

MULTILATERAL INVESTMENT FUND PROJECT ABSTRACT

EL SALVADOR

I. BASIC PROJECT DATA

Country:	El Salvador		
Program Name/Number:	Support for Fedecredito second-tier microfinance institution (ES-M1015)		
Team Leader/Members:	Valentina Sequi (MIF/INV), team leader; Takatoshi Kamezawa (MIF/INV); Antonio Gaspar (MIF/DEU); Guillermo Villacorta (COF/CES); Javier Diaz (LEG).		
Date of Request:	August 2006		
Beneficiaries:	Salvadorian micro enterprises through credit unions and worker banks.		
Executing Agency:	Federación de Cajas de Crédito y de Bancos de los Trabajadores, Sociedad Cooperativa de R. L.		
MIF Classification	SMF/MCRO		
Financing Plan:	<i>Loan:</i>		
	MIF (IIIB)	US\$	3,000,000
	Taiwan-ICDF Fund ¹	US\$	3,000,000
	<i>Technical Assistance:</i>		
	MIF (IIIA)	US\$	330,000
	Fedecredito	US\$	300,000
	Taiwan-ICDF Fund	US\$	30,000
	Total	US\$	6,660,000
Tentative Dates:	CESI: September 2006 Donors: November 2006		

II. BACKGROUND AND PROBLEM STATEMENT

A. Microenterprises in El Salvador

- 2.1 A comprehensive study carried out in 2004 by the El Salvador National Commission for Micro and Small Enterprises (CONAMYPE), estimated that the country has approximately 500,000 microenterprises employing a permanent workforce of over 1 million people, the equivalent of 40% of the country's active population.
- 2.2 Despite the importance of microenterprises in the country's business make-up, the availability of microfinance is still limited relative to potential demand. Of the microenterprises surveyed by CONAMYPE, just 28% reported having received financing in the previous 12 months. Of those who did, only slightly more than half (54.5%) had received loans from financial institutions such as commercial banks², NGOs, communal banks and cooperatives. The remaining group (45.5%) depended on family members, providers, money-lenders and remittances for their financing.

¹ Funds invested "pari-passu" with MIF under the Agreement between the Inter-American Development Bank and the International Cooperation and Development Fund of Taipei, China, to establish a Specialized Financial Intermediary Development Fund. Agreement signed on March 27, 2006.

² Including Financiera Calpiá, now a regulated bank, under the name of Banco Procredit..

- 2.3 The problem of lack of microfinance is especially acute in El Salvador's rural areas. Indeed, 80% of the microfinance lending in El Salvador is concentrated in just 50 municipalities, while certain well-served urban areas are already reaching saturation. Rural markets are considered too expensive to serve and too risky for most regulated institutions. During 2005, the government launched the "Tu Crédito" Program as part of Plan *Oportunidades* to focus on the most economically and socially disadvantaged groups in the country's poorest municipalities. One of its priority areas is to increase the provision of microfinance services, providing 100,000 new credits by 2009. In 2005, the government commissioned a *Poverty Map* to determine the location and characteristics of extreme poverty in the country which is being used as an input into this process.
- 2.4 Micro and small enterprises in El Salvador also continue to face disproportionately high interest rates compared to larger-sized companies. According to a study conducted by the Fundación Salvadoreña para el Desarrollo Económico y Social (FUSADES) in 2003, microenterprises have an average cost of capital of over 30%, which is more than twice the cost of capital for small companies (12-14%) and seven times the rates charged to large companies (4-6%).

B. Microfinance Institutions in El Salvador

- 2.5 The leader in the Salvadorian microfinance industry is Banco Procredit (former Financiera Calpiá), with a loan portfolio of US\$ 101 million and 70,000 borrowers at the end of 2005. The realization that microfinance is a profitable and highly established market has encouraged the downscaling of traditional banking institutions. Banks that have moved into the microfinance market include Banco Agrícola, Banco Salvadoreño, Banco Hipotecario and Banco Uno.
- 2.6 In addition to regulated banks, the microfinance industry in El Salvador is made up of 7 non-bank regulated institutions including two cooperatives, four workers' banks, and the Federación de Cajas de Crédito y de Bancos de los Trabajadores Sociedad Cooperativa de Responsabilidad Limitada de C.V. (*Fedecredito*), a second-tier financial institution. A large number of unregulated financial institutions round out the microfinance market, including cooperatives, credit unions, the Federation of Savings and Loan Cooperatives of El Salvador (FEDECACES), and NGOs. Apoyo Integral, ACCION's partner in El Salvador, is the largest of these unregulated microfinance institutions (MFIs), with a portfolio of US\$17 million for 21,000 clients as of December 2005.
- 2.7 According to CONAMYPE, the demand for credit among Salvadorian micro and small enterprises (MSEs) increased by 67% between 1999 and 2003 but the supply of financing has not kept pace.

C. Program Rationale and Additionality

- 2.8 Among the most important providers of financial services to the microenterprise segment are the member institutions of Fedecredito, a second-tier institution formed in 1943 to provide liquidity and non-financial services to its first-tier members including 7 worker banks and 48 credit unions³. Together, Fedecredito's member institutions have a loan portfolio approximately three times the size of El Salvador's biggest microfinance institution and have approximately twice as many microenterprise clients. Fedecredito's members are located throughout the country in 91 branches, giving Fedecredito the

³ Both *Credit unions* and *Worker banks* are cooperatives that take deposits from their members and provide financial services to both members and the general public.

- largest network of MFIs in El Salvador. Fedecredito's partner institutions have a total of 481,229 members, who were the ultimate beneficiaries of Fedecredito's loans.
- 2.9 In 2001, the MIF approved a technical assistance program for Fedecredito aimed at modernization and institutional strengthening (ATN/ME-7359-ES). The project recognized Fedecredito as one of the most important promoters of microfinance in the country given its broad geographic coverage, its ability to reach the lowest income segments, and its role as provider of both financial and non-financial services to support its member institutions.
 - 2.10 The first MIF project tackled the following specific areas: (1) Organizational development; (2) Financial risk management; (3) Training programs to support member institutions; (4) Internal control and audit system (5) Development of a standard communication and information system throughout the member institutions. The project is in its final stages and has been performing in a satisfactory way (see Annex I for PPMR). This project has already had a positive impact on the Fedecredito system as evidenced by the strong growth in the loan portfolios of Fedecredito's member institutions, which grew over 20% annually in the past 4 years.
 - 2.11 This new project intends to build-upon the progress that Fedecredito had made in the last few years, especially recognizing the robust financial management processes it has put in place and the improvement in the training programs it offers to its members. MIF's support will be provided through a combination of a loan for on-lending and an associated technical assistance component aimed primarily at improving Fedecredito's ability to serve the poorest segments of the country's population, especially in the rural areas. The technical assistance component will be carefully designed to ensure complementarity and prevent duplication with the MIF project that Fedecredito is currently winding up.
 - 2.12 The MIF's participation in the project is consistent with its mission of expanding access to financial services to MSEs. By choosing to support a second tier institution, the MIF's intervention can be deployed through a large number of small intermediary institutions thereby maximizing the impact on the country's microenterprises.
 - 2.13 The MIF has financed a number of highly successful projects in the Salvadorian microfinance market in the last several years. In June 2006, the MIF obtained donors' approval to provide a technical assistance to Banco Uno (MIF/AT-743) to downscale its operations into the microfinance and small business market. In 2004, the MIF provided a renewable line of credit to Banco ProCredit to expand its lending to small and microenterprises (MIF/AT-163). MIF has also played a role in the formalization of NGO AMPES which became Financiera Calpia S.A. through an equity operation (MIF/AT-6), as well as AMC Savings and Loan Cooperative (MIF/AT-537) and Apoyo Integral S.A. (MIF/AT-538). MIF is shareholder in Apoyo Integral S.A. through the Gateway Fund, both with no-reimbursable technical cooperation.

III. PROGRAM OBJECTIVES AND DESCRIPTION

A. Objectives

- 3.1 The main objective of this project is to deepen the total provision of microfinance in El Salvador by supporting a second tier institution with broad outreach. This deepening process will improve the access of lower-income households to financial services,

- thereby furthering the level of financial democracy in the country and contributing to enhance the incomes and living standards of the population at the bottom of the pyramid.
- 3.2 The specific objectives of the project are to: (i) provide reimbursable financing to enable Fedecredito to expand its lending operations in support of its first tier MFI members; (ii) a non-reimbursable technical assistance aimed primarily at improving Fedecredito's ability to serve the poorest segments of the country's population, especially in rural areas.

B. Description

- 3.3 The project will implement the following two components:

Component I. The MIF will provide a USD\$6 million loan at market interest rates of which will be evenly divided between the MIF and the Taiwan-ICDF Fund. The overall availability of the loan will be no more than six years. The loan will enable Fedecredito's MFI members to make 2,500 new loans, with an average loan size average of US\$2,400.

Component II. A technical assistance grant will be made to support Fedecredito's entry into new market niches specifically targeting the poorest segments of the population. Fedecredito intends to use the government's *Poverty Map* exercise as a basis upon which to extend its reach to the poorest communities as well as those that are currently least served by MFIs. Specific components are likely to include consulting studies aimed at: (1) identifying geographical and demographic markets least served by microfinance and developing a plan to improve Fedecredito's outreach there; (2) defining and designing new financial products aimed at serving these new markets; (3) developing a marketing plan to build awareness of new microfinance products and services; (4) providing institutional strengthening services to those first tier MFIs that are specifically reaching out to the underserved segments.

A small portion of the technical assistance may also be used to improve Fedecredito's internal processes, such as: (1) implementing a human resource policy based on variable salary structures and incentive programs; and (2) streamlining Fedecredito's internal loan approval processes. During the due-diligence, the team will meet with the firm⁴ that has been providing the institutional strengthening advisory services to Fedecredito under the first MIF-financed project. The team will gain a thorough understanding of the scope and impact of the ongoing project in order to design a new technical assistance project that builds upon the work that has been done without duplicating the effort.

IV. COST AND FINANCING

- 4.1 The total cost of the project is estimated to be US\$6,660,000. The MIF contribution includes an up to US\$6,000,000 loan and a US\$360,000 technical assistance grant to strengthen Fedecredito's ability to reach out to the poorest segment of the population. The loan component will be divided *pari-passu* with the Taiwan-ICDF Fund⁵. US\$30,000 of the MIF's technical assistance contribution will be used to cover legal, supervision and evaluation costs. This amount will be matched *pari-passu* by the Taiwan-ICDF Fund. Fedecredito will provide counterpart funds of US\$300,000.

⁴ Confederación Española de Cajas de Ahorro, CECA

⁵ According to the agreement signed with the International Cooperation and Development Fund of Taipei, China, the MIF and the Taiwan-ICDF Fund must invest with the same terms and conditions.

V. EXECUTING AGENCY AND EXECUTION STRUCTURE

- 5.1 Fedecredito is a limited liability cooperative regulated by the Non-Bank Regulated Financial Institutions Law and supervised by the *Superintendencia del Sistema Financiero*. Its shareholders are the member institutions. Its mission is to contribute to the development of a strong system of MFIs that is dedicated to providing financial services in both rural and urban areas, targeting (i) households at the lower end of the income scale, and (ii) micro, small and medium enterprises in all economic sectors.
- 5.2 Fedecredito offers its members medium and long-term loans for onlending to microentrepreneurs, for low-income housing and for small consumption. Fedecredito assigns credit lines to its members that average US\$2.55 million. The risk policy dictates that credit lines can be as high as 5 times the institutions' equity for A-rated institutions, 4.5 times for B-rated institutions and 4 times for C-rated institutions. On average, Fedecredito's loans account for 53% of the first tier MFIs' total liabilities. Active rates charged by Fedecredito range from 8.75% to 10.35% for A-rated institutions and from 9.25% to 10.85% for C-rated MFIs (depending on use of funds and term). Almost all of Fedecredito's loans are backed by the member institutions' own loan portfolios.
- 5.3 In addition to providing liquidity to its member cooperatives, Fedecredito carries out other important functions. One of the main tasks is to carry out the supervision and control over non-regulated members⁶, a task delegated to it by the Financial System Superintendency. Fedecredito helps ensure their sound management and operations by issuing norms for self-regulation. All of Fedecredito's members have an internal auditor who issues reports for its Board with copies sent to Fedecredito. Fedecredito, furthermore, has responsibility over the reserves that each deposit-taking institution is required to hold.⁷ Fedecredito also provides support and training services and generally carries out coordination of its member cooperatives.
- 5.4 As of December 31, 2005, Fedecredito's outstanding loan balance with its member institutions was US\$106 million, having grown at a healthy rate of 11.3% over the past 4 years. Significantly, Fedecredito has no past-due loans and has not had any for several years. Its capital adequacy ratio was 24.2%, which indicates a healthy level of solvency if it is compared to the prudential minimum requirement of 15%. This level of solvency would allow Fedecredito to safely increase its assets by US\$70 million. A low Debt to Equity ratio of 2.85 times. Fedecredito has had good levels of profitability with a Return on Equity of 6.8% and a Return on Assets of 1.8% in 2005.

Table 1: Key Financial Performance Indicators of Fedecredito

(\$ Million)	2002	2003	2004	2005	Growth
Loan Portfolio	77.1	86.5	97.7	106.2	11.3%
Net Income	0.94	0.96	1.07	1.87	26.1%
Equity	20.6	23.1	26.1	29.8	13.1%

- 5.5 Fedecredito's funding structure is not well diversified. The Banco Multisectorial de Inversiones (BMI) accounts for 53% of Fedecredito's funding, commercial banks account for another 38%, and, to a lesser extent, the Central American Bank for Economic Integration provides 6% and the National Fund for Low Income Housing provides 2%. The German bank KfW recently obtained an approval of a US\$10 million loan to

⁶ All but four worker banks are unregulated. However, 27 Credit unions and 3 Worker Banks are authorized to capture funds from their members. The regulated worker banks are authorized to capture deposits from the public.

⁷ Regulated institutions must constitute a legal reserve with 20% of annual net income up to 50% of paid-in capital.

- Fedecredito, of which US\$4 million have already been disbursed. Fedecredito approached MIF to further diversify its funding sources, and reduce its reliance on BMI.
- 5.6 Fedecredito's member institutions have increased their portfolios at an average annual rate of 21.2% since 2002, reaching a total portfolio of US\$340 million as of year-end 2005. Fedecredito members had 140,000 loans in their combined portfolios as of December 2005, with an average loan size of US\$2,400. Approximately 37% of the loans went towards financing microenterprises, 39% to small consumer loans, and 24% for low-income housing loans. Furthermore, the portfolio was well distributed with approximately half the portfolio in rural areas and half in urban areas. Finally, 52% of the loans made by Fedecredito's members are to women.
 - 5.7 Fedecredito's members, as a whole, showed relatively healthy portfolio quality indicators: past due loans over 90 days were approximately 4.1% and past due loans between 30 and 90 days were approximately 9.1% at year end 2005. These figures are comparable to other small non-regulated cooperatives in the region.
 - 5.8 Fedecredito recently carried out training courses aimed at increasing the level of deposits held by its member institutions. The initial results are very positive since deposits increased by 30.5% to US\$74 million between 2004 and 2005.

Table 2: Key Financial Performance Indicators of Fedecredito Member Institutions

(\$ Million)	2002	2003	2004	2005	Growth
Loan Portfolio	191.4	233.7	287.0	340.4	21.2%
Net Income	8.1	9.4	11.5	11.8	13.4%
Equity	61.3	71.4	82.2	94.5	15.5%

VI. MAJOR ISSUES

- 6.1 The main issue in the due diligence will be to verify the scope and specific results of the MIF's original institutional strengthening project (ATN/ME-7359-ES), in order to design appropriate new technical assistance initiatives. Most of the new technical assistance will be used to help Fedecredito enter interesting new market niches – an issue which was not addressed in the first project. A small portion of new technical assistance funds may be used for further institutional strengthening activities as long as they directly complement the MIF's proposed loan to Fedecredito. The project team will negotiate the terms and conditions of the MIF loan, and review under what terms and conditions Fedecredito has obtained funding from commercial banks and donor agencies.

VII. ENVIRONMENT AND SOCIAL ISSUES

- 7.1 Fedecredito's policy is to contractually bind all its member institutions to enforce national environmental regulations and any additional norms issued by Fedecredito regarding environmental protection. These terms are included in the financing contract between Fedecredito and each member institution and spell out that it is the member institution's responsibility to verify that the final beneficiaries of their loans are complying with national environmental laws and taking appropriate actions to mitigate potentially negative effects on the environment. If the member institutions fail to supervise the environmental impacts of their lending operations, Fedecredito's loan could be suspended and/or revoked. Fedecredito's member institutions will also be required to comply with the guidelines for IDB Microenterprise operations that include: the requirement to establish environmental policies and procedures, to enforce the IDB Prohibited Activities list and to determine appropriate risk mitigation measures depending on the Risk Classification of each individual loan.