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BRAZIL

BNDES: CCLIP LINE AND PROGRAM TO SUPPORT MICRO, SMALL, AND MEDIUM-SIZED ENTERPRISES

(BR-0358)

LOAN PROPOSAL

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CONTENTS

Electronic References	
Basic socioeconomic data	http://www.iadb.org/res/index.cfm?fuseaction=externallinks.countrydata
Active portfolio	http://opsws3.reg.iadb.org/idbdocswebservices/getDocument.aspx?DOCNUM=432584
Information available in the RE1/FI1 files	http://opsws3.reg.iadb.org/idbdocswebservices/getDocument.aspx?DOCNUM=432586
Logical framework / Policy letter	http://opsws3.reg.iadb.org/idbdocswebservices/getDocument.aspx?DOCNUM=432587 http://opsws3.reg.iadb.org/idbdocswebservices/getDocument.aspx?DOCNUM=432588 http://opsws3.reg.iadb.org/idbdocswebservices/getDocument.aspx?DOCNUM=432589
Table of indicators	http://opsws3.reg.iadb.org/idbdocswebservices/getDocument.aspx?DOCNUM=432590

ABBREVIATIONS

BACEN	Banco Central do Brasil [Central Bank of Brazil]
BNDES	Banco Nacional de Desenvolvimento Econômico e Social [National Economic and Social Development Bank]
CCLIP	Conditional Credit Line for Investment Projects
CESI	Committee on Environment and Social Impact
CMN	Conselho Monetário Nacional [National Monetary Council]
CODEFAT	Conselho Deliberativo do Fundo de Amparo ao Trabalhador [Deliberative Council of the Workers' Support Fund]
COF/CBR	IDB Country Office in Brazil
COFIEX	Comissão de Financiamentos Externos [External Financing Commission]
CONAMA	Conselho Nacional de Meio Ambiente [National Environmental Commission]
DEAOI	Departamento de Acompanhamento de Operações Indiretas [Indirect Operations Support Department]
DECAP	Departamento de Captação de Recursos [Borrowings Department]
FAT	Fundo de Amparo ao Trabalhador [Workers' Support Fund]
FGPC	Fundo de Garantia para a Promoção da Competitividade [Guarantee fund for the promotion of competitiveness]
FI1	Finance and Basic Infrastructure Division 1
FINAME	Agência Especial de Financiamento Industrial [Special Industrial Finance Agency]
GDP	Gross domestic product
IBGE	Instituto Brasileiro de Geografia e Estatística [Brazilian Geographical and Statistical Institute]
IFIs	Intermediary financial institutions
IMF	International Monetary Fund
JBIC	Japan Bank for International Cooperation
JEXIMBANK	Export – Import Bank of Japan
LIBOR	London Interbank Offered Rate
MCP	Multisector credit program
MERCOSUR	Southern Common Market (Argentina, Brazil, Paraguay and Uruguay)
MSMEs	Micro, small, and medium-sized enterprises
OC	Ordinary Capital
SEBRAE	Serviço Brazileiro de Apoio às Micro e Pequenas Empresas [Brazilian Support Service for Microenterprises and Small Businesses]
SELIC	Sistema Especial de Liquidação e Custódia [Special Settlement and Custody System]
SFC	Secretaria Federal de Controle [Federal Secretariat for Auditing]
SMEs	Small and medium-sized enterprises
TJLP	Taxa de Juros de Longo Prazo [Long-term interest rate]

PROJECT SUMMARY

BRAZIL

BNDES: CCLIP LINE AND PROGRAM TO SUPPORT MICRO, SMALL, AND MEDIUM-SIZED ENTERPRISES

FINANCIAL TERMS AND CONDITIONS [1]					
Borrower: Banco Nacional de Desenvolvimento Econômico e Social (BNDES)				Amortization period:	20 years
Guarantor: Federative Republic of Brazil				Grace period:	4 years
Executing agency: BNDES				Disbursement:	4 years
SOURCE	%	**Program**	**Line**	Interest rate:	LIBOR (U.S. dollars)
IDB (OC)	50%	US$1 billion	US$3 billion	Inspection and supervision fee:	0%
Local	50%	US$1 billion	US$3 billion		
Other/Cofinancing				Credit fee:	0.25%
TOTAL	**100%**	US$2 billion	US$6 billion	Currency:	Single Currency Facility

PROJECT OUTLINE

Project objective:

To support the development and modernization of micro, small, and medium-sized Brazilian enterprises by providing medium- and long-term financing for investment projects designed to make those firms more competitive.

Special contractual conditions:

Prior to the signature of the CCLIP line agreement and the first individual loan contract, and as a result of regulatory requirements in Brazil, the borrower will present evidence that the Comissão de Financiamentos Externos [External Financing Commission] (COFIEX) has supplemented its recommendation 675 of 22 October 2003 with one authorizing future preparation of the credit line's other two programs. If that second recommendation is not approved, the CCLIP line will not be implemented, and steps would be taken to sign a loan contract equivalent to the amount of the credit line's first program.

Prior to the first disbursement of funds in each of the CCLIP line's programs, the borrower will provide evidence that the Credit Regulations for the operation agreed upon with the Bank are in force.

Subloans disbursed between January 2004 and the date the program is approved by the Board, in the amount of US$250 million from the loan and an equivalent amount from the counterpart contribution, will be recognized.

Exceptions to Bank policy:

The guarantee of the Federative Republic of Brazil will be limited to debt servicing and to the obligation to take the necessary steps for the borrower to fulfill its positive contractual covenants.

The project is in keeping with the country strategy: Yes [X] No [ ]

The project qualifies as: SEQ[ ] PTI [ ] Sector [ ] Geography [ ] % of beneficiaries [ ]

CESI verification date: 8 October 2004

Environmental and social review: N.A.

Procurement: N.A.

[1] The interest rate, credit fee, and inspection and supervision fee mentioned herein are established pursuant to document FN-568-3 Rev. They may be changed by the Board of Executive Directors, taking into account the available background information, as well as the respective Finance Department recommendation. In no case will the credit fee exceed 0.75% or the inspection and supervision fee exceed 1% of the loan amount.*

* In any given six-month period, the inspection and supervision fee will in no case exceed the amount that would result from the application of a charge of 1% of the loan amount, divided by the number of six-month periods included in the original disbursement period.

I. FRAME OF REFERENCE

A. Coverage

1.1 The Bank has successfully conducted four multisector credit programs (MCPs) with the Banco Nacional de Desenvolvimento Econômico e Social [National Economic and Social Development Bank] (BNDES). This program is being conducted under the Conditional Credit Line for Investment Projects (CCLIP), and this project report therefore covers both the credit line and the first of the CCLIP programs.

B. Macroeconomic considerations

1.2 The macroeconomic situation in Brazil over the past 25 years can be divided into three main periods: (i) a period of rapid, highly inequitable growth that lasted through the 1980s, when per capita GDP shrank owing to the presence of severe domestic distortions; (ii) the 1990s, when a structural reform package allowed the country to make major improvements, albeit with some ups and downs, in its basic indicators; and (iii) the early years of the twenty-first century, when, following a period in which the prospects of a change in Administration had a negative impact on macroeconomic variables, the country has since embarked on a path of convergence plotted out by the new Administration's macroeconomic policies. Link 1

C. The financial sector

1. The banking system

1.3 The Brazilian financial system's regulatory structure is headed up by the Conselho Monetário Nacional [National Monetary Council] (CMN), which is composed of the Minister of Finance, the Minister of Planning, Budget, and Management and the Chairman of the central bank, Banco Central do Brasil (BACEN). The central bank regulates and supervises the country's banking system.

1.4 Over the past 25 years, the Brazilian banking system has evolved from a system in which public-sector banking maintained a strong presence, foreign banks played a very minor role, competition was limited, directed lending was used quite extensively, and high inflation rates underpinned intermediation profits, into a system composed of well-capitalized banks and marked by a significant degree of participation by foreign banks, a decline in the presence of public-sector banking, and a shrinking role for directed lending. The system has succeeded in withstanding external shocks and has been an efficient deposit-taker for the public (providing security and purchasing power), has avoided dollarization (and, hence, the loss of various basic functions of the local currency, such as a measure of value, a unit of account, and a medium of exchange) through the use of indexation, and has ensured the availability of means of payment. Link 2

1.5 The system continues to face a number of challenges deriving from structural problems, however. These issues are being addressed by the government and by BACEN, and include the need to lower intermediation costs and boost the economy's credit supply. In the first case, BACEN undertook a series of studies to determine why Brazil's bank spreads have been among the highest in the world so that, once the causes were identified, it could take steps to reduce them.[1] In this respect, the consensus opinion is that, for the last two years, bank spreads can be broken down as follows: liquidity margin, 40%; direct taxes, 21%; indirect taxes and the deposit guarantee fund, 8%; administrative costs, 14%; and the impact of the delinquency rate, 17%. The steps being taken to improve the available supply of information and cut transaction costs include: (i) the creation of a risk center; (ii) the CMN's adoption of measures aimed at streamlining lending operations through the use of bank credit cards [Cédulas de Crédito Bancário] (CCB); (iii) the creation of receivables investment funds [*Fundos de Investimento em Direitos Creditorios*] (FIDC) in order to improve the management of intermediary institutions' portfolio liquidity; and (iv) the CMN's authorization of credit derivative operations. A new bankruptcy law is also in the process of being ratified. In order to heighten competition in the sector, BACEN is also making information about the system public and is requiring intermediaries to disclose specified information about their performance.

2. The existing credit situation

1.6 The volume of credit in the economy needs to be increased because the financial system is not satisfactorily fulfilling its role of financing growth by providing credit to the private sector. In point of fact, credit represented only 26% of the system's total assets in 2003 (with unearmarked credit accounting for only 14.4% of the latter), whereas the volume of portfolio securities in the financial system (chiefly public bonds) and placements on the money market amounted to 37%. The reasons for this have to be analyzed from a variety of vantage points: repayment periods, amounts, interest rate levels, and interest-rate volatility.

1.7 In terms of repayment periods, the system has maintained its short-term deposit profile owing to continued uncertainty about the country's macroeconomic status in the medium term. Consequently, deposit-taking by intermediary financial institutions (IFIs) has chiefly been based on short-term instruments (savings deposits, fixed-term (mostly 30-day) certificates of deposit) and non-interest-bearing sight deposits (checking accounts). Since these savings instruments' maturities are generally less than four months, IFIs find it very difficult to operate with loans having repayment periods of more than one year, since this would make it difficult for them to avoid maturity mismatches that could pose a threat to their liquidity and solvency. For loan portfolios, the systemwide average was

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[1] In 1999 the average spread in the system stood at 62 percentage points (45 points for corporate loans and 98 points for loans to individuals). The situation had changed a great deal by December 2003, when the rates for unearmarked funds averaged 30 points (14.4 for corporate loans and 50.8 for loans to individuals).

approximately 220 days, and the longest-term segment (housing mortgages) had an average term of 1,519 days.

1.8 With respect to the amounts involved, it should be noted that a substantial portion of the system's funding is not readily available, since various targeting mechanisms translate into a reduction in disposable resources. In 2003, mechanisms of this sort included: (i) sight deposits that were blocked in order to satisfy the BACEN's legal reserve requirement (45%) or channeled to the rural sector (14% of the portfolio); and (ii) the *cadernetas de poupança* (passbook savings accounts) for prospective homeowners (7.2% of the portfolio). As a result, readily available funding is scarce and primarily comes from short-term certificates of deposit.

1.9 In the case of interest rates, credit is expensive for three reasons: (i) the system's real base rates have been very high for years now (the SELIC rate—see Link 1—climbed to 26.32% in 2003 as a consequence both of the tight macroeconomic policies designed by the BACEN in an effort to reduce inflation and of the public sector's borrowing requirements); (ii) the directed funding mix is such that the readily available portion of those resources comes primarily from certificates of deposit, which carry rates very close to the SELIC; and (iii) the width of average intermediation spreads. The end result of all this is very high real short-term lending rates. In addition, the marked degree of volatility drives up the level of risk for credit purchasers by raising the possibility of unforeseen increases in financing costs.

1.10 As a consequence of all these factors, commercial banks extend virtually no medium- or long-term loans, since they would entail such high costs that no intermediary would: (i) have a reasonable expectation that profitable ventures could exist at those rates; and (ii) have incentives to generate long-term liabilities in order to fund such dubious assets.[2] This lack of medium- and long-term credit forces smaller firms (those lacking access to capital markets) to rely on self-financing or short-term revolving credit, which increases both the cost of funding and the risk of discontinuity.

3. The strategic role of BNDES

1.11 Under these circumstances, the country has cast BNDES in a strategic role as a source of leverage, since it is now the only significant source of medium- and long-term funding for financial intermediaries. Its key importance is illustrated by the fact that in 2003: (i) the funding it provided represented nearly 3% of GDP; and (ii) its indirect operations with IFIs accounted for 12.21% of the system's total credit supply (through more than 90,000 transactions). Link 3

[2] This situation will be characterized as a structural gap in a later section (paragraphs, 1.18, 1.25, 1.31).

D. The real sector of the economy

1.12 Micro, small, and medium-sized enterprises (MSMEs) predominate in the Brazilian economy,[3] representing 95% of all firms and providing 64% of the jobs in the country. The sector's strength, productivity, growth, and profitability are therefore essential factors for both the economy and employment in Brazil.

1. Microenterprise

1.13 The microenterprise sector is comprised of businesses having 19 or fewer employees and gross sales of US$400,000 equivalent per year or less. The *Serviço Brazileiro de Apoio às Micro e Pequenas Empresas* [Brazilian Support Service for Microenterprises and Small Businesses] (SEBRAE) estimates that there are some 10 million informal microenterprises in existence. Over the past decade, the sector has grown for a number of reasons. Some of the main factors have been the structural reorganization of public enterprises and the civil service (privatizations, voluntary resignation programs, and the end of job stability in the civil service) and staff downsizing in private firms striving to become more competitive, since it is assumed that some of the persons who have been laid off have used their severance pay to set up their own microenterprises. Link 4

1.14 BNDES performs three different functions in this sector: (i) channeling a large portion of indirect loan (onlending) operations to tax-paying microenterprises (the last IDB program (1374/OC-BR) directed the equivalent of US$219 million to such enterprises out of a total of US$900 million); (ii) backstopping informal microenterprises through its Economic Solidarity Departments (lending to microfinance institutions, State development agencies, municipalities, and relevant public and private agencies); and (iii) providing technical assistance, with support from the Bank (under the ATN/SF-5714-BR technical cooperation project), for the development of new products and the institutional strengthening of nongovernmental microfinance organizations.

2. Small and medium-sized enterprises

1.15 The formal small and medium-sized enterprise (SME) sector is composed of firms having between 20 and 499 employees and gross sales of under US$20 million per year. According to the information provided in the *Relaçao Anual de Informaçoes Sociais* [annual record of social information] (RAIS) database, SMEs: (i) accounted for 5% of entrepreneurs and 30.7% of private employment as of 2001; and (ii) their share of GDP and exports is relatively small and is shrinking (they accounted for 28.1% of exports at the end of 1997, but only 24.4% in 2001, although, in terms of value, these exports have remained roughly constant). The problems SMEs are having in obtaining financing need to be addressed because their competitiveness is

[3] MERCOSUR defines micro, small, and medium-sized enterprises as firms whose gross annual sales are equivalent to or less than US$400,000, US$3.5 million, and US$20 million, respectively.

of importance for the entire country, given their role in the modernization of industry, the development of outsourcing, and the reengineering of production processes.

3. Strategy

1.16 The core objective of the Government of Brazil's 2004-2007 Multi-year Plan [Plano Plurianual] (PPA), which has a budget of US$150 billion, is to achieve sustained, socially inclusive growth and promote greater democratization and citizenship. To this end, the plan is broken down into three key "mega" objectives: (i) social inclusion and poverty reduction; (ii) growth of a type that creates jobs, generates income, is environmentally sustainable, and reduces regional inequalities; and (iii) the promotion and expansion of citizenship and the strengthening of democracy. The first two objectives entail the challenge of promoting and strengthening MSMEs by: (a) stimulating cooperativism, the formation of partnerships, and the development of new types of cooperative associations; (b) using the government's purchasing power to strengthen MSMEs; (c) fostering MSME participation in production chains; (d) promoting the formation of MSME associations in order to achieve economies of scale in production and marketing; (e) revamping the tax system to facilitate the creation of microenterprises; (f) providing incentives for microentrepreneurs and small business owners through cooperative associations; (g) making innovative scientific platforms available to MSMEs; (h) promoting policy incentives for the creation of MSMEs that will ensure their formalization and sustainability; (i) providing fiscal, credit, and technological support to MSMEs; and (j) providing a supply of credit and microcredit on suitable terms and conditions.

E. Medium- and long-term financing for MSMEs

1. The problem

1.17 The provision of medium- and long-term financing for productive investment has been a recurring problem in Latin America and the Caribbean. Such financing is all the more problematic for MSMEs, whose financial position is characterized by: (i) a lack of transparency and the existence of information asymmetries that have the effect of blocking direct access to capital markets; (ii) the fact that the only remaining source of financing—the commercial banking system—is reluctant to enter a market segment that typically has high administration costs and a high level of perceived risk owing to high business mortality rates and insufficient guarantees or collateral; and (iii) a financial structure based on self-financing, supplier credit, and a short-term bank component (which usually depends on the firm's size and is therefore virtually nonexistent for microenterprises) at what are often untenable interest rates from the standpoint of these ventures' rates of return.[4] The fact that

[4] For a more comprehensive overview of the conceptual problems involved in MSME financing, see the relevant chapter of the 2004 edition of IPES.

MSMEs are so important in terms of both GDP and employment makes this problem an extremely important one, since, given the frailty of their financial foundations, structural shocks can have devastating impacts on the productive fabric and employment, generate social instability, and make the country less competitive.

1.18 Brazilian MSMEs are adversely affected by this general state of affairs, but in their case the problem is compounded by the existence of a structural gap between their ventures' internal rates of return and lending rates (i.e., the average rate charged for financing in the system plus the IFIs' spreads). The end result is that long-term credit is virtually nonexistent in the marketplace.

2. Strategy

1.19 Given the importance of this problem, the government has adopted an approach, based on the Constitution of 1988 (Article 239), aimed at softening the impact of structural shocks or adjustment policies on MSMEs by setting up programs to provide them with access to medium- and long-term credit. These programs, backstopped by BNDES, thus serve to leverage the development of competitiveness and employment. Their defining features are: (i) the origin of the funds; (ii) the financial protection mechanisms they employ; and (iii) their distribution channel.

1.20 ***Origin.*** The funds come from contributions (a given percentage of total sales) paid by all types of organizations (including public agencies and bodies) into the Workers' Support Fund [*Fundo de Amparo ao Trabalhador*] (FAT). A minimum of 40% of these resources are passed on to BNDES, which in turn channels these earmarked funds into job-creating ventures. These funds: (i) are administered by BNDES, and their authorized uses are, in general terms, specified in advance by the Deliberative Council of the Workers' Support Fund [Conselho Deliberativo do Fundo de Amparo ao Trabalhador] (CODEFAT);[5] and (ii) have increasingly been channeled to MSMEs in view of their importance in terms of job creation.

1.21 ***Protection mechanisms.*** The Constitution assigns an additional fiduciary role to BNDES in the maintenance of the real value of the FAT funds it administers. This means that BNDES must invest these funds in a way that will fulfill its development and job-creation objectives while also, on average, recouping its principal plus a certain percentage as a hedge against inflation. In order to ensure that these objectives are attained, the following standards and rules have been established: (i) the yield of investments made by BNDES must, as a minimum, be equivalent to its spread plus an annual risk-adjusted inflation rate (the long-term

[5] One of CODEFAT's duties is to draw up guidelines for the use of FAT resources.

interest rate, *Taxa de Juros de Longo Prazo (TJLP)*;[6] and (ii) BNDES must pay that rate, as applied to the funds at its disposal, into the FAT on an annual basis. This required rate of return on BNDES investments is designed to ensure the fiscal and financial sustainability of its programs.[7]

1.22 ***Distribution channel.*** BNDES distributes FAT funds allocated to it via a classic second-tier banking scheme whereby it onlends funds to 173 qualifying intermediaries (with nearly 15,100 agencies) using a specialized onlending window for IFIs that are supervised by the central bank and have been declared eligible by BNDES. The funds are onlent at the TJLP rate plus a spread that, in the case of MSMEs, is set at 1%, regardless of the sector or geographic location involved. Although BNDES provides the loan funds, the IFIs are the ones that screen the credits and that provide BNDES with full surety as to the funds' proper use, and they therefore are at liberty to set their own spread for the borrower.[8] Mean spreads have clearly trended downward thanks to the penetration ("capillarity") of the BNDES network and competition among IFIs to place these funds; in recent years it has hovered around 3%-4%.

1.23 ***Program outputs.*** These programs' outputs have been in keeping with the system's importance for the Brazilian authorities, since they have channeled very large sums to MSMEs. In 2002 and 2003, 117,342 and 96,486 operations with MSMEs were approved and R$8.3 billion and R$10 billion were disbursed, respectively. The fund distribution mechanism has some very positive features: (i) lower delinquency rates than those registered for unearmarked credits (2.8% versus 4% as of December 2003); (ii) the amounts that have been channeled to the target groups (the loans

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[6] The TJLP, which was created in 1994: (i) is now governed by BACEN Resolution 2.121, as amended by resolutions 2.145, 2.335, 2.587, and 2.654; (ii) is calculated for the coming quarter and published by the *Conselho Monetário Nacional* [National Monetary Council] on the last day of the preceding quarter; and (iii) is expressed in annual terms. Since 1999, the TJLP is computed on the basis of two components: (i) an inflation target, which is prorated over the next 12 months, starting from the first month in which it enters into effect (including that first month), based on the annual inflation targets set by the National Monetary Council (CMN); and (ii) a risk premium that incorporates a real international interest rate and a long-term risk component for Brazil. In the absence of a medium- and long-term credit market and of the corresponding curve, the TJLP is intended to serve as the base rate for what would be long-term rates in a private credit market and thus seeks to filter out short-term market rate volatility. TJLP

[7] This scheme is supplemented by a system of reciprocal credit guarantees known as the *Fundo de Garantia para a Promoção da Competitividade* [Guarantee Fund for the Promotion of Competitiveness] (FGPC), which is designed to provide a partial hedge for IFI credit risk and operations that meet certain requirements: (i) borrowers with arrears of less than 90 days; (ii) IFIs whose portfolio arrears are below 12% and have spreads of under 4%; (iii) a decreasing scale of guarantees based on the portfolio's overall delinquency rate and the relevant type of operation's risk rating; (iv) IFI access to the funds only when court-ordered repossession has been initiated; and (v) an annual 2% cumulative cost over the IFI spreads. In 2003, this charge has only been levied on 2.5% of operations (6% in terms of volume).

[8] The funds loaned to MSMEs therefore incorporate the risk inherent in the nature of such enterprises and the distribution chain, which include: (i) the public risk associated with the funding source and inflation, which are incorporated in the base rate (TJLP); (ii) the risk borne by BNDES, which is reflected in its spread; and (iii) the IFIs' risk, which is packaged into their spread.

issued under the most recent program for MSMEs have averaged, respectively, US$34,645.50, US$66,132.20, and US$123,465.50); (iii) fairly lengthy average repayment periods (an average of 60 months over the past three years); (iv) average spreads applied by IFIs of 3.27%; (v) the development of expertise in the IFIs for rating MSME risk, which has enabled them to put together packages to complement BNDES financing (using their own short-term funds to provide working capital for the ventures), thereby attaining a greater degree of bank coverage; and (vi) the progressive formalization of MSMEs, which can then become more competitive, pay into the FAT (thereby helping to fund the system), and become part of the tax base.

3. Bank support

1.24 The Bank has been supporting this strategy by undertaking multisector credit programs (MCPs) with BNDES. Since 1995, these programs have been yielding significant results in terms of the amounts they have channeled to the sector and their outputs within the framework of this approach (see below and footnote 10).

F. Lessons learned

1. Macrofinance

1.25 In recent years, Brazil has been subject to a structural disconnect in terms of the relationship between the lending rates charged by financial intermediaries and the rates of return of MSME ventures.[9] This gap stems from the macroeconomic situation and the inefficiencies, as noted earlier, in the workings of the financial system. Central bank studies and independent analysts agree that the level of lending rates is attributable to the combined effect of the level of intermediation spreads (40%) and high deposit rates (60%). In this regard: (i) the consensus view is that the wide spread is accounted for by the structural components discussed above; and (ii) the high deposit rates and their volatility stem from the high SELIC rates set by the BACEN in an effort to combat inflation. As noted earlier, the government and the central bank are implementing a strategy designed to do away with the causes of these problems. Accordingly: (a) the effort to combat inflation, which is being conducted by means of a tight monetary policy based on open market operations, is bearing fruit, since inflation has fallen from a peak of 17.24% in the second quarter of 2003 to 5.26% in the second quarter of 2004; and (b) the results in terms of financial spreads, although positive, have been less dramatic, with the spread narrowing from 32% in early 2003 to 27% as of June 2004.

1.26 At the same time, and despite the structural measures that have been adopted, the terms in place for the mobilization of resources have not lengthened to any

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[9] In 2003, the average lending rate for the system as a whole was 53.4% per annum (with inflation at 15%, the real rate for MSMEs was 38.4%). The average lending rate for corporate borrowers was 35.8%.

substantial degree, and the system therefore lacks a sufficient time horizon for lending operations.

1.27 In keeping with the course of action that the Bank has consistently advocated in the region, the government is working to mitigate the symptoms of this problem (the lack of financing for MSMEs) based on an awareness of their role in serving the public interest in the areas of employment and competitiveness. In line with this effort, the BNDES programs have a number of noteworthy features: (i) they provide funds for medium- and long-term productive investments at rates that are in keeping with projects' viability; and (ii) they make it possible to: (a) finance those productive investments with fiscal resources while using the country's network of financial intermediaries as the distribution channel for the funds and ensuring the fiscal/financial sustainability of the system; and (b) boost the production system's competitiveness, set the stage for a stable social situation, and enhance the system's ability to absorb structural shocks.

1.28 This reaffirms the experiences of other countries in the region in the following areas: (i) the ability to mobilize savings and effectively channel them to investment is influenced by monetary stability and financial repression; (ii) the extension of maturities and lending terms is the result of a process in which those circumstances are necessary but not sufficient conditions; and (iii) the lack of medium- and long-term financing for MSMEs can be mitigated by action on the part of government authorities.

2. Program structure

1.29 In situations such as this, the Bank has provided support for the sector through MCPs designed to help provide funding for MSME activities on softer terms and conditions than those dictated by existing equilibrium trends in the market. These programs necessarily entail the transfer of fiscal resources to the MSMEs. The MCPs are typically: (i) undertaken within the framework of a global approach;[10] and (ii) abide by a series of general principles that are reflected in the Bank's practices and are aimed at preventing transfers from creating undue distortions, such as: (a) such transfers are to be directed to the best companies; (b) the level of MCP resources is to be maintained in real terms; (c) public financing of MCPs (and, thus, Bank financing) is always to supplement, rather than take the place of, funding provided by the financial system; (d) the implementation of an MCP must not adversely affect domestic savings deposits in financial institutions, which would discourage them from providing long-term financing; and (e) transfers should be transparent and quantifiable.

[10] This approach involves: (i) a diagnostic assessment of the causes of these market failures; (ii) the use of MCPs to mitigate their effects, which are usually manifested in a shortage of financing on credit for MSMEs; and (iii) the design and implementation of sector programs and programs to boost competitiveness aimed at eliminating those causes.

1.30 The MCPs have been implemented by means of second-tier operations based on the participation of a group of eligible IFIs that assume the credit risk and guarantee the fulfillment of principles (a) and (b) as set out in the preceding paragraph. In order to ensure observance of the other three principles, the Bank has been limiting its support to transfer mechanisms that abide by a ***practical rule, i.e., that the onlending rate may not be lower than the average funds rate of the participating*** *IFIs.*[11] This practical rule: (i) entails compliance with the last three principles; (ii) has the advantage of simplicity in terms of its application and "elegance"; and (iii) reflects the underlying philosophy that IFI participation in the MCPs should not have the effect of reallocating capital. Link 5

1.31 **Within the framework of this philosophy, Brazil displays a number of distinct features, owing to its macroeconomic situation, which make this rule unviable in this case. More specifically, some of the key elements here are, first, the structural gap which, as mentioned earlier, exists between lending rates and MSME ventures' rates of return and, second, the marked volatility of interest rates.** As stated in footnote 9, with real rates for MSMEs on the order of 38% in 2003: (i) programs that were required to abide by that rule could not be implemented (the IFIs would be paying a very high rate for funding that they would be unable to use), would be unviable given the lack of disbursements, and, moreover, would not prevent structural shocks, like those of the past, from having the aforementioned impact; and (ii) overzealous efforts to make sure that distortions are not introduced into the financial system could lead to the discontinuation of support for programs that are having very positive effects but that do not comply with the above-mentioned condition.

1.32 This state of affairs needs to be put in its quantitative and qualitative context, however. To do so, the size of existing spreads has to be gauged and the exact nature of some of the characteristics of the BNDES onlending system must be spelled out. Accordingly, from a quantitative standpoint:

a. In 2003, the average differential between the actual TJLP (as opposed to its projected level) plus the spread applied by BNDES and the average funds rate for unearmarked resources as calculated by the central bank was 9.05 points (12.5% – 21.55%). If the overall average funds rate of the system's three biggest banks is used, then the spread narrows to 3.99 points (12.5% – 16.49%).

b. As a consequence of the monetary policy's success, the data for December 2003 differ substantially, with the differential between the TJLP plus the spread applied by BNDES and the average funds rate for unearmarked resources came to 3.81 points (12% – 15.81%); if the overall average funds rate for the system's three biggest banks is used, then the spread amounts to 0.32 points (12% – 12.32%).

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[11] Differentiating between the marginal rate and the average rate is not regarded as being necessary for this discussion.

c. The only long-term market rate (the rate carried by national treasury bonds [*Notas do Tesouro Nacional*]), which, like the TJLP, explicitly incorporates inflation, was below the SELIC and was 2.66 points above the TJLP in December. This appears to indicate that the rate/term curve was slightly inverted and, if the market were to wholly discount the success of the tight monetary policy and the continuation of structural reforms, the structural gap between rates would narrow or close altogether, with the SELIC and the TJLP gradually converging. In that event, the basic rule applying to the Bank's practices would be fully satisfied.

1.33 From a qualitative standpoint, the project team feels that BNDES, thanks to its years of experience, has succeeded in implementing an onlending facility which, although it does not fulfill the practical rule mentioned in paragraph 1.30, does uphold the underlying philosophy, inasmuch as: (i) the potential distortions that these spreads could create in the existing allocation of capital are mitigated by the positive features of the system; and (ii) there is no indication of perverse incentives that would perpetuate the causes of this problem. (Link 5 and Link 8)

G. Program rationale and relevance

1.34 As mentioned in Section C, MSMEs are one of the most vibrant sectors in the country's economy and are the strongest job creator. The stabilization of macroeconomic conditions has set the stage for a gradual increase in private investment, which has fueled demand for medium- and long-term investment loans. Under these circumstances, and given the MSMEs' difficulties in obtaining financing, their only sources of medium- and long-term bank credit are the programs financed by BNDES. The government continues to place a high priority on MSMEs as part of its growth strategy and to consider the continued promotion of this sector's expansion, integration, and access to financing as essential.

1.35 In an effort to attain these objectives, and in line with the priorities of both the government and the Bank's country strategy with Brazil, the program has been designed to:

a. Dovetail with the government's policy (paragraph 1.16) of seeking to expand the supply of long-term financing, strengthen the MSME segment, and deepen its role in integrating the Brazilian economy with the rest of the world, and fit in with the priorities set for BNDES by the Ministry of Planning and the Budget.

b. Be consistent with the Bank's country strategy with Brazil (2004-2007) within the spirit of the Nuevo León initiative, which is aimed at boosting support for MSMEs. The Bank's course of action, pursuant to the Monterrey Consensus (2002) as it relates to the prioritization of an effective use of resources, is divided into four main areas, one of which is supporting MSMEs with medium- and long-term credits for use in financing investment projects. In addition, as part of its objective of macroeconomic stabilization, the Bank recognizes the

importance of financial system reform, not only because of the effect that a deepening of the credit market has on growth, but also because public resources must be readily available in order to mount a comprehensive effort. Declaration of Nuevo León

c. Take the form of multilateral credit programs (MCPs), given their proven operational effectiveness in responding to the types and structure of the target groups' demand for credit (numerous small-scale projects in a wide variety of economic sectors and geographic regions throughout the country), thereby: (i) providing access to a wide spectrum within the target group through the use of fairly small loans; (ii) ensuring the transparency of resource allocation based on profitability and market criteria and on proper management and oversight; and (iii) using the BNDES system to maximize the impact of these resources in financing efficient investment projects that will boost competitiveness.

1.36 The program is expected to have a substantial impact in generating new private investments since, assuming it is valid to extrapolate from the sample prepared by the Bank's Country Office in Brazil (BNDES funds are approximately equivalent, on average, to 25% of the total investment project), such investments would amount to US$24 billion.

H. Rationale and relevance of the Conditional Credit Line for Investment Projects (CCLIP)

1. Proposal

1.37 The CCLIP is designed to provide a line of credit for additional projects in cases where the Bank has already financed a succession of similar investment projects. In order to use this type of credit line, the following requirements must be met: (i) execution of the previous projects must have been fully satisfactory; (ii) the projects must have been properly carried out and maintained; and (iii) the proposed executing agency must be the same as before and have a solid track record as a good manager. These three requirements are fulfilled extremely well by the proposed program. Given this fact, together with the project's rationale, relevance, and additionality, it is proposed that the Bank make a CCLIP line available. Link CCLIP

1.38 Eligibility for the CCLIP is based on: (i) the existence of four previous programs that are equivalent to the one being proposed here and that were completed successfully;[12] (ii) full compliance by the borrower and the executing agency of the contractual terms and conditions and the disbursement policies that have been established; (iii) the existence of audited financial statements for the relevant

[12] The Bank has extended 18 loans totaling US$4.2 billion to BNDES. Seven of those loans have been amortized and the other 11 have been fully disbursed and are in the process of amortization. Four of those 11 (totaling US$3.5 billion) are MCPs for MSMEs.

periods to which there has been no objection; and (iv) the investments financed by these programs, which were conducted on the basis of an incentive-compatible market system, can be assumed to have been properly carried out and maintained in view of the delinquency rates of the projects in question. By the same token, the institutional structure of the executing agency has permitted the programs to establish a solid track record with respect to disbursements and performance, and there is no reason whatsoever to believe that this state of affairs is going to change (paragraph 3.20 and Link 6).

2. Previous operations

1.39 The main characteristics of the MCPs approved to date are as follows:

- ***The first operation***, approved in 1995 for US$600 million, was designed to provide credit support for SMEs. This operation was financed partially by the Bank (US$300 million) and partially by JEXIMBANK (now known as the Japan Bank for International Cooperation (JBIC)) (US$300 million). Disbursement of the program's funds was completed in December 1997; 1,045 subloans were made through over 90 certified IFIs located throughout the country. In all, 63% of the operations and 32% of the financing involved firms with annual sales of less than US$500,000. The sector distribution was as follows: manufacturing, 27%; commerce, 23%; agriculture and agroindustry, 25%; and services, 25%.

- ***The second operation*** was approved in late 1998 for US$1.1 billion (1125/OC-BR) to support a US$2.2 billion program. The program had three credit components: (i) US$500 million for microenterprise; (ii) US$1.5 billion for SMEs; and (iii) up to US$200 million for private education and health. The distribution of the resources, by economic sector, was as follows: commerce, 9.8%; agriculture, 26.8%; manufacturing, 26.8%; and miscellaneous services, 36.6%. Its execution was completed in 2003.

- ***The third operation*** was approved in 1999 as a US$1.2 billion emergency loan (1175/OC-BR) for SMEs. Disbursement of the funds was completed in late 2000, and nearly 10,000 companies (35% small businesses and 65% medium-sized enterprises) benefited from the operation. The sector distribution was as follows: commerce, 14%; agriculture and agroindustry, 4%; manufacturing, 40%; and miscellaneous services, 42%.[13]

- ***The last operation*** was approved in May 2002 for US$900 million (1374/OC-BR) to support a US$1.8 billion program. The disbursements were

[13] These last two operations are part of the Macroeconomic Support Program that Brazil negotiated with the IMF in late 1998. The purpose of this program was to provide financial support to help overcome the effects that the Asian and Russian crises had on Brazilian markets. The operations were designed to ensure the continuity of medium- and long-term financing for smaller firms during the adjustment process made necessary by those crises.

completed in April 2004 and averaged US$63,600. Their distribution was as follows: (i) microenterprises, 44.7% of the firms and 24.4% of the funds; (ii) small businesses, 35.2% of the firms and 36.6% of the disbursements; and (iii) medium-sized enterprises, 20.1% of the firms and 39% of the funds. As of February, it had included a total of 28,214 operations. The sector distribution was as follows: (a) services, 56.5%; (b) manufacturing, 24.4%; (c) commerce, 15.2%; (d) agriculture and livestock, 2.2%; and (e) mining, 1.7%.

3. Impacts achieved

1.40 These programs sought to mitigate symptoms of the existing structural problems by covering part of the shortfall of medium- and long-term financing for MSMEs:

- ***From a financial standpoint***, the (quite positive) characteristics of the BNDES package of indirect operations—and, hence, of the programs included in it—are described in paragraph 1.23.

- ***From an economic standpoint***, the programs were in keeping with their inherent philosophy**.** While their basic financial characteristics fell within program design expectations, and since the IFIs act as an incentive-compatible mechanism for selecting the most viable companies, the impact of the projects they choose (assuming the economy's structural variables remain constant) will be determined by market conditions. The IFIs will choose the best firms and, as these enterprises repay the credits (with suitably low delinquency rates), market mechanisms will ensure that the best projects are selected.[14] Given this dynamic: (i) it was not possible to determine the impacts that each of the programs would have on an *a priori* basis, but (ii) given how important it was to conduct *ex post evaluations of what outputs the market had made it possible to attain at each point in time*, in 1999 work began on the design of an ad hoc mechanism, to be managed by the Bank's Country Office in Brazil, for monitoring and assessing these projects' economic impact on investment and employment on an ongoing basis using a representative sample of beneficiary MSMEs. The findings for that sample as regards project impact indicate the following: (i) gross sales rose by 61%; (ii) the number of jobs climbed from 16,731 to 33,928 (a 103% increase, with an average of 24 jobs being created per subloan); (iii) the sums invested were on the order of 4.12 times as much as the amount of program financing (the MSMEs' own capital inputs plus the working capital provided by the IFIs); and (iv) the entrepreneurs who were surveyed rated 87.7% of the operations as satisfactory or very satisfactory.

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[14] Equating this with a design criterion focused solely on disbursements would be an inappropriate interpretation of the MCPs, since one of their core features is that they rely on the market to ensure that the operations will have the maximum impact at any given point in time.

- ***From the standpoint of the reinvestment of program resources in eligible credits*** (a key factor in gauging BNDES' commitment to MSME development), an analysis of the past five years indicates that: (i) BNDES has not amortized its counterpart contributions and has consequently maintained surplus program funding; and (ii) it has increased program allocations by nearly R$3 billion. BNDES has therefore contributed nearly R$7.7 billion more than required to comply with the contractual terms and conditions relating to the reinvestment of program-generated funds.[15] The corresponding calculations have been computed using the following equation:

  NPI = increase in portfolio of eligible loans – (Bank loans – debt service payable to the Bank + BNDES counterpart funds)

Table L5-1
MSME Support Program
in billions of reais (R$)

	Bank loans	BNDES counterpart funds	Debt service payable to the Bank	Available resources	Increase in eligible loans	NPI
		(A) x 0.85		(A) - (C) + (B)		(E) - (D)
	(A)	(B)	(C)	(D)	(E)	(F)
2000	1.558	1.324	252	2.630	922	-1.708
2001	1.113	946	463	1.597	1.332	-265
2002	2.267	1.927	1.631	2.562	2.148	-414
2003	1.368	1.163	2.348	183	3.172	2.989
2004	18	15	1.226	-1.193	943	2.136
TOTAL	**6.324**	**5.376**	**5.920**	**5.780**	**8.517**	**2.738**

- ***From the standpoint of program completion reports (PCRs),*** the findings clearly indicate that:

  (i) The programs achieved their overall objectives in terms of quantity, quality, and loan maturities, and all disbursements were conducted by or before the corresponding deadlines;

  (ii) During the programs' execution, the supply of credit extended via BNDES for small and medium-sized enterprises steadily expanded, the number of financial agents in the system working with these financial products rose, and loan portfolio quality improved;

15 In measuring fulfillment of the commitment, both the funds supplied by the new programs and those generated through the recovery of existing loans have been taken into consideration. The level of the net program increase (NPI) variable measures how much BNDES has contributed to the financing of MSMEs. In the first few years, this condition was not met because of macroeconomic disruptions that made it difficult to disburse rapidly enough. It is possible, however, that if the amortization of the BNDES's contribution was included, then the calculations would show that this condition was met.

(iii) Although these programs did not have specific objectives built into them ex ante in terms of financial and economic rates of return, it can be concluded that the projects financed by these programs had suitable rate of returns in keeping with expectations, given the IFIs' continued interest in these lines of credit, the MSMEs' interest in this type of financing, the operations' low delinquency rates, the steady growth of the BNDES facility for MSMEs, and the overall stability of the financial system;

(iv) These programs' execution was facilitated by the IDB's ample experience in working with BNDES and by the latter's large installed capacity for programs such as FINAME (Agência Especial de Financiamento Industrial [Special Industrial Finance Agency]) and BNDES Automático.

4. Other additionalities

1.41 Use of the CCLIP will have other additionalities from a financial standpoint since: (i) it will consolidate the positive effects of the BNDES programs (via the incentives referred to in paragraph 2.13) by providing a broad enough framework to enable BNDES to design such incentives and to allow them to take effect; (ii) the investments being made by IFIs in order to serve this market segment could be reinforced by expectations of program continuity; and (iii) it will enable BNDES to program its financial operations in this sector over the long term, will facilitate the processing of future operations, and will lower the cost of doing so.

5. Scope

1.42 The size of the proposed credit line has to be in keeping with existing needs and the disbursements made in recent years. Based on an evaluation of demand, it is estimated that a line of US$3 billion over a term of nine years would have an additionality in the real sector of the economy equivalent to those of previous programs. An operation of this scale could be executed without difficulty and could finance nearly 10,500 new credit operations per year (Link 7), which would entail disbursements equivalent to those being made to date.

II. PROPOSED CREDIT LINE AND PROGRAM

A. Objectives and strategy

2.1 The objective of the proposed CCLIP line and program is to support efforts to strengthen private-sector MSME competitiveness and job creation by providing medium- and long-term financing for investment projects. The CCLIP line and program will be aligned with preceding operations and with the strategy for supporting the government's efforts to make the country's production sectors more competitive.

B. Description

2.2 Under the proposed CCLIP line and program, medium- and long-term financing will be channeled by BNDES to MSMEs through regulated IFIs for investment projects aimed at expanding, modernizing, and diversifying the production activities of ventures that display the requisite technical, financial, economic, legal, and environmental viability. All the funds to be provided under this program and credit line, which will total US$6 billion, will be used to provide *real*-denominated financing for eligible firms for use in investment projects and as permanent working capital. This nine-year credit line will take the form of three successive US$1 billion loans, with the funds (in US dollars) being drawn from the Bank's Ordinary Capital under the Single Currency Facility. The first program loan will be in the amount of US$1 billion.

2.3 All funds will be channeled by BNDES through second-tier mechanisms of proven efficiency. The activities and components involved in this operation are described in the attached logical framework. Operational policies are reflected in the respective Credit Regulations agreed upon by the Bank and BNDES, which should enter into effect prior to the first disbursement.

C. The loans

2.4 The credit to be provided to microenterprises and microentrepreneurs (individuals), for the first of the credit line's programs, will be packaged as *real*-denominated subloans. These subloans will be for a maximum of US$200,000 and will be granted to units having gross annual sales of up to US$400,000. The funds for small businesses will take the form of *real*-denominated subloans of up to US$1 million and will be granted to firms having gross annual sales of between US$400,000 and US$3.5 million. The funds for medium-sized enterprises will be used to provide *real*-denominated subloans of up to US$4 million to firms having gross annual

sales of between US$3.5 million and US$20 million.[16] This credit will be granted for use in financing investments and as working capital for projects designed to modernize and expand production and service activities.

D. The onlending system

2.5 As noted in paragraph 1.33, the BNDES onlending system mitigates the possible distortions that the onlending rate could produce in the existing capital allocation structure and does not generate perverse incentives that might perpetuate the problem that is being addressed. To analyze these two elements, it is necessary to examine each of the components of an onlending system in which the credit line and program funds: (i) will come from the fiscal sector; (ii) will be provided to MSMEs at rates consistent with their ventures' rates of return; (iii) will be earmarked by BNDES for the MSMEs and will be channeled through IFIs; and (iv) will be distributed by IFIs, which will act as an incentive-compatible distribution mechanism.

2.6 From all of these standpoints (Link 8), the system now in use does not depart from the philosophy underlying the basic principles listed in paragraph 1.30. From a financial viewpoint, there are sufficient grounds to conclude that: (i) the BNDES program financing does not supplant financing provided by the financial system (since the latter was not forthcoming in the programs' absence); (ii) domestic savings deposited with financial institutions have not been altered (since the signals that act upon such savings—deposit rates—are not affected); (iii) the programs do not appear to interfere with efforts to solve the structural problems in question (since these problems stem from the behavior of savers, which is influenced by risk aversion plus the formation of expectations, and from the MSMEs' capacity to generate returns, i.e., their competitiveness); moreover, there is an entire line of action directed at eliminating these structural imbalances; and (iv) the structural gap between lending rates and MSME rates of return does not appear to have been negatively affected by the programs' implementation.

2.7 These circumstances appear to indicate that any distortions that might be generated by existing spreads between the actual onlending rate and the average funds rate will be minor in scale relative to the social and economic benefits afforded by the program. BNDES' existing indirect operations facility could therefore be supported by the Bank without departing from best practices.

2.8 For all of these reasons, the rates and spreads used in connection with the first of the CCLIP line's programs for MSMEs will be the same as those now in use in the

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16 These amounts are also denominated in reais in the contract. The maximum amount of the balances due on subloans granted to a subborrower, funded with resources from the program and from previous programs, may not exceed these ceilings. In keeping with trends of recent years, BNDES is seeking to focus the credit line increasingly on microenterprises and small businesses, while eventually phasing out such loans for medium-sized firms.

BNDES system, which are: (i) the TJLP; (ii) the usual BNDES spread (1%); and (iii) the spread used by the IFIs, which they set at their discretion.

E. Exchange-rate risk

2.9 The exchange-rate risk to which BNDES will be exposed when it converts the dollars (US$) of the IDB loan into reais (R$) will be adequately covered, since BNDES policies stipulate that it must fully cover its exchange-rate risk at all times. It accomplishes this by hedging all of its operations. The methodology used by BNDES conforms to the usual practices in this area.

F. Other financial effects

2.10 The CCLIP line and program, by supporting the current BNDES system, will have a variety of positive effects on the financial system:

a. They will promote the development and deepening of financial markets by enabling IFIs to generate funds, by providing financing, on market terms and conditions, for use as working capital. This will: (i) deepen banking coverage; (ii) permit targeted lending;[17] and (iii) gradually formalize MSMEs, which, once they begin to engage in formal banking operations, can then boost their competitiveness, become part of the tax base, and pay into the FAT (thereby helping to fund the system).

b. Average loan maturities in the financial system are largely determined by the level of risk perceived by depositors. This, in turn, is influenced by a number of factors, including the quality of institutional assets and the volatility of macroeconomic variables. From both of these standpoints, the CCLIP line and program will have a positive impact on the length of maturities in the system for the following reasons: (i) if the BNDES system's delinquency rate stays low, the market will view the IFI portfolio as a quality portfolio; and (ii) BNDES policies contribute to macroeconomic stability.

c. They will minimize the asymmetric-information costs borne by IFIs by helping them to obtain information on borrowers, their businesses, and their use of the loans, thereby enabling them to narrow their spreads. At the same time, the commercial banking system will continue to develop appropriate technology for MSME credit management which will outlive the MCP and facilitate the extension of bank credit to this sector.

[17] According to the Bank's own estimates for previous programs, 20% and 60% of the credits funded by IFIs have gone, respectively, to microenterprises and to small and medium-sized enterprises (source: permanent representative sample developed by the Bank's Country Office in Brazil with assistance from the University of Brasilia).

G. Characteristics and effects of the CCLIP line

2.11 The contract for the CCLIP line, which must be signed before the first program contract, will have the following features: (i) it will not require a government guarantee, above and beyond the guarantees that may be obtained for each of the component programs; (ii) it will not give rise to any individual operations that, at the time of their submission, are found to be ineligible by the Bank; and (iii) it will be governed by the corresponding agreement and will be subject to the contracts and Credit Regulations pertaining to each individual program.

2.12 Prior to the signature of the CCLIP line agreement and the first individual loan contract, and as a result of regulatory requirements in Brazil, the borrower will present evidence that the Comissão de Financiamentos Externos [External Financing Commission] (COFIEX) has supplemented its recommendation 675 of 22 October 2003 with one authorizing future preparation of the credit line's other two programs. If that second recommendation is not approved, the CCLIP line will not be implemented, and steps would be taken to sign a loan contract equivalent to the amount of the credit line's first program. The revised recommendation is expected to be approved one month after negotiations.

2.13 The program's inclusion in a CLIPP line will help BNDES to gradually introduce into its indirect operations facility a number of promising innovations agreed on in credit line agreement, such as:

a. ***Cofinancing***. To date, the BNDES system is alleviating the shortfall of medium- and long-term credit generated by problems in the financial system. These problems are associated with: (i) the structural gap between MSMEs' rate of return and the banking system's average funds rate; (ii) the shortness of maturities; and (iii) the volatile price of credit. In the past year, the rate has declined substantially and is now approaching the TJLP. If this trend continues, and if the other two variables gradually improve, it is conceivable that, in the future, the IFIs will be in a position to provide an increasing amount of funding of their own, with the same maturities, for BNDES programs. Thus, BNDES could gradually, over the long term and when possible, encourage the IFIs to provide such financing on their own as their liabilities profiles improve. The package of incentives will be directed toward promoting the formation of the more mature type of financial system sought by the financial authorities. This will have to be a voluntary process, however, since market acceptance of these incentives is something that cannot and should not be imposed.

b. ***Monitoring the programs' loan portfolio***. BNDES will pledge that the funds provided by the new programs included in the CCLIP line, plus those generated by the recovery of existing loans, will be reinvested in loans analogous to those of the programs (i.e., eligible credit operations) and that the *sum total of those loans will be greater than the amount deriving from the obligations set forth in the standard Bank contract*. This provision will consolidate current BNDES

practices. The base amount will be the NPI (net program increase) variable defined in paragraph 1.40. Thus, as long as the NPI variable, as defined herein, is not negative, the fulfillment of the above-mentioned condition will be assured.

c. ***Impact indicators***. Under this credit line, BNDES will employ a logical framework methodology to develop a set of impact indicators for use in its MSME operations. These indicators will be based on: (i) the data provided by loan applications and their possible expansion; and (ii) the preparation of samples, as deemed necessary. In relation to the first element, new information fields will be included in the IDB/BNDES statistical sample. With regard to the second, BNDES will evaluate, based on market trends, the advisability of introducing new questions to help measure the programs' impact. A sample of IFIs will also be incorporated into the IDB/BNDES statistical sample in order to provide feedback for the system.

H. Scale, Bank financing, disbursements, and costs

2.14 An evaluation of the potential demand for financing indicates that the CCLIP line and program could be executed in nine and three years, respectively. Since, for the most recent operation, the individual BNDES loans averaged the equivalent of US$63,600, it is estimated that the CCLIP line and program could finance approximately 10,500 new credit operations per year (Link 7). In that regard: (i) the sources of the CCLIP line and program financing will be the US$3 billion in loan funds plus US$3 billion in local counterpart funding (including the funds of both BNDES and the subborrowers, which will be equivalent to at least 15% of each subloan in the first program under the credit line); (ii) the US$3 billion in IDB loan funds will be in dollars (Single Currency Facility based on the LIBOR) and will be drawn from the Bank's Ordinary Capital; (iii) BNDES could opt to request partial execution at the adjustable rate for the Single Currency Facility; (iv) the commitment and disbursement periods for the CCLIP line's programs have been set at three and four years, respectively (the funds will be considered to have been committed when the borrower has notified the IFIs that the respective credit lines are available; (v) the estimated timetable provides for total disbursements of US$660 million per year, with 50% of this sum being disbursed by BNDES and 50% by the Bank. This provision is subject to the BNDES system's financing requirements, however (which provided there is sufficient demand will in no case be less than 15% of the program in each year); and (vi) subloans disbursed between 1 January 2004 and the date the program is approved by the Board in the amount of US$250 million from the loan and an equivalent amount from the counterpart contribution will be recognized.

2.15 The costs of the CCLIP line and program will be distributed as follows:

Table II-2: Program Cost, by Source of Financing
(millions of US$)

Investment component	IDB	Local contribution	Total
Credit	2,970	3,000	5,970
Inspection and supervision	30	-	30
Total	**3,000**	**3,000**	**6,000**
Percentage	50%	50%	100%

III. IMPLEMENTATION

A. Borrower, executing agency, and guarantor

3.1 The borrower and executing agency of the CCLIP line and program will be the Banco Nacional de Desenvolvimento Econômico e Social [National Economic and Social Development Bank] (BNDES), which was founded by Law No. 1628 of 1952 and is regulated by Law No. 5662 of 1971. The guarantor will be the Federative Republic of Brazil. The guarantee will be limited to debt servicing and to the obligation to take the necessary steps for the borrower to fulfill its positive contractual covenants. In that regard, the Republic, respectively: (i) will not assume responsibility for making the counterpart contributions, since they are not provided for in the national budget and would be difficult to add given current fiscal constraints; and (ii) in no case can directly assume the positive covenants of BNDES (as a bank).

3.2 Under its charter, BNDES is authorized to secure the necessary domestic and external financial resources for its operations. Previous programs have demonstrated that BNDES has the necessary experience and incentives to execute this project.

B. IFI eligibility

3.3 Commercial and multipurpose banks (both private and public) possessing a development banking portfolio, investment banks, development banks, and other regulated institutions that meet the requirements established by BNDES can qualify as IFIs for the purposes of the CCLIP line and program. The procedures involved in determining the eligibility of IFIs working with the BNDES system and their risk ratings include an initial assessment for those purposes, the establishment of a credit limit, and semiannual monitoring of each production unit's economic and financial performance in order to provide a basis for reaffirming or modifying the risk ratings and lending ceilings. The current screening process entails strict eligibility criteria based on a comparative index methodology for similar IFIs. This methodology looks at: (a) variations in risk indices; (b) the statistical significance of the resulting values; (c) the financial agents' size, quality, and risk concentration; and (d) the level of management and management changes. It also covers the performance and quality of the IFIs' portfolios of loans funded with BNDES resources. This last factor is of particular importance in rating the institution and in the semiannual reviews of its credit ceilings. These criteria are in keeping with current BACEN regulations concerning solvency, liquidity, and rates of return, as well as with BNDES' internal policies on eligibility and credit ceilings. Link 9

3.4 In order to participate in Indirect Operations Programs, IFIs must: (i) comply with BACEN regulations, since BACEN oversees the system; (ii) have borrowings from the BNDES system consistent with the risk assessments performed; (iii) submit an

independent, external audit each year that is free of exceptions or observations; (iv) have no payments arrears with BNDES from previous operations; (v) commit to full disclosure of relevant information concerning subborrowers in the program upon request to the Bank or BNDES; (vi) allow the body selected by the Federative Republic of Brazil to audit and inspect program operations; and (vii) have a reporting system that provides information on the nature of subprojects, their financing sources and conditions, progress in the execution of subloans, and their payment status.

C. Operational aspects

1. Operational procedures

3.5 All (100%) of the credit line and program funds will be channeled through IFIs. The operational procedures, which have already been drawn up, are the standard ones used for BNDES credit lines and were employed in the preceding operation (1374/OC-BR).

2. IFI financial responsibility

3.6 The IFIs will be wholly responsible for evaluating the risk associated with subborrowers and for the decision to grant financing in accordance with the Regulations and with BNDES' policies on indirect operations with MSMEs. The IFIs will assume responsibility for the servicing and repayment of the subloans to BNDES, regardless of whether or not the subborrowers fulfill their servicing obligations with the IFIs.

3. Credit Regulations

3.7 Each program under the credit line will have its own Credit Regulations: (i) that are consistent with the regulations and policies of BNDES and the Bank and with the financial practices and laws in force in the country; (ii) that reflect the main features of the CCLIP line and program; and (iii) whose approval by the Bank and implementation by BNDES will be a condition precedent to the Bank's first disbursement of the loans for the respective program. The main provisions include those set out below. Failure to comply with these provisions will result in the denial of access to financing.

a. Subborrowers and use of the funds

3.8 Private-sector MSMEs and individuals, as defined in Brazilian law, which are legally resident in the country may participate as borrowers in programs conducted under this credit line if, in accordance with each program under the credit line and in the judgment of BNDES and the participating IFIs, they possess the administrative, technical, financial, legal, and environmental capacity to execute the

projects for which the loans are extended.[18] The funds provided under the CCLIP programs are to be used to finance IFI subloans for fixed investments or for use as permanent working capital for the execution of investment projects by qualifying Brazilian MSMEs.[19] "Permanent working capital" is defined as capital associated with fixed investments financed by the CCLIP line and program. IFIs must immediately deliver to BNDES any and all funds obtained through the recovery of subloans or the receipt of advance payments on such subloans, in accordance with the latter's operating procedures.

b. Participation of IFIs

3.9 The financial institutions cited in paragraph 3.3 and other regulated entities that meet the limits and requirements set forth in the BNDES operational policies now in force, which have been incorporated into the Credit Regulations for each operation, will be eligible to participate in the program as IFIs.

c. Financial terms and conditions of subloans

3.10 ***Maturities***: For all programs under the credit line, subloan maturities will be determined by the IFIs in accordance with each project's characteristics and the subborrower's repayment capacity, bearing in mind the conditions set forth in BNDES operational policies and the maximum limits established in each set of Credit Regulations.

3.11 ***Denomination*****:** For the first program under the credit line, the funds onlent through IFIs to subborrowers will be denominated in *reais* (R$).

3.12 ***Interest rates and other financial charges*****:** For all programs under the credit line, the final rate applied to subborrowers will be consistent with Bank policies for that type of financing and, in all instances, will include the respective intermediation spread for each IFI, which will be freely negotiated by the IFI and the subborrower. For the first program under the credit line, the annual interest rate to be charged on loan funds onlent to IFIs will be the basic long-term interest rate (TJLP), plus 1%. This rate will be adjusted quarterly. Any change in the criteria used to calculate the TJLP or the spread applied by BNDES must, as in the case of the other provisions contained in the Credit Regulations, have the Bank's approval prior to its application to the to CCLIP line and the program.

3.13 ***Delinquency charges***: For all programs under the CCLIP line, BNDES and the IFIs, in each case, may include interest charges and financial penalties for delinquency in the event of nonperformance of the relevant onlending and subloan contracts.

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18 The obligations of subborrowers are set out in Article 10 of the Credit Regulations.

19 All projects that are financed with program resources are required to have the corresponding financial and environmental feasibility study prepared in accordance with BNDES policies.

3.14 ***Subprogram limits***: The Credit Regulations for the first program under the CCLIP line will establish the following limits: (i) the subloan ceilings for micro, small, and medium-sized enterprises under this program are the equivalent of US$200,000, US$1 million, and US$4 million, respectively; (ii) the ceilings for the balances due on subloans funded with program resources or loans granted under previous IDB-funded programs are the same as above; and (iii) in the event that BNDES, BNDESPAR (the BNDES holding company) (see Link 3), the IFIs, their shareholders, or groups to which they belong hold voting shares (equal to or greater than 15% of such shares) in the enterprise applying for a subloan, the extension of said loan will be contingent upon the express approval of BNDES and the nonobjection of the Bank.

3.15 ***Disbursement procedures:*** Funds for each program under the CCLIP line will be disbursed by BNDES to IFIs, individually through each subloan, so that they may then onlend those funds to eligible firms in accordance with established BNDES procedures for such operations. To date, the onlending of such resources has been channeled through the FINAME and BNDES Automático facilities.

d. Restrictions on the use of program funds

3.16 CCLIP and program funds may not be used to finance the following: (i) the purchase of immovable assets; (ii) dividend payments or recovery of invested capital; (iii) the purchase of equities, bonds, or other movable assets; (iv) subborrowers' general or administrative expenditures; (v) projects that do not meet the environmental standards set forth under Brazilian law or established by the relevant public agencies; (vi) debt refinancing; and (vii) working capital other than permanent working capital associated with a project or with imported inputs or inputs having a significant import content, in accordance with BNDES' operational policies. IDB financing may not be used for any of the following purposes either: (i) tax payments; (ii) the purchase of used movable goods, except in the case of used equipment and machinery that has an independent technical and economic appraisal, with the prior approval of the Bank; and (iii) the purchase of goods and services from countries that are not members of the Bank.

e. Environmental and social monitoring

3.17 The proposed CCLIP line and program will be subject to environmental requirements similar to those applying to previous programs[20] (Link 10). Accordingly: (i) subloans may be granted only to projects that submit the necessary authorizations and fully comply with Brazilian environmental legislation; and (ii) the *comprehensive mechanism for subproject environmental quality control* designed on the basis of the environmental standards of the Conselho Nacional de

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20 The requirements specified in *Environmental Procedures and SEA Guidance* for CCLIP lines are not applicable here because they are not intended for MCP operations.

Meio Ambiente [National Environmental Commission] (CONAMA) must be fully operative.

3.18 This mechanism, which now applies to all BNDES loan operations, is composed of: (i) internal environmental policies and procedures that emphasize rating, approval, and monitoring of performance of contractual obligations pertaining to loans granted by IFIs; (ii) review of the files on each loan operation to verify that they contain, as appropriate, the proper environmental certificates issued by the competent authorities, and on-site supervision of program users based on the sample prepared jointly by the Bank's Country Office in Brazil and BNDES; and (iii) to date, the mechanism has functioned satisfactorily.[21] For these reasons, this mechanism will remain in use with no major changes planned. The corresponding reports will be submitted upon each program's completion. In addition, since 2002 BNDES has employed the concept of social inclusion as a basic guideline for its operations and has been supporting projects that have a direct impact on the population's living conditions.

3.19 At its meeting of 3 September 2004, the Committee on Environment and Social Impact (CESI) reviewed the project report submitted for the CCLIP line and program. The Committee found BNDES' current environmental monitoring mechanisms for operations of this type to be satisfactory. The CCLIP line and program will therefore employ the current environmental monitoring mechanisms and procedures as described herein, which are substantially similar to those used for previous programs.

D. Implementability and institutional structure of the executing agency

3.20 The implementability of the CCLIP line and program derives from the institutional structure of BNDES. Prime responsibility for coordinating execution of the CCLIP programs will be borne by the unit in charge of operations with international agencies within the Departamento de Captação de Recursos [Borrowings Department] (DECAP) in the BNDES financial cluster. The BNDES departments responsible for the evaluation of financial agents, operations, and portfolio monitoring will also be directly involved in executing these programs. The Bank will supervise and oversee the CCLIP line and the program through the IDB Country Office in Brazil. The BNDES/IDB joint technical committee[22] will also monitor the progress of the CCLIP line and the program and will exchange information regarding topics of mutual interest relating to credit programs. Link 6

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21 BNDES has submitted an environmental monitoring report on each of the operations financed by loans 1125/OC-BR, 1175/OC-BR, and 1374/OC-BR. These reports corroborate this statement.

22 This committee was established under Global Multisector Financing Program (1125/OC-BR) and is composed of the Bank's Country Office in Brazil, Regional Operations Department 1, and BNDES (International Financial Cluster). It meets periodically to analyze the operations' progress and to exchange information.

E. Program and executing agency audits

3.21 BNDES and the IFIs will keep special files on the operations financed under the CCLIP programs. These files will include records of: (i) the amounts of the subloans funded by the Bank and by the local counterpart; (ii) the interest falling due and collected on the funds used; (iii) the subloans granted; and (iv) the establishment and use of loan-loss provisions. These data should permit the preparation of annual statements of account, income statements, and other reports on the CCLIP line and the program.

3.22 Auditing of the CCLIP programs' financial statements will be the responsibility of the Secretaria Federal de Controle [Federal Secretariat for Auditing] (SFC). BNDES' audits will be conducted by an independent auditing firm that meets with the satisfaction of the Bank. Audits of previous programs demonstrate the capacity for financial management, the administration of accounting systems, and the use of internal controls, and the establishment of preventive measures is therefore considered unnecessary. The scope of the audits and the deadlines for their submission will be determined in accordance with the Bank's policies.

F. Evaluations

1. Regular financial evaluations

3.23 In accordance with Bank policy, during execution the borrower and the executing agency, on the one hand, and the Bank, on the other, are to review the interest rates being applied to subloans on a regular basis. The borrower and executing agency will, if necessary, takes appropriate steps, in keeping with the country's economic policies, to reconcile the subloan interest rates with the Bank's policy objectives. Should changes occur in the applicable base rate, its method of calculation, or the way in which the basic spread to be charged by BNDES is computed, such changes must be approved by the Bank before they take effect in the CCLIP programs.

2. Mid-term review

3.24 Within the time frame set for each progam (for the first program: 18 months after the first disbursement or once 50% of the loan has been committed, whichever comes first), the borrower and the Bank will review program performance. This review will cover the following: (i) objectives and outcomes, based on the attached logical framework and table of indicators and on the means of verification set forth therein (Link 11); (ii) environmental requirements, in accordance with Brazilian law and Bank policy; and (iii) the tangible forms in which BNDES pursues its objectives of gender and social inclusion. If it is found that the CCLIP programs have not achieved their objectives to a substantial extent, then appropriate steps will be taken.

3. Ex post evaluation

3.25 In accordance with Bank policy and following consultations on the subject, the executing agency has decided not to include an ex post evaluation among the activities of the CCLIP line and the program. BNDES has based its decision on the grounds that the regular evaluations of the CCLIP programs during their execution will provide sufficient information on their progress and outcomes. It is possible, however, that the ex post evaluation could be conducted nonetheless, since the necessary information will be available.

G. Sharing experience

3.26 During the programs' execution, BNDES and the Bank will exchange technical information of mutual interest through the aforementioned joint technical committee. At least two meetings per year are planned. At these meetings, discussions will cover the programs' progress and the following topics: (i) the performance of the CCLIP line and the advisability of introducing new products; (ii) the exchange and dissemination of experiences with credit programs and programs aimed at developing new financial products for the MSMEs of the region; and (iii) progress in the development of a framework of impact indicators.

IV. VIABILITY, RISKS, AND BENEFITS

A. Viability of the CCLIP line and the program

1. Macroeconomic aspects

4.1 During 2004, the country has witnessed a recovery in the level of economic activity that has surpassed the original GDP growth projection of 3.5%, thanks to its success in keeping its fiscal accounts on a solid footing. (The public sector has a primary surplus equivalent to 4.25% of GDP.) The positive expectations generated by its performance and the scope of the CCLIP line and the program relative to the level of unmet demand for medium- and long-term credit provide grounds for the belief that both will be macroeconomically viable.

2. Institutional aspects

4.2 Current banking laws, their supplementary regulations, and the supervisory policies and procedures of BACEN and BNDES provide an appropriate framework for regulating the performance of financial agents and safeguarding their solvency, stability, and liquidity. In addition, BNDES: (i) has demonstrated, through this analysis and experiences with previous programs, that it performs its duties responsibly and competently; (ii) has the experience, administrative and operational capacity, and qualified personnel to execute the proposed program; (iii) has the only IFI network in the country of sufficient quality and scope to ensure a broad distribution of the operation's resources across regions and sectors; and (iv) has the appropriate evaluation and oversight procedures, standards, and capacity to ensure the satisfactory operational management of a program of this size.

3. Economic and financial aspects

4.3 As has been true of previous programs, the economic viability of the CCLIP line and the program stems from the nature of these initiatives. Since the basic financial features of previous programs will be maintained and the IFIs will serve as incentive-compatible mechanisms for selecting the most viable companies, the impact of the projects they choose (assuming the economy's structural variables remain constant) will be determined by market conditions. The IFIs will choose the best firms and, as these enterprises repay the credits (with suitably low delinquency rates), market mechanisms will ensure that the best projects are selected. Viewed in this light, the impact indicators can only be regarded as *a priori* estimates.

4.4 The financial viability of the CCLIP line and the program will be determined by interest rates, the maintenance of the value of the credit to be provided, and the ready availability of the local counterpart funds. The subloan finance charges will enable BNDES and the IFIs to cover their financial costs and administrative expenses, realize a reasonable profit, and offset their credit risk. The borrower will

assume the exchange-rate risk associated with this credit operation by repositioning its loan portfolio in order to keep its currency mix in balance without altering the organization's overall risk profile. The local counterpart funds will be composed of the contributions mentioned in paragraph 2.14.

4.5 In sum, in order to become more competitive, the Brazilian economy needs to deepen its financial activities in various areas and boost their efficiency, particularly with regard to the availability of medium- and long-term financing for the modernization of MSMEs, which play an important role in the country's production apparatus. To that end, the CCLIP line and the program will: (i) promote the expansion of medium- and long-term financing to cover private-sector activities conducted by these enterprises; and (ii) indirectly (by increasing the supply of financing available under suitable terms and conditions) help deepen medium- and long-term credit markets (particularly for small and medium-sized entrepreneurs), thereby contributing to the consolidation of the country's economic base and the expansion of its domestic market.

B. Risks

4.6 The success of the proposed CCLIP line and program will hinge upon the continued existence of a macroeconomic and financial framework that is conducive to private investment. Relevant considerations in this regard include: (i) although the various indicators point to a recovery in economic activity (Link 1), this reactivation is subject to the risks inherent in countries that finance their accounts via a high external savings rate and where local investors are periodically influenced by a lack of credibility; and (ii) the risk that imbalances will arise in the financial system is now quite small, given the system's consolidation and the strengthening of regulatory and oversight mechanisms.

4.7 In addition, the structure of the CCLIP line and the program will mitigate, insofar as possible, the macrofinancial risks (paragraph 2.10) by acting as a catalyst for sound practices. This catalytic effect will be transmitted via the demands that BNDES will make of the IFIs concerning the use of rigorous screening and portfolio monitoring mechanisms. Past experience with BNDES attests to its efficient execution of these types of programs and its achievement of a high degree of capillarity in its credit operations, together with delinquency rates that are consistently below the average for loan portfolios in the banking system as a whole.

C. Poverty-targeting and social sector classification

4.8 Although the productive investments to be financed by the CCLIP programs included in this credit line will create new jobs in a business segment that primarily employs people from lower-income groups, thereby having a positive impact in these sectors, these programs are not regarded as a poverty-targeted operation.