. Support to the private sector is one of the priorities of the Bank's strategy for Mexico. The Bank's strategy for the private sector would consist of the following: (i) modernizing laws and regulations; (ii) financing private investment projects; (iii) financing public projects associated with private investment, and (iv) financing and supporting micro-, small- and medium-sized enterprise. The Bank currently has two other operations in the pipeline for the financial sector: one with the bank savings protection institute [Instituto de Protección del Ahorro Bancario] (IPAB) (ME-0227) to assist with the reforms now being introduced in the financial sector, and another to help the housing sector through the mortgage bank operating and financing fund [Fondo de Operación y Financiamiento Bancario de la Vivienda] (FOVI) (ME-0137).

NAFIN's experience in the MSME sector and its command of the products to serve them makes it the best intermediary through which to channel the proposed operation's resources. The program would capitalize on NAFIN's role as a catalyst in the growth of the financial market, in other words its ability to attract and establish partnerships with financial intermediaries, and to leverage its position as a catalyst to supply stable, long-term resources for lending, which will be an important inducement to financial intermediaries to increase their lending to the MSME. The program is expected to benefit some 3,900 businesses.

The support this operation will provide to NAFIN will come just as it is completing its financial restructuring and implementing an in-depth institutional reform through a strategic program designed to make it an efficient provider of second-tier financial services. The operation will enable NAFIN to consolidate and expand the delivery of financial services to the MSME, with more emphasis on the smaller businesses within this sector.

- Environmental and social review:** The Committee on Environment and Social Impact (CESI) approved the program last May 19 and its recommendations were built into the design of the strategy for the present operation.
- Benefits:** Under the present operation, a number of benefits will accrue to the target population, the principal one being greater access to financial services for micro-, small- and medium-sized enterprise, thereby helping to create jobs for the Mexican people. IFIs will be able to participate provided they meet sufficiently stringent eligibility criteria, the effect of which will be to upgrade the intermediaries participating in NAFIN's lending programs. The program will also be pivotal in getting NAFIN's restructuring process fully in place, which will give the institution the operating efficiency that the reforms were intended to achieve. The program's technical assistance component will further the development and introduction of new products, thus enabling NAFIN to be more instrumental in deepening Mexico's financial market.
- Risks:**
- The macroeconomic climate and financial system.** The program's success will largely depend on whether the macroeconomic situation remains stable, with fiscal and monetary policies conducive to growth and expansion of credit to the private sector. The structural reforms instituted within the financial system have to be continued to ensure that it recovers and functions normally. The government is determined to follow through with those reforms and to maintain monetary and fiscal discipline, thus minimizing the risk of both these variables.
- Operating risk.** NAFIN has made significant progress with its reform and institution building. However, the improvement NAFIN has made to upgrade its capacity to analyze and manage risk assets will have to be sustained if the institution is to lend more without jeopardizing its financial position. The operating risk is also mitigated as more and more risk analysis procedures are automated and because the eligibility criteria being introduced are program-specific.
- Timing of the operation.** The proximity of Mexico's elections and the possibility of a change of administration could be regarded as potentially detrimental to execution of this operation. However, inasmuch as NAFIN's activities under this program are among the services that the institution provides to the private sector, the political process is not expected to have any effect whatever on those services. Moreover, the election process does not appear to have had any ill effect on NAFIN's lending during the first quarter of 2000.

Special contractual clauses:

1. Prior to the first disbursement from the credit component, the borrower must show the following, to the Bank's satisfaction:
 - a. evidence of having put into force the credit regulations that will govern the program, as previously agreed with the Bank;
 - b. the draft contracts to be entered into with the IFIs, as previously agreed with the Bank;
 - c. a report establishing the procedures that will be used to put into practice the environment-related provisions of the credit regulations and the NAFIN departments responsible for implementation.
2. Prior to disbursement of the resources from the technical assistance component, NAFIN must submit, to the Bank's satisfaction, a plan of operation for the component, outlining the activities to be performed and the work schedule, as previously agreed with the Bank.

Poverty-targeting and social sector classification:

This operation qualifies as a project that promotes social equity, as described in the key objectives for the Bank's activities in the report on the eighth general increase in resources (documents AB-1704). It does not qualify as a poverty-targeted investment (PTI).

Exceptions to Bank policy:

N/A

Procurement:

The Bank's normal procurement rules will apply.

Revolving Fund:

The Bank normally allows the borrower to request up to 5% of the financing under a revolving fund. However, the borrower is requesting that the revolving fund be increased to 10% for this operation to make program lending more efficient, especially under the auction mechanism. The same percentage was requested for loan 911/OC-ME.

I. FRAME OF REFERENCE

A. Introduction

- 1.1 In March 1999, the Government of Mexico (GOM) presented a request to the Bank for a loan of US\$300 million for a multisector credit program to be conducted by Nacional Financiera, S.N.C. (NAFIN). The program is construed as an extension of the multisector credit component of loan 911/OC-ME, which is nearing completion. Inasmuch as the financial system's recovery and NAFIN's institutional restructuring are ongoing, the proposed program has been designed as a two-year transitional operation. It will provide medium- and long-term credit to micro-, small- and medium-sized enterprises via eligible private financial intermediaries.

B. Macroeconomic framework

- 1.2 After coping with major challenges in 1994, 1997 and 1998, the Mexican economy is entering the new millennium well poised for recovery. In 1999, results exceeded the authorities' expectations. The economy's performance that year and in the first quarter of 2000 has been excellent, due mainly to better terms on international capital markets and high oil prices.
- 1.3 The economy's recovery from the slowdown in late 1998 was initially driven by higher exports and investments and more recently by a significant increase in private consumption. While the vigorous growth of exports and more robust domestic demand raised the external current account deficit by more than had been projected, the increase was fully offset by inflows of private capital, especially through direct foreign investment, resulting in healthy gains in international reserves. Improved labor productivity and wage and salary curbs helped keep Mexico competitive on foreign markets, as indicated by the real effective exchange rate based on unit labor costs and the boom in non-oil exports.
- 1.4 In the monetary area, the Banco de México's policy was consistent with the steadfast commitment to reaching the inflation goal. The money supply grew rapidly in 1999, amid declining inflation and greater market confidence. At the present time, the monetary base is growing at the planned pace. However, bank lending to the private sector fell 10% in real terms, continuing a trend that began back in 1995. As of March 2000, the decline was slowing to 8% per annum. Short-term domestic interest rates fell by more than 1,700 basis points to 16.5% as of December 1999 and the stock market index was sharply higher.
- 1.5 Productivity and employment continued to improve in 1999, although at a slower pace than in recent years. Between January and November, average per-worker productivity was up 2% over 1998; industrial employment increased 1% during that same period, while real wages and salaries remained virtually unchanged. Open unemployment was down to 2% by the end of 1999, by comparison to 2.6% at the end of 1998.

- 1.6 In August 1999, Moody's rating for Mexico was raised from Ba2 to Ba1 and investments improved in March 2000, affording the country better access to international capital markets. Of the US\$11.5 billion in bonds floated on international markets in 1999, almost US\$7.5 billion were floated by the public sector. The spread between Mexico's sovereign bonds and United States Treasury bonds narrowed markedly from 800 basis points in January 1999 to 370 basis points in December 1999. In January 2000, the government floated US\$1.5 billion in 10-year bonds with a 315 basis-point spread, the lowest since March 1998.
- 1.7 The economic program for the year 2000 is forecasting inflation down to 10%, real economic growth of 4.5% and a global fiscal deficit of 1% of GDP. The GOM has indicated that it is determined to resist any pressure exerted to change the direction of economic policy in the wake of the presidential elections and the high oil prices. The GOM recently took important steps to improve the financial system with passage of regulations governing the bankruptcy and securitization process. The stronger financial system will make more vigorous lending to the private sector possible.

C. Mexico's banking system

- 1.8 With the economic crisis in late 1994, the Mexican authorities adopted a number of measures to prevent the collapse of the banking system. These measures included financial assistance to banks that were experiencing difficulties, debtor-assistance programs, regulatory flexibility and bank restructuring operations. Although the position of the banks has improved in recent years, the banking system is still undercapitalized by international standards. The remaining problems with the legal and institutional standards governing banking operations are now being corrected.
- 1.9 As of December 1999, 19 universal banking institutions were in operation, with assets totaling US\$145 billion and a positive net worth of US\$14.164 billion. However, the official capital adequacy ratios show that whereas the banks' equity capital continues to increase, the system's financial position is still weak. As of December 1999, the banking system's average capital adequacy ratio for credit and market risks was 16.2%, compared to 14.2% and 13.6% in December 1998 and 1997, respectively. However, due mainly to differing accounting practices, especially as regards the definition of bank capital, loan reserves and asset valuation, and the prevalent accommodation as regards rules and regulations, these figures tended to exaggerate the banks' capital by substantial margins. To correct the problem, the authorities have established new capital requirements that the system's banks must meet by January 2003. Official data on the banks' profits also reflect their improved financial position. The rate of return on capital, which fell to -17% in 1996, was up to 7% in 1998 and improved again in 1999.
- 1.10 The loan portfolios of the banks in the system are showing signs of significant improvement. The delinquent portfolio went from 11.5% in June 1999 to 8.9% in

December 1999, excluding those banks that underwent IPAB intervention. Also, coverage of the allowances for delinquent portfolios increased from 66% in late 1998 to 107.8% in December 1999. However, under GOM's various programs, a significant portion of the banks' current portfolio has been restructured a number of times and now poses an even greater risk to the financial institutions.

- 1.11 The Government of Mexico (GOM) has taken significant measures to strengthen the banking system's operating environment and to facilitate its recovery. The definition of statutory capital has been improved and will be introduced toward the end of 2002, to coincide with the suspension of the universal deposit guarantee system that will be replaced by a limited insurance system. Also, allowances for losses on credit cards and mortgage loans have been adjusted to be consistent with the higher allowance levels. Oversight authorities have made progress with internal banking controls, accounting procedures, disclosure and money-laundering policies. To encourage transparency and make it possible to compare the institutions' performances, banks will have to disclose the specific terms under which they were accorded some regulatory accommodation and to specify the impact that accommodation has had on their financial statements.

D. Credit supply and demand

- 1.12 In the last five years, the economic slowdown, a deteriorating credit-risk outlook, unstable sources of funding, high interest rates and their extreme volatility, and the disappearance of many specialized credit sources, dampened both the supply and demand for credit, restricting the business sector's borrowings. In the 1995-1999 period, credit from the banking system to the private sector fell 21% per annum in real terms. As of December 1999, the balance of commercial bank financing to the private sector was, in real terms, only 56.9% of what it was at the end of 1994. Bank credit went mainly toward working capital.
- 1.13 The quarterly evaluation surveys that the Banco de México conducts of the credit market found that in 1999, alternative sources of business financing were available. Of these, credit-services providers were the most common, especially among small and non-exporting businesses. Fewer than 40% of the businesses surveyed used bank credit, mainly because of the high and volatile interest rates and the banks' considerable reluctance to lend. Lending policies had turned more conservative as banks worked to rebuild capital adequacy ratios and restructure their portfolios. The gaps in the legal framework in the area of securitization and bankruptcy procedures were major deterrents to bank lending.
- 1.14 Despite its importance to the Mexican economy, micro-, small- and medium-sized enterprise (MSME), which accounts for some 70% of the country's employment sources, was the sector that the crisis hit hardest. According to Banco de México data, as of June 1999 72% of the small- and medium-sized businesses said they were financing themselves with internally generated revenues and credit sources

other than banks. Chief among these non-banking sources of credit were credit-services providers, which accounted for 84%, revealing how the payments chain had extended. However, given their volume, availability, features and cost, credit sources other than banks are limited in terms of their ability to accommodate the sector's growth.

- 1.15 Although commercial bank financing to the private sector was just 22.6% of GDP in late 1999, there are indications that bank lending is no longer on the decline and is staging a recovery that began in the last quarter of 1999. Universal banking's overdue portfolio dropped to 8.4% in real terms, due mainly to a decline in overdue mortgage and business loans thanks to the reorganization of the loans under the *Punto Final* program.
- 1.16 Structural imbalances and the shifts in the Mexican economy as a result of the 1995 crisis make it difficult to gauge the MSMEs' potential credit demand. A forecast of the private business sector's demand for credit, done by Nacional Financiera, S.N.C. (NAFIN) for the period 1999-2004 and based on the past pattern of borrowings in relation to GDP growth, shows a gross annual increase of credit demand of some US\$22 billion. In the case of the MSME, the forecast assumes that the MSME sector will account for some 65% of the total anticipated demand, which implies a gross annual increase in credit demand of US\$12 billion by 2004.

E. Nacional Financiera

- 1.17 In operation since 1934, Nacional Financiera, S.N.C. (NAFIN) is a development bank currently governed by its organic statute -published in the December 26, 1986 edition of the Federation's *Diario Oficial*-, the lending institutions act and the rules set by the national securities and banking commission [Comisión Nacional Bancaria y de Valores, CNBV]. Traditionally, NAFIN's business was targeted at promoting self-sustaining projects that could create jobs, bring in foreign exchange earnings and promote regional development by financing economic activities in the private sector and public productive sector, and at lending directly to public entities, serving as the federal government's financial agent and operating in capital markets. At the present time, the institution has 1200 employees and is organized into five offices: (i) promotion; (ii) finance; (iii) legal and fiduciary affairs; (iv) financial information, and (v) management. NAFIN has its main office in the Federal District and branch offices in all federal states.
- 1.18 The 1994 crisis also adversely affected public development banks. Their assets declined, both in terms of volume and quality; their access to external credit decreased, and their equity position deteriorated. The deterioration in their financial position and the decline in their business exerted added pressure in favor of reforming NAFIN and the other institutions in the sector. Having stopped making direct loans to the private sector in the early 1990s, NAFIN heavily increased its lending to second-tier banks, channeling resources to banking financial institutions

(BFIs) and non-banking financial institutions (NBFIs). Loans to the latter increased appreciably in 1993 and 1994, and then caused significant losses.

- 1.19 Given the portfolio losses sustained and the need to downscale the institution's business activities and improve its operating efficiency, GOM planned to modernize and rationalize NAFIN in order to adjust it to the needs of a restructured financial sector and position it to serve as a tool for financing the MSME. The government launched NAFIN's institutional and financial modernization in 1997, which the Bank supported with a program for corporate strengthening of financial institutions (Loan 911/OC-ME). The purpose of the process is to modernize and consolidate the institution as a second-tier financial agency, with emphasis on operating efficiency. Given NAFIN's strategic plan, the process targets four areas: (1) risk management; (2) redesign of procedures, especially in the credit area; (3) organization and human resources, and (4) technology and software.

1. Institutional reform program

- 1.20 A pivotal part of the modernization is creating evaluation and *risk management* mechanisms for all NAFIN operations that reflect a new approach to managing its risk assets. The three main risk committees established determine risk policy for all operational areas. A risk management unit was created and reports directly to the general management office. It analyzes and tracks NAFIN's risk exposure in all its market operations, weighing the specific portfolio risks (credit risk) and the market risks. It is also in charge of the recently instituted procedure for rating financial intermediaries. Coupled with these measures are plans to modernize software and introduce new tools for computerized analysis and management, a process that will be completed in 2001. The introduction of the "risk" concept as a central consideration in NAFIN's operational management was combined with changes in policies on analyzing, making, tracking and collecting loans and an overhaul in operating procedures.
- 1.21 The *credit area* was improved by introducing the portfolio management and recovery system (Sistema de Administración y Recuperación de Cartera – SIRAC) and centralizing the functions involved in examining loans. Clear responsibilities have been delegated and any duplication of functions has been eliminated. A model was introduced that the NBFIs will be required to use to evaluate smaller loans intended for the MSME. An independent area created for portfolio recovery and management of bad portfolios is a major innovation in NAFIN's organizational structure, since for the first time the specific function of portfolio recovery is delegated in a single unit.
- 1.22 NAFIN's modernization was coupled with a *reorganization of structures* and staffing cuts to create a compact operational structure able to respond to the ebb and flow of business and without its characteristic segmentation. Large organizational areas were created, namely: (i) development, which includes lending, products and

promotion and investments; (ii) finance; (iii) legal and fiduciary affairs; (iv) financial and administrative data systems; and (v) management. The majority of the back office functions have been combined into a single organizational unit. With the reorganization, the staff was cut by 65% between 1996 and 1999, from 3,400 to 1,200 employees. In addition to NAFIN's new management model, area-, product-, and activity-based costing systems will be introduced and are currently in development.

- 1.23 The ***technology and software program*** made significant headway. The modern systems introduced for risk analysis, loan evaluation and portfolio management have made NAFIN a better second-tier bank. By modernizing and upgrading procedures, NAFIN has become more efficient. The introduction of these systems, in combination with the institutional modernization already underway, has improved NAFIN's capacity to carry out the proposed operation efficiently. Nevertheless, other measures are still needed to modernize the data and administrative systems but have been delayed due to problems with the bidding process and with timely allocation of budgeted resources. These steps will be completed in 2001 and the delay will not affect NAFIN's capacity to carry out the proposed program.

2. The risk analysis system

- 1.24 The risk management office has devised a method for rating and ***analyzing the risks*** of banks in the system and for determining the maximum exposure that each institution can tolerate. Two analysis modules were established: a) one that rates a bank's credit risk; and b) one that assigns the maximum risk exposure, determined by the capacity to leverage the equity of the bank and NAFIN. Four parameters are factored in when determining a national bank's credit risk: "financial positioning"; "stability"; "trend"; and "consistency". The analysis of financial positioning examines the ratios of each bank for nine financial variables selected over a given period and compares them with "performance benchmarks" and the performance of the other banks, establishing each institution's position relative to the others. The nine variables make up a "CAMEL" model and include the following: (1) capitalization; (2) earned capital/positive net worth; (3) delinquency; (4) percentage of portfolio rated "A"; (5) operating expenses/operating revenues; (6) return on capital; (7) net profit over total earnings; (8) liquid assets/total assets, and (9) liquid assets/borrowings. This method draws upon monthly financial data supplied by the CNBV.
- 1.25 The "financial positioning" factor carries a weight of 80% in the evaluation of a bank's risk and is coupled with the evaluation of the institution's relative performance (dynamic analysis), which measures the other three parameters named above. The "stability" factor measures the variation in each bank's financial position over time; "trend" measures the direction that each bank's financial position is taking with the changes that occur over time; and "consistency"

measures the capacity to sustain the financial position levels over time. The weight of each of these three criteria ranges from 5% to 10% in the risk analysis, and the three combined represent 20% of the evaluation. When these four factors are combined, the resulting bank rating will fall into one of five categories.

- 1.26 To **determine maximum risk exposure**, NAFIN uses the risk rating adjusted by establishing rating equivalencies and probabilities of noncompliance with international standards, to yield an adjusted equity leveraging ratio. Equivalencies are established between the NAFIN rating and Moody's rating system. The principle of the system is that a Mexican bank that receives NAFIN's highest credit rating (AA) would, under Moody's system, receive a rating equivalent to Mexico's risk rating (BAA3) based on the local currency. Then, national banks with a Moody's rating and representative of NAFIN's best and worst ratings are compared. Thus, for each NAFIN rating an equivalency is established with a Moody's rating and the corresponding probability of loss is determined and, with that, a table of equivalencies is established (Table I-1).
- 1.27 Every intermediary's loss probability is figured on the basis of its capacity to leverage equity. This is compared with the NAFIN equity leveraging ratio and the lesser of the two will be NAFIN's maximum risk exposure in all its financial transactions with a given intermediary.

Table I-1
Equivalencies for Credit Ratings and Probability of Noncompliance by Time Period

Moody's Rating	Fitch Rating		NAFIN Method	Probability of noncompliance 1 year
	Short term	Long term		
BAA1	F3	BBB+	AA	0.13%
BAA2		BBB		0.16%
BAA3		BBB-		0.70%
BA1	B	BB+	A	1.25%
BA2		BB	BB	1.79%
BA3		BB-	B	3.96%
B1	C	B+	C	6.14%
B2		B		8.31%
B3		B-		15.08%

- 1.28 The method used to evaluate the *non-banking financial intermediaries* differs from the method used for banks. It is based on a parametric analysis of the institutions, where the chief consideration is the quality of the intermediary's portfolio, which carries a weight of 50%. Other factors considered in the analysis are the intermediary's financial situation; the quality of the borrower's portfolio with NAFIN; the distribution of the net portfolio and exposure to tied loans;

business-management indices; the age of the NBFi and how long it has served as a NAFIN financial intermediary, with a weighting of between 2.5% and 15%.

- 1.29 The system classifies the intermediaries into three groups: viable, with a rating higher than 80%; potentially viable, and nonviable, where the rating is below 70%. NAFIN only lends to institutions that receive a “viable” rating. NAFIN’s risk exposure with a NBFi is determined on the basis of the institution’s capital adequacy ratio, which must be greater than 10%, and NAFIN’s leverage, which ought not to exceed 3%.
- 1.30 The evaluation system uses financial data supplied monthly by the CNBV and information generated by NAFIN.¹ Analyses are done on a monthly basis. At the present time, the system encompasses all the credit unions that are NAFIN intermediaries¹ and leasing firms. However, the system will apply to the other institutions during the third quarter of 2000.

3. Financial position

- 1.31 NAFIN’s financial position has varied appreciably in the last five years of the 1990s with the financial crisis the country experienced in 1994/1995, the global financial crises in 1997 and 1998, and the changes made to the institution itself. The institution’s assets decreased markedly, its returns declined and its equity position was adversely affected. In late 1999, NAFIN’s assets totaled US\$22.2 billion, its positive net worth was US\$735 million and the institution reported net positive earnings of barely US\$1.7 million. This was in contrast to the situation in late 1994, when the institution reported total assets in excess of US\$44.3 billion, equity of US\$1.4 billion and a net positive balance sheet of US\$5.9 million.
- 1.32 After growing its lending activities by 70% in real terms between 1993 and 1994, NAFIN saw its portfolio shrink by almost 50% in the next five years, one reason why its real assets were down 55% between 1994 and 1999. In late 1999, its loan portfolio was US\$17.5 billion, which was 12.5% less in real terms than what it was as of December 1993. When only loans with the BFIs and NBFIs are considered, the decrease was even greater since second-tier lending to BFIs and NBFIs was off 77% and 92%, respectively, in that period. One major factor in the sharp decline in loans to the NBFIs was that many credit unions went bankrupt. The portfolio losses incurred when these credit unions when bankrupt were passed on to the GOM in 1996. The number of credit unions with which NAFIN does business has dropped from over 500 in 1994 to just 34 at the present time.
- 1.33 NAFIN’s second tier portfolio continued to shrink until 1996 and finally stabilized in 1997. An analysis of the loans to BFIs and NBFIs between 1997 and 1999 reveals the gradual recovery of the institution’s lending activity, which increased

¹ At the present time only 26 of the more than 50 active credit unions have qualified to apply for financing.

from US\$892.5 million in 1997 to US\$1.42 billion in 1999. During the first quarter of 2000, NAFIN second tier borrowings totaled some US\$300 million. The portfolio's average balance between 1997 and 1999 was US\$1.6 billion.

- 1.34 With the decline in second-tier lending, these borrowings dropped from 30% to 9% of NAFIN's assets between 1994 and 1999 (Table I-2). Accordingly, NAFIN's other areas of business accounted for a greater share of the institution's assets, since the nominal volume of their activities remained unchanged. This shift in the composition of NAFIN's assets caused the institution's global financial market to narrow, because its most profitable area of business declined.
- 1.35 **Structure and composition of assets.** Any financial analysis of the institution must begin by recognizing that NAFIN engages in four different and independent areas of business, each with a different risk profile and returns: (i) GOM's financial agent; (ii) direct lender to states and public entities; (iii) financial agent on capital markets; and (iv) second-tier lender for banking and non-banking intermediaries. The following table shows how NAFIN's assets are divided among these four areas of business.

Table I-2
Composition of Assets 1994-1999
(as a % of total assets)

Assets	1994	1995	1996	1997	1998	1999
Financial agent	33	37	38	42	45	45
Second tier banking	30	16	11	9	9	9
Lender, public entities	5	8	16	20	21	24
Capital markets operations	13	21	24	22	18	15
Total assets (current pesos)	166.4	243.3	241.6	240.9	236.2	222.1
Total assets (1998 pesos)	443.4	426.5	331.6	240.9	236.2	201.5
Risk assets (current pesos)	135.8	197.6	215.2	226.3	220.0	208.2
Risk assets (1998 pesos)	254.9	356.8	302.1	226.3	220.0	188.9

- 1.36 **Liabilities structure.** The decline in NAFIN's assets was paralleled by a structural shift in the composition of its liabilities. In 1994, NAFIN financed 61% of its business with long-term resources, mainly from international organizations; short-term loans financed only 18% of NAFIN's business. By late 1999, the latter had risen to 42%, at an average cost of Libor 3m + 1.823 as of March 2000. This financial intermediation structure not only adversely affects NAFIN's capacity to make longer-term loans but also exerts pressure on financial spreads, already substantially narrowed by the risk-assets structure.
- 1.37 **Equity position and portfolio cleanup.** As with the entire financial system, the crisis that began in 1994 took its toll on NAFIN's credit assets, especially its

portfolio with the NBFIs. The portfolio of overdue second-tier loans went from approximately 2.6% in 1993 to 4.7% in 1994 and 21.2% in 1995, but went down thereafter thanks to a portfolio recovery and cleanup program. By late 1999, the overdue second-tier portfolio was at 4.8%. Starting in 1997, a reduction in the overdue portfolio was coupled with an aggressive program of establishing allowances to cover bad debts. Those allowances have been anywhere from 12% to 30% higher than the delinquent portfolio.

- 1.38 The rapid deterioration in the quality of the loan assets that began in 1994 caused a significant decline in the institution's equity. In real terms, equity went from US\$1.56 billion in 1993 to US\$1.07 billion in 1995, which lowered its simple capital ratio² to 2.52%. The capital ratio weighted for the asset risk dropped from some 15.5% to 10.3% in the period, but still held above the 10% ratio established by the Secretariat of the Treasury and Public Credit (SHCP). In late 1999, NAFIN's capital ratio was 22.35%. (Table I-3).

Table I-3
NAFIN – Portfolio Quality and Capital - 1993 to 1999
(in %)

Ratio/Year	1993	1994	1995	1996	1997	1998	1999
Capitalization ¹	n.a.	15.5	10.3	13.9	18.0	15.0	22.6
Overdue portfolio ²	2.7	4.7	21.2	6.1	12.9	10.1	4.8
Allowance for losses ³	n.a.	n.a.	n.a.	n.a.	126.5	118.8	129.2

1 Net capital/risk assets

2 Overdue portfolio/total portfolio

3 Allowances/overdue portfolio

n.a. = not available

- 1.39 To build up its capital, in December 1996 NAFIN and the SHCP concluded a financial restructuring agreement that enabled the former to write off some US\$2.74 billion of its bad debt portfolio and replace it with a loan from the GOM-guaranteed auxiliary lending institutions settlement fund (Fideicomiso de Liquidación de Instituciones Auxiliares de Crédito – FIDELIQ). With that the risk-weighted capital ratio rose to 13.9% by the end of 1996, even though the absolute value of NAFIN's equity did not increase. The latter was barely 50% of its 1993 real value. In 1999, NAFIN undertook another portfolio cleanup of some US\$149 million, mainly involving its lending activities with the NBFIs, liquidating the portfolio at a 75% discount. The operation generated a modest equity gain and raised the institution's risk-weighted capital ratio to 22.35%. The view is that with

² Equity/total assets.

the 1999 reorganization, NAFIN has completed its post-crisis portfolio cleanup. Also, the high ratio of reserves to cover loan losses leaves a significant margin for the stability of its equity position.

- 1.40 **Performance.** With the change in the composition of risk assets and the decrease in the portfolio of interest-bearing loans, NAFIN was less able to generate earnings. The financial spread on the lending transactions, which had risen to 6.1% in 1993, fell off in the post-crisis years to less than 1% and then went negative at -1.6% in 1998. The figures for 1999 indicate a performance recovery with a slightly positive financial spread. As a result of the institutional restructuring, current and operating expenses dropped 21% in real terms between 1993 and 1999. In 1999, these costs totaled US\$160 million, which was some 0.9% of the mean portfolio of loans.
- 1.41 Expenditures and a narrow financial spread have meant operating losses in NAFIN's lending business since 1993. But in all those years, those losses were offset by the positive net earnings from NAFIN's investments. Because of this, the institution was able to put in a positive performance; for 1999 NAFIN is reporting earnings before taxes of some US\$16 million. The net profit for the year is US\$5.1 million, which is a return on assets and capital of 0.02% and 0.70%, respectively.
- 1.42 **Outlook.** NAFIN's financial analysis indicates that having endured the aftermath of the 1994 financial crisis, the institution is now stronger and more solvent and is gradually increasing its rate of return, as is apparent from the 1999 performance. Nevertheless, the analysis also shows that to better sustain its financial position, NAFIN has to increase the operating margin on its lending activities by increasing the financial spread and operating efficiency. The financial spread would be raised mainly by increasing the volume of second-tier lending, especially with the most profitable segments and products, and to a lesser extent by reducing the cost of liabilities, since the institution is presently pricing its assets at market levels. Current and operating expenditures, although down dramatically from previous years, are still somewhat high for a second-tier bank.
- 1.43 NAFIN's financial projections for the period from 2000 to 2003 underscore how important it is to increase the volume of second-tier loans and improve operating efficiency to strengthen the institution's financial structure. With a real increase in second tier loans of 5.67% per annum and a better financial intermediation costs structure, NAFIN is forecasting real annual average growth in the financial spread of 22.1% up to the year 2003; allowances to cover portfolio losses will be kept at their present levels. In that same period, current and operating expenditures are expected to go down by approximately 3.2%, which will mean a gradual decline in the institution's operating deficit and yield positive net profits. The return on capital is expected to increase from 1.27% in the year 2001 to 2.61% in the year 2003.

F. Past experiences and lessons learned from the 911/OC-ME program

- 1.44 In November 1995 the Bank approved loan 911/OC-ME for NAFIN, in the amount of US\$250 million. The purpose was to finance a program that targeted small- and medium-sized enterprise. The program's total cost was an estimated US\$750 million and the Bank's resources were combined with contributions from NAFIN and Japan's EXIMBANK, each in the amount of US\$250 million. By late March 2000, approximately 79% of the financing had been disbursed. Pending disbursement were the roughly US\$50.0 million remaining from the Bank loan, US\$5.0 million from NAFIN's contribution and US\$104 million from EXIMBANK.
- 1.45 The 911/OC-ME program has three components: (a) a loan for modernizing private financial institutions; (b) technical assistance for the corporate strengthening of NAFIN; and (c) multisector credit. While the loan was approved in November 1995, it was not until April 1997 that it was declared eligible for disbursement, due in part to the financial system's condition. To facilitate program execution and adjust it to the financial sector's needs in the wake of the crisis, at NAFIN's request the Bank approved amendments to the loan contract and credit regulations on two occasions. The principal changes were: i) the transfer of US\$90 million of the US\$100 million earmarked for the modernization component to the multisector credit component, because demand from the IFIs was weak; ii) disqualification of any businesses with access to long-term capital markets; iii) a change to allow loan applications for debt restructuring, something that had already been considered when the operation was presented to the Bank's Board of Executive Directors for consideration; iv) modification of the system for IFI eligibility; and v) inclusion of EXIMBANK funds in the program. The program's environmental requirements were also tightened
- 1.46 An evaluation of the 911/OC-ME program teaches lessons similar to those learned from other operations of this type, which have informed the design of the present operation. Salient among these is how important it is to have a design that allows for the maximum possible flexibility, transparency and agility in the allocation of resources to the financial intermediaries, to keep financial intermediation competitive. This requires, *inter alia*, a design that facilitates funding of new products, that streamlines the procedures involved in resource allocation, that emphasizes ex post evaluations on required ex ante documentation, and that establishes efficient feedback mechanisms with the intermediaries as to the procedures used. Secondly, it underscores how important it is that the eligibility criteria used for the participating financial intermediaries ensure that the resources go to the best institutions in the system. Also, an important element in the design of multisector operations, both from the standpoint of pricing resources and tailoring them over time, are mechanisms to set the second-tier interest rate. These lessons learned from the 911/OC-ME program have been built into this operation's design.

1. The multisector credit component

- 1.47 The multisector credit component in the 911/OC-ME program was designed to support NAFIN's global second-tier lending program, by helping to finance all the institution's various loan products. The result was that the operation's design did not place a premium on separate systems developed to manage and track the program's portfolio, systems apart from those used for NAFIN's other activities. This meant that there was less program-specific data available on some aspects of the portfolio being financed. As of March 2000, borrowings from the multisector credit component totaled US\$558 million; the sum of US\$154 million has as yet not been disbursed. Borrowings transacted with program resources were in Mexican pesos and United States dollars, on variable- and fixed-rate loans.
- 1.48 Program 911/OC-ME stipulated that the resources could be used to finance business activities in all the various sectors and that the working-capital and fixed-assets loans would be eligible. Loans could also be requested for debt restructuring. As of late 1999, the component had financed 3268 loans made to 2772 businesses, involving a total of US\$558.2 million. A breakdown by economic sector shows that 70.5% of the businesses to which loans were made were in the industrial sector, which absorbed 81.3% of the financing. In terms of use of funds, the number of loans for working capital and those for fixed assets was virtually the same. Although the loans made for debt restructuring were far fewer in number, they still accounted for 50% of the resources. The loan per business averaged US\$201 thousand; the average for the industrial sector was US\$232 thousand. The overall average loan under the program was US\$171 thousand (Table I-4).

Table I-4
Loans under Program 911/OC-ME
(in US\$ thousands)

	Loans	Businesses	US\$	Average
Fixed assets	1,573		158,559	100.8
Working capital	1,601		123,525	77.1
Debt restructuring	93		276,106	2,968.9
Total	3,267		558,191	170.9
Commerce		276	20,113	72.9
Industry		1,954	453,988	232.3
Services		542	84,089	155.1
Total		2,772	558,191	201.4

- 1.49 As with NAFIN's other lending resources, the bulk of the component's resources were placed through a BFI. An analysis of NAFIN's second-tier disbursements since 1996 shows that almost 80.5% went through banks, while the remainder were placed through NBFIs. Prominent here are the borrowings transacted with factoring

businesses. Borrowings transacted with credit unions represent only 3.4% of the total loan. Between 1997 and 1999, the program's resources were assigned to a total of 27 banks, thereby increasing the number of active borrowers from 8 institutions in 1997 to 23 in 1999. The increase in the number of borrowing banks meant that the lending was not so concentrated as it had been in the past. While in 1997 the four most active institutions absorbed 97.6% of the resources, by 1999 that figure had dropped to 62.9% (Table I-5).

Table I-5
Principal BFIs' participation in the program 911/OC-ME, 1997 to 1999
(in % of loans)

1997		1998		1999		Total	
BFI	%	BFI	%	BFI	%	BFI	%
Serfin	49.0	Banrural	39.1	Banrural	18.4	Banrural	23.4
Bancrecer	25.7	Confia	13.4	Confia	17.4	Serfin	14.3
Bancomer	12.6	Bitel	10.8	Banorte	15.8	Confia	11.2
Quadrup	10.3	Banorte	7.6	Banamex	11.3	Bancomer	9.2
Total	97.6		70.9		62.9		58.1

2. Pricing and lending of funds

- 1.50 NAFIN places its second tier resources in both pesos and United States dollars in various forms, which differ in terms of the pricing system and lending mechanism used. Loans in pesos are offered at variable and fixed rates, through "rediscounting" mechanisms, while loans in United States dollars are offered only at variable rates, through auctions and discounts. The pricing of NAFIN's resources, regardless of modality, is based on the premise that the funds will be loaned at market terms and conditions, to avoid crowding out domestic lenders and to ensure that the institution's costs are covered. In national currency, the reference rate for the pricing is the interbank equilibrium interest rate (IEIR). As of March 2000, NAFIN's financial intermediation was between IEIR - 0.5 (variable rate) and IEIR + 0.9 (fixed rate), while the interest rates on the loans ranged from IEIR + 3 for variable-rate loans and IEIR + 5 for fixed-rate loans, depending on who the intermediary institution is and the lifetime of the loan. This compares, for example, with a three-year commercial loan from a premier national bank with a coupon of 15.10%, roughly the IEIR as of that date.
- 1.51 The pricing of the resources in American dollars is done by a public auction of funds among the intermediaries participating in the program, thereby allowing the dollar funds to be loaned at market terms and conditions (Table I-6).

Table I-6
Pricing and Types of Loans
(March 2000)

	Pesos		Dollars	
	Base cost	Borrowing	Base cost	Borrowing
Fixed rate	Financial intermediation + spread	IEIR + 2.25 – IEIR + 5		
Variable rate	IEIR - 0.5	IEIR – IEIR + 3	Financial intermediation + spread	Auction
Discount		Yes		Yes
Auction				Yes

3. The auction mechanism

- 1.52 NAFIN has been using an auction mechanism to price and place dollar loans since 1996. A considerable percentage of the resources from program 911/OC-ME were placed via this method. The auction has been designed as a “discriminatory price auction”, where the competitive bidding is by amortization period. Generally, NAFIN has auctioned off resources on a monthly basis and is averaging bids from four banks. Given their transparency, auctions have as a rule proven to be an efficient means to generate market signals and assign resources. Until April 2000, approximately 33% of the demand was placed at an average rate of Libor (3m) + 3.18, thereby yielding a mean spread of 43 basis points over the floor rate set by NAFIN. That rate is figured on the basis of the financial intermediation cost of the resources and the cost coverage spread and is reviewed monthly.
- 1.53 Despite the auction’s positive results overall, experience indicates that the mechanics need to be fine-tuned to avoid distortions caused by “adverse selection”. This means establishing and enforcing stringent criteria for the intermediaries to qualify to participate in the auctions.³ Risk exposure limits will have to be set for each intermediary, based on asset leveraging. NAFIN has made headway on both these fronts and the proposed program’s method of operation will factor in previous experience. The program will also help NAFIN evaluate the possibility of introducing additional changes in the auction system to make a distinction for intermediaries’ risk ratings (see paragraph 2.3 (a) (iv)).

³ The major participant in the auctions, especially in 1997 and 1998, was Banco Serfin, which had its own crisis and was intervened. However, as of September 1999, Moody’s long-term credit rating for that bank was “Ba1”, the same rating the Banamex, Bancomer and Santander banks have.

G. The strategy of the country and of the Bank

1. NAFIN's role and the operation's justification

- 1.54 NAFIN has the potential to play a significant role in getting the lending business back on track in Mexico. Piping resources into the financial sector via NAFIN is particularly important in the case of the MSME, a sector that the GOM is very interested in developing because of its share in the GDP and the jobs it creates for large sectors of the population. NAFIN's lending will be most important in the next two years, when a slow but sustained recovery in the banking business is expected. Against this backdrop, the funds from the program will hasten access to resources for an important segment of the economy, which will find it easier to take advantage of the opportunities that economic growth will bring.
- 1.55 NAFIN's experience with the MSME and its understanding of the products needed to serve that sector make it the best intermediary through which to pipe the resources from the proposed operation. The program will exploit NAFIN's role as a catalyst in the growth of the financial market; in other words, its reputation and capacity to build partnerships with financial intermediaries, leveraging this by supplying stable, long-term financing. This would be a considerable inducement to financial intermediaries to increase their lending to the MSME. Estimates are that some 3,900 businesses would benefit.
- 1.56 The operation will support NAFIN just as its financial restructuring is coming to completion. With its strategic plan, the institution is introducing in-depth institutional reform that will make it a more efficient provider of second-tier financial services. The proposed operation will enable NAFIN to consolidate and expand financial services to MSME, and will induce it to devote more and more attention to the smaller businesses within this sector.

2. The Bank's strategy for the private sector

- 1.57 The Bank's strategy for the sector matches that of Mexico, which is why the present operation was included in the country paper that the Bank's Programming Committee approved last October. Support to the private sector is a priority in the Bank's strategy for Mexico, the main thrusts being: (i) modernization of the legal and regulatory frameworks; (ii) financing of private investment projects; (iii) financing of public projects associated with private investment, and (iv) financing and support of micro-, small-, and medium-sized enterprise.⁴

⁴ GN-2045-1. Country Paper, May 1999.

3. The Bank's strategy for the financial sector

- 1.58 The Bank's strategy for the financial sector has focused on providing the government with support for reform and modernization of Mexico's system of public development banks. The Bank has funded modernization programs at NAFIN and Banobras (two of the more important development banks) and has kept up an ongoing dialogue with authorities concerning the future role of development banking institutions as tools of government economic policy.
- 1.59 In recent months, Mexico's financial authorities introduced basic reforms in the banking system's legal and institutional framework. Those changes include reformulation of the State's protection of bank depositors and other creditors (bank savings protection act, already enacted), and standards regulating bankruptcy and securitization. These and other changes, in particular the standards recently put into place to govern bank capitalization, portfolio classification and loan allowances, are essential to ensuring the banking system's viability in the medium-term, and mark a fundamental shift in government policy vis-à-vis the sector. The policy shift is intended to create a legal and institutional framework conducive to finding a solution that goes to the core of the banking system's problem. It also opens up new prospects for the Bank's participation in this sector, in which there are currently two other operations in the pipeline for the financial sector: one with the bank savings protection institute [Instituto de Protección del Ahorro Bancario] (IPAB) (ME-0227) to assist with the reforms being made in the financial sector, and another to support the housing sector through the mortgage bank operating and financing fund [Fondo de Operación y Financiamiento Bancario de la Vivienda] (FOVI) (ME-0137).
- 1.60 The present operation gives the Bank's strategy continuity in that it helps deepen the services that the financial sector provides to micro-, small- and medium-sized enterprise, and further strengthens NAFIN as a second-tier bank.

II. OBJECTIVE AND DESCRIPTION OF THE PROGRAM

A. Objective

- 2.1 The program's objective is to assist in the growth of micro-, small- and medium-sized enterprise (MSME) by increasing the supply of credit services geared to this sector's needs. To accomplish its objective the program will make resources available to NAFIN to finance loans that financial intermediaries will make to MSME. It will also provide funds with which to develop specialized lending technologies to serve this sector efficiently. The proposed program has two components.

B. Description of the program

- 2.2 **Multisector credit component (US\$586.75 million).** This component will provide resources to expand NAFIN's roll-over programs for loans that eligible financial intermediaries make to MSMEs. With this component, medium- and long-term resources will be piped in via auction and rediscount programs; short-term lending, albeit on a more limited scale, will be piped in through the credit services providers program.⁵ For the latter program, a maximum of US\$100 million equivalent will be assigned under the program, which may be adjusted in the credit regulations. Estimates are that the program will finance loans to some 3,900 businesses.
- 2.3 The component is to be carried out in accordance with the program's credit regulations. The resources will go toward NAFIN's second-tier operations with formal, supervised financial intermediaries that meet the program's eligibility requirements. The subloans will go to businesses classified as micro-, small or medium-sized establishments in urban and rural industry, commerce or services. The intermediaries will undertake the full credit risk on loans to the MSME, and are free to establish the terms and conditions of those subloans. **Technical assistance component (US\$8 million).** This component's specific objective is to enhance the institutional capability of the financial intermediaries and of NAFIN to serve the MSME and to make the products they offer more competitive. This component has three subcomponents: (1) technology transfer and competitiveness; (2) strengthening of specialized credit services providers and development of new pipelines, (3) improvement of MSMEs' competitiveness.
- a. The **technology transfer component** is mainly intended to build up NAFIN's capacity to provide financial products and the financial entities' capacity to broker these products. This will be done by upgrading systems and procedures, and through staff training. In addition, this area will cover activities aimed at

⁵ The program will only finance the lending of resources through financial institutions, mainly in the form of factoring services.

devising new products and developing new markets, and NAFIN institution-building. Among the specific activities to be funded are: (i) development of parametric loan analysis systems; (ii) automation of discounting procedures; (iii) staff training and instruction in "best practices"; and (iv) improvement of the operating and control procedures. This subcomponent will cost an estimated US\$5.5 million.

- b. With the subcomponent for **strengthening specialized credit services providers** and developing new pipelines, the program will help design and implement measures to develop new, formal credit services providers, especially for microenterprise. Market and legal studies will be conducted and business plans mapped out. The program will also help put those credit services providers in business. The cost of this subcomponent is estimated at US\$0.5 million.
- c. The subcomponent for **improvement of MSME competitiveness** will finance studies of the nonfinancial services market and of the design of mechanisms to energize the market, as well as expansion of regional pilot projects in the development of credit services providers and business networking. With this subcomponent the program will also help with the design and introduction of measures to publicize international industrial standards and norms, as well as ISO rules. The cost of this subcomponent is estimated at US\$2 million.

C. Scale of the program

- 2.4 The scale of the program was based on the figures on past NAFIN lending programs that the Bank declared eligible under the earlier program, and on an estimate of the additional resources required for loans to MSME, according to NAFIN's financial projections for the period 2001-2002. This contrasts with a projected gross credit demand for the sector in excess of US\$24 billion for the same period. The figure of US\$8 million as the cost of the technical assistance program is based on the projected costs of the technical assistance planned.

D. Cost and financing

- 2.5 Of the program's estimated US\$600.0 million cost, US\$300.0 million will come from the Bank's dollar window, while the remaining US\$300.0 will be the local contribution. The cost of the multisector credit component will be US\$586.75 million, and the cost of the technical assistance component US\$8 million. The full amount of the Bank's financing resources will go toward the multisector credit component.

Table II-1
Cost of the Program
(in US\$ millions)

	Bank	NAFIN	Total	%
Multisector credit component	297.00	289.75	586.75	97.8
Technical assistance component		8.0	8.0	1.3
Inspection and supervision	3.0		3.0	0.5
Credit fee		2.25	2.25	0.375
Total	300.00	300.0	600.0	100.0

- 2.6 NAFIN will undertake the exchange risk of the operation, covering it by means of its daily treasury operations, in accordance with what the Bank of Mexico has determined in this regard. An evaluation of the *Foreign Currency Exposure* of the 1998 and 1999 balance sheets shows virtual equilibrium, with a deficit of 259 thousand pesos and 519 thousand pesos, respectively, the equivalent of 0.1% and 0.3% of the foreign currency positions in those two years. Moreover, NAFIN and the SHCP are now studying the idea of creating a reserve to cover any exchange risks involved in the NAFIN operation.

III. PROGRAM EXECUTION

A. Executing agency and life of project

- 3.1 The program's borrower and executor will be Nacional Financiera S.N.C. (NAFIN), which will have the guarantee of the United Mexican States. Its execution will be in the hands of various line units designated by NAFIN, which will also appoint a management executive as the project's general coordinator. This coordinator and the NAFIN line units in charge of executing the program's components and specific activities will be assisted by specialized consultants. NAFIN will contract these specialized consultants in coordination with the Bank and according to the technical support it requires. Program resources will be used to hire these consultants.
- 3.2 Inasmuch as this operation is perceived as assistance to NAFIN during a transition period, the program will be carried out over a period of twenty-four (24) months.

B. Credit regulations

- 3.3 The credit component will be carried out according to the provisions of the program's credit regulations, the general agreements and loan contracts that NAFIN will conclude with each intermediary. Evidence from NAFIN that the aforementioned documents have entered into effect will be a condition precedent to the first disbursement of the Bank's financing.

1. Eligibility criteria

- 3.4 Any formal, supervised private intermediary financial institution (IFIs) duly established to engage in financial activities in the United Mexican States and meeting the eligibility requirements stipulated in the credit regulations, will be eligible to participate in the program. NAFIN will identify and select those IFIs that qualify to participate in the program, using the most recent information published by the CNBV, the Banco de México, and other pertinent regulatory, control and oversight agencies.
- 3.5 To qualify to participate in the program, an IFI will have to meet the following requirements:
- a. Be subject to CNBV oversight;
 - b. Be in compliance with the regulations, circulars and provisions that the CNBV, the Banco de México, and other pertinent regulatory, control and oversight agencies have established;

- c. Not be subject to any sanction, special oversight, intervention or financial restructuring ordered by the CNBV, the Banco de México or other pertinent regulatory, control and oversight agency;
- d. Have at least a “AA”, “A”, or “BB” rating in the case of the BFIs in accordance with NAFIN’s methodology. Those rated as “B” will be eligible provided that total disbursements to intermediaries of this rating does not exceed 17.5% of program resources. A NBFI rated as “viable” will be subject to NAFIN’s risk evaluation criteria, based on the following considerations:
 - (i) Capital adequacy
 - (ii) Portfolio quality
 - (iii) Liquidity ratio
 - (iv) Management capacity and capacity for credit risk analysis.

2. Subborrowers

- 3.6 The loan recipients under the program will be natural or juristic persons established in the United Mexican States and engaged in production, commerce or services on a scale that qualifies as micro-, small- or medium-sized enterprise (MSME). The following criteria will determine what constitutes a micro-, small-, or medium-sized enterprise, based on the number of permanent salaried employees (Table III-1).

Table III-1
Classification of Businesses by Number of Employees

Sector/Size	Micro	Small	Medium
<i>Industry</i>	30	100	500
<i>Commerce</i>	5	20	100
<i>Services</i>	20	50	100

3. Loan eligibility

- 3.7 The funds from the program will go toward financing MSME loans to finance:
- a. fixed assets
 - b. permanent working capital
 - c. the cost of technical-management services to support investments in fixed assets, including pre-investment and environmental-impact studies

- d. the cost of technical-management services to modernize and streamline a business and make it competitive, including market studies, certification costs and technical and management-related advisory services in connection with an investment in fixed assets.

- 3.8 The subloans funded with program resources may be secured with NAFIN guaranteed funds provided that cash flow is not negative. NAFIN will provide, together with the semiannual progress reports on the program, information on the use of such funds.

4. Terms and conditions of NAFIN loans to the IFIs

- 3.9 The loans that NAFIN transacts with the IFIs using program funds will be done in accordance with the credit regulations, loan contract, NAFIN's general regulations and the existing laws.
- 3.10 Loans funded with program resources may be denominated in either Mexico pesos or United States dollars, provided they comply with the regulations of NAFIN, the CNBV and the Banco de México in this regard. Disbursements and amortization will be in the same currency. NAFIN may lend program resources by either auctioning off the funds or using the rediscount mechanism.
- 3.11 The interest rates on the loans that NAFIN makes to the IFIs with program resources will be determined by the market and must be sufficient to cover the full financial risk and operating costs to the institution. Interest rates on loans in Mexican pesos will be set using the IEIR. The interest rates on dollar loans will be determined by the outcome of the monthly competitive auctions.
- 3.12 Interest rates on loans denominated in Mexican pesos will be reviewed at least once a month. Interest rates on the dollar loans will be reviewed on every auction date. Any change in interest rates will apply to any loans made as of the date on which the change takes effect.
- 3.13 The subloan amortization periods will be a maximum of twelve (12) years. The disbursement and amortization schedules and grace periods will be established when each subloan's terms and conditions are determined.

5. Terms and conditions of the subloans to the MSMEs

- 3.14 IFIs may use program resources to make subloans to MSMEs in all sectors of the economy. IFIs will decide the amount of a subloan, its disbursement features, interest rate and fees, amortization period, frequency of repayment installments and grace periods, based on a credit analysis of the subloan and of the useful life of the project. Loans financed with program resources may be denominated in either Mexican pesos or United States dollars, provided they conform to the rules of

NAFIN, the CNBV, and the Banco de México in this regard. Disbursements and the respective amortization payments will be in the same currency.

- 3.15 NAFIN shall ensure that the average amount of a subloan does not exceed the equivalent of US\$150,000 and that the program covers at least 3,900 businesses.
- 3.16 The average term of a subloan to an MSME shall be twenty-four (24) months, with the exception of those granted under the supplier credit program.
- 3.17 IFIs will be solely responsible for monitoring recovery of subloans made with program resources.
- 3.18 The sub-borrowers will be responsible for all taxes, fees or charges currently or eventually required under Mexican law.

6. Environment

- 3.19 An MSME must be in compliance with the country's environmental laws in order to receive a loan made with program resources. Before any subloan for a project considered to have adverse environmental effects by the standards of the national environmental classification system can be disbursed, NAFIN or the IFI must have copies of all necessary documentation from the country's environmental authorities certifying that the respective business is in compliance, and will keep that documentation in the subloan's files. Before a loan can be disbursed to the IFI for a project that national environmental authorities classify as a "high risk" activity, NAFIN or the IFI must have a copy of all authorizations and evaluations done to check for compliance with environmental rules.

C. Technical assistance component

- 3.20 Execution of this component will conform to a specific Operating Regulations and plans to be agreed upon with the Bank as a condition precedent to the first disbursement from the component. To monitor and evaluate the results of the activities planned for this component and to share experiences, NAFIN will set up mechanisms for regular exchanges and consultations, with the participation of NAFIN line units involved in the activities, other institutions in the MSME sector, and the Bank.

D. Revolving Fund

- 3.21 The Bank normally allows the borrower to request up to 5% of the financing under a revolving fund. However, the borrower is requesting that the revolving fund be increased to 10% for this operation to make program lending more efficient, especially under the auction mechanism. The same percentage was requested for loan 911/OC-ME.

E. Environmental considerations

- 3.22 The program will help mitigate any negative environmental consequences that might ensue as a result of the loans to the MSMEs. Therefore, any MSME that receives a loan made with program resources will have to have the appropriate environmental certifications, issued by the proper national authorities. This might include any environmental permits and licenses needed to establish and operate the business being financed, such as: an *Environmental License*; *Operating License*; *Single Environmental License*; *Annual Operation Card*, and others. The credit regulations charge the NAFIN and the IFIs with overseeing compliance with the program's environmental provisions. The IFIs will factor the environmental risks into their credit analyses and circulate instructive materials on the subject to their technical staff and the MSMEs in the program.
- 3.23 Under the 911/OC-ME program, NAFIN conducted various activities intended to build up its institutional expertise in environmental matters and to disseminate information and educate the IFIs and the MSMEs. NAFIN has also concluded cooperation agreements to assist the strategies of the combined industrial regulation and environmental management system (Sistema Integrado de Regulación y Gestión Ambiental de la Industria – SIRG) of SEMARNAP, to reduce investment risks and the costs to the subloans of compliance with environmental rules and regulations.
- 3.24 While the program is in progress, NAFIN is to present an annual environmental evaluation of the loans made, based on the national authorities' classification systems and a representative sample of the subloans. Prior to the first disbursement from the Bank loan, NAFIN is to inform the Bank of the mechanisms that will be used to introduce the environmental factors required in the credit regulations.

F. Use of the program's recoveries

- 3.25 Under the terms of the loan contract for the present program and its credit regulations, recoveries of loans made to the IFIs that exceed the amounts needed to meet the borrower's obligations vis-à-vis the Bank may only be used to make new loans to the IFIs. Five years after the final disbursement of program resources the Bank and the borrower may agree upon an alternative use for the program's recoveries, provided that use is within the general purpose that the program's financing is intended to serve.

G. Inspection of the program

- 3.26 The borrower will be required to permit the Bank at any time to examine the status of the program and review such records and documents as the latter may deem necessary. The borrower will lend its full cooperation to this activity. The Bank's Country Office in Mexico will handle all matters involved in monitoring the program's execution.

- 3.27 The borrower shall submit the financial statements of the program and those of the executing agency, duly audited by an independent firm of chartered accountants, acceptable to the Bank, each year for the duration of the program.

H. Monitoring and evaluation

- 3.28 During execution, the Bank will track the program's progress and determine its impact in terms of increasing MSME access to financial services. When 50% of program resources have been committed, a review of the multisector credit component in order to determine whether subloans have been issued to at least 1,950 businesses. If the target has not been fulfilled, the borrower and the Bank will agree on the necessary adjustment measures.
- 3.29 In the semiannual reports that NAFIN will present to the Bank during program execution, the following indicators will be monitored: (i) the number of businesses served and loans awarded; (ii) the size of the beneficiary businesses and their distribution by sector; (iii) the breakdown of the loans by amount and the average amount; (iv) the loan repayment periods; and (v) the number of IFIs participating in the program. To keep track of the program, NAFIN and the participating financial intermediaries will keep records that identify the loans and subloans made with program resources. The ex post evaluation provided for in the program will evaluate fulfillment of the program objectives.

Table III-2
Program's Performance Indicators

Indicators	Program	Loan 911/OC-ME
Businesses served (#)	3,900	2,772
Loans placed (#)	5,250	3,267
Average loan size (US\$)	150	171
Average term (months)	24	n.a
Distribution by sector (%) ¹		
*Industry	70	70.5
*Commerce	10	10.0
*Services	20	19.5
Distribution by size (%) ¹		
*Micro	30	n.a
*Small	40	n.a
*Medium	30	n.a
Distribution by use (%) ¹		
Fixed assets	75	28.4
Working capital	25	22.1

¹ Distribution by resources loaned

IV. VIABILITY AND RISKS

A. Viability

- 4.1 The proposed program is part of the Bank's support of the Mexican authorities' efforts to achieve sustained economic growth and expand financial services to all sectors of the country's economy. Mexican authorities have taken a number of measures to strengthen the legal framework of credit markets, which will give the banking community a more positive impression of the risk involved in lending; the macroeconomic strengthening could increase the demand from the business sector. This would create a process of sustained credit expansion that would also include the MSME sector.
- 4.2 The institutional reforms to NAFIN, especially the strengthening of its capacity to analyze and manage risks and loan processing, its more efficient operations and stabilization of its financial situation, have improved the institution's operating capacity and leave it well positioned to carry out the proposed operation. This strengthening is coupled with NAFIN's experience with multisector credit operations and development of new product lines. As for the new products component, NAFIN has already started to launch pilot projects like those proposed in the new program. These programs will be backed up by studies done on a broader scale that will enable NAFIN to launch pilot activities that are broader than those it is currently conducting.

B. Risks

- 4.3 **The macroeconomic environment and financial system.** The program's success will depend in large part on sustained macroeconomic stability, with fiscal and monetary policies conducive to growth and increasing credit to the private sector. The structural reforms instituted in the financial system must move forward in order to ensure that the system recovers and functions normally. The government is determined to pursue the reforms and to maintain monetary and fiscal discipline, which will minimize the risk that both factors pose.
- 4.4 **Operating risk.** NAFIN has made significant headway with its reforms and corporate strengthening, especially in the improvements it has made to upgrade its capacity to analyze and manage risk assets. Maintaining the caliber of this expertise is essential in order to be able to successfully expand lending without jeopardizing the institution's financial position. This risk is mitigated by the continual automation of the risk-analysis process and by the introduction of specific eligibility criteria for the present program.
- 4.5 **Timing of the operation.** The proximity of the Mexican elections and the possibility that the administration might change might be construed as negatives for

this operation. However, inasmuch as NAFIN's activities under this program are among those that institutions of this kind routinely provide to the private sector, the outcome of the political process is not expected to change those services. Furthermore, the election process does not appear to have had any adverse effect on NAFIN's lending in the first quarter of 2000.

C. Benefits

- 4.6 The present operation will benefit the target population in a variety of ways, the principal one being that micro-, small- and medium-sized enterprise will have greater access to financial services, which will in turn help create jobs for the Mexican public. The eligibility criteria for participation in the program will be sufficiently stringent to upgrade the quality of the intermediaries participating in NAFIN's lending programs. The program will also be instrumental in getting NAFIN's restructuring process fully implemented, which will give the institution the operating efficiency that the reforms were intended to achieve. The program's technical assistance component will further the development and introduction of new products. With that, NAFIN will make a more active contribution toward deepening Mexico's financial market.

**MULTISECTOR GLOBAL CREDIT PROGRAM
ME-0117**

LOGICAL FRAMEWORK

Narrative summary	Objectively verifiable indicators	Means of verification	Assumptions
Development of micro-, small-, and medium-sized enterprise (MSME)	<ol style="list-style-type: none"> 1. An increase in small enterprise's share of the GDP 2. An increase in investment and employment as a percentage of GDP 	<p>Statistics from NAFIN and the Banco de México</p> <p>Information from NAFIN, from the Banco de México and from the CNBV</p>	<p>Sustained macroeconomic stability</p> <p>Normal functioning of the financial system</p>
Medium- and long-term credit for MSMEs, by way of NAFIN, to meet investment needs and working capital needs of 3,900 MSMEs.	<ol style="list-style-type: none"> 1. Number of MSMEs benefited 2. Working capital and investment financed. 	Credit-related statistics from the Banco de México, the CNBV and NAFIN.	An increase in IFIs' demand for credit
Long-term credit for MSMEs	<p>For Component a)</p> <ol style="list-style-type: none"> 1. 3,900 businesses (#) 2. 5,250 subloans (#) 3. Average loan placed, 150 4. Average loan term (months) 24 5. Distribution by sector (%) <ul style="list-style-type: none"> Industry 70 Commerce 10 Services 20 6. Distribution by size (%) <ul style="list-style-type: none"> Micro 30 Small 40 Medium 30 7. Distribution by use (%) <ul style="list-style-type: none"> Fixed assets Working capital by size and economic sector of business 	a. Six-month program progress reports	a. Selection of IFIs to avail themselves of NAFIN's resources

Component: Narrative summary	Objectively verifiable indicators	Means of verification	Assumptions
	8. Number and type of participating IFIs		
<p>assistance component</p> <p><i>Technology transfer and competitiveness</i></p> <p><i>Strengthening of specialized services providers</i></p> <p><i>Strengthening competitiveness of MSMEs</i></p> <p>Market studies</p> <p>Introduction of mechanisms to formalize market</p> <p>Introduction of regional pilot projects</p>	<p>For Component b)</p> <p>(i) <i>Technology transfer and competitiveness</i></p> <p>Number of procedures and systems changed and staff trained by NAFIN and IFIs to develop their products.</p> <p>(ii) <i>Strengthening of specialized credit providers</i></p> <p>Number of new providers formalized</p> <p>(iii) <i>Strengthening Competitiveness of MSMEs</i></p> <p>Number of businesses benefited</p> <p>Number of regional pilot projects developed</p>	<p>b. Six-month program progress reports</p>	<p>b. Proper functioning of NAFIN product development unit.</p>
<p>Introduction of auction mechanism to place</p> <p>Introduction of discount mechanism to</p> <p>Introduction of discount mechanism to place</p>	<p>Component a)</p> <ul style="list-style-type: none"> - Number of auctions - Number of direct discount and rediscount operations 	<p>Component a)</p> <ul style="list-style-type: none"> - Six-month progress reports on the program 	<ul style="list-style-type: none"> - Proper upkeep of NAFIN's and risk areas - Observance of the credit and regulations - Introduction of the proper environmental requirements
<p><i>Technology transfer and competitiveness</i></p> <p>Introduction of parametric loan systems</p> <p>Introduction of discount procedures</p> <p>Training of personnel and introduction of "best practices"</p> <p><i>Strengthening of specialized credit</i></p>	<p>Component b)</p> <ul style="list-style-type: none"> - Number of systems developed - Number of IFIs benefited - Number of staff trained 	<p>Component b)</p> <ul style="list-style-type: none"> - Six month progress reports on the program 	

Narrative summary	Objectively verifiable indicators	Means of verification	Assumptions
<p>udies</p> <p>yses</p> <p>business plans</p> <p>ormalization of credit providers</p> <p><i>MSMEs' competitiveness</i></p> <p>plementation of measures to onal norms and standards</p> <p>the IFIs' observance of the standards established by competent agencies</p> <p>l audits</p>	<ul style="list-style-type: none"> - Number and type of market studies - Number of credit services providers formalized - Number of regional pilot projects developed - Number of market studies - Number of businesses that comply with this provision <p>Number of environmental licenses presented by the businesses participating in the program</p> <ul style="list-style-type: none"> - Number of environmental audits conducted 	<p>Six-month progress reports</p> <p>Six-month progress reports</p>	

RGII-ME147P
ME-0117
Original: Spanish

PROPOSED RESOLUTION

MEXICO. LOAN No. ____/OC-ME TO NACIONAL FINANCIERA, S.N.C.

Global Multisectoral Credit Program

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with Nacional Financiera, S.N.C., as Borrower, and the Estados Unidos Mexicanos, as Guarantor, for the purpose of granting the former a financing to cooperate in the execution of a Global Multisectoral Credit Program. Such financing will be for the amount of up to US\$300,000,000, from the resources of the U.S. Dollar Window of the ordinary capital of the Bank, and will be subject to the "Financial Terms and Conditions" and the "Special Contractual Conditions" of the Executive Summary of the Loan Proposal.