DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

EL SALVADOR

LIQUIDITY PROGRAM FOR GROWTH SUSTAINABILITY

(ES-L1029)

LOAN PROPOSAL

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ABBREVIATIONS

BCR	Banco Central de Reserva de El Salvador [Central Reserve Bank of El Salvador]
FDI	Foreign direct investment
GDP	Gross domestic product
NFPS	Nonfinancial public sector
LPGS	Liquidity Program for Growth Sustainability
SSF	Superintendencia del Sistema Financiero [Superintendency of the Financial System]

PROJECT SUMMARY

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Financial Terms and Conditions				
Borrower and executing agency: Banco Central de Reserva of El Salvador [Central Reserve Bank of El Salvador] (BCR)			Amortization period:	5 years
			Grace period:	3 years
			Disbursement period:	12 months[1]
Source	**Amount (US$ million)**		Interest rate:	6-month US$ LIBOR plus 400 basis points
IDB (Ordinary Capital)	400		Initial commitment fee:	1.0%
Local	0		Credit fee:	0.75%
Cofinancing	0			
Total	400		Currency:	U.S. dollar from the Single Currency Facility

Project at a glance

Project objective/description:
The goal of the Liquidity Program for Growth Sustainability (LPGS) in El Salvador is to facilitate access by the private productive sector to financial resources to help sustain the country's economic growth. Its purpose is to provide the Central Reserve Bank (BCR) with funding to acquire short-term loan portfolio receivables for working capital and trade financing, and to provide financial institutions with liquidity to grant new short-term loans for working capital and trade financing in accordance with program requirements.

Special contractual conditions:
As conditions precedent to the first disbursement (i) the Credit Regulations for the program must be approved; and (ii) an agreement must be signed between the BCR and the BMI for the purposes expressed in paragraph 3.2.

Other special conditions are (i) the environmental management mechanism (paragraph 2.2); IFI eligibility criteria (paragraph 3.4); eligibility criteria for loans (paragraph 3.8); utilization of program resources (paragraph 3.10); and reports and monitoring (paragraph 3.11).

Exceptions to Bank policies:
To complement the Central Bank's asset and liability management strategy, it is requested that the option of charging LIBOR on outstanding balances be included in accordance with document FN-507-4.

Special considerations. Revolving Fund: The Bank will disburse the proceeds of the financing to the BCR through a revolving fund for 20% of the Bank financing (paragraph 3.3). This amount is justified since the initial portfolio purchase will be sizeable, and IFIs can finance new operations within the specified period. Eligible loans will be loans disbursed up to six months after signature of the portfolio purchase agreement with the IFI. In the case of the initial portfolio purchase, however, eligible loans may include loans disbursed up to 12 months prior to signature of the purchase agreement. (3.8).

Project consistent with country strategy: Yes [ ] No [ ]
Project qualifies as: SEQ [ ] PTI [ ] Sector [ ] Geographic [ ] Headcount [ ]
Verified by CESI on: 26 November 2008
Procurement: N/A

[*] The credit fee and inspection and supervision fee will be established periodically by the Board of Executive Directors as part of its review of the Bank's lending charges, in accordance with the applicable provisions of the Bank's policy on lending rate methodology for Ordinary Capital loans. In no case will the credit fee exceed 0.75% or the inspection and supervision fee exceed, in a given six-month period, the amount that would result from applying 1% to the loan amount divided by the number of six-month periods included in the original disbursement period.

[1] This period may be extended automatically to 18 months if during the first 12 months 50% of the financing has been disbursed.

I. DESCRIPTION AND RESULTS MONITORING

A. Reference framework, problem addressed, and rationale

1.1 In the context of the current global financial crisis, the IDB has launched the Liquidity Program for Growth Sustainability (LPGS) to support the Latin American and Caribbean countries in their efforts to address this challenge and maintain economic growth. The goal of the LPGS is to maintain the flow of credit to the real economy, temporarily offsetting to some extent shortfalls in normal credit flows to the region resulting from the global financial crisis. The aim is to support domestic production and facilitate trade and thereby protect employment from a temporary exogenous shock, while strengthening macroeconomic conditions in the region.

1.2 The program approved by the Bank would offer financing in a maximum amount of US$500 million per country to regulated financial institutions with reduced access to foreign credit lines and interbank credit, so that they in turn can provide trade credit lines to exporters and domestic producers and maintain access by private firms to working capital.

1. Recent macroeconomic performance

1.3 The Salvadoran economy has recovered in the last two years, with growth of 4.7% in 2007, on the strength of the reforms introduced in recent years and the entry into force of CAFTA-DR. As a result of the global crisis, however, the country's GDP growth is likely to slow to 3% in 2008 and 2.5% in 2009. The expected slow down would be due to falling exports, a drop in remittances, leading to lower domestic consumption, and a contraction in private sector credit, and thus less investment. In the medium term, reduced capital flows to the region may make it more difficult to achieve sustained growth if the crisis becomes prolonged and the recession in the United States and/or Europe continues.

1.4 For the external sector, the 2007 current account deficit was 5.5% of GDP, owing to the negative effects of the food and oil price shock and declining maquila exports. The trade deficit rose to 20% of GDP, and was financed primarily by family remittances, which represented 18% of GDP in 2007. Despite this important economic flow, the current account balance was negative and was financed in part by foreign direct investment, which was higher than usual owing to the acquisition of three major commercial banks. For 2008, the current account deficit is expected to rise to approximately 6.3% as a result of volatile oil prices, despite substantial export growth. Although such deficits are not as large as those of other countries in the region, they are an underlying weakness, especially in the context of a less favorable international environment.

1.5 In recent years, the Salvadoran government has pursued a relatively strict fiscal policy. In 2007, performance in that area was very good, and the nonfinancial public sector (NFPS) primary balance-to-GDP ratio improved from a deficit of 0.5% of GDP in 2006 to a surplus of 0.6% in 2007. The primary balance-to-GDP ratio is likely to deteriorate for 2008, reflecting higher subsidy costs owing to trends in oil prices in the first half of the year, selective wage increases, and an expansion

of free education and the school meal program. The wider deficit in October/2008 has meant the government must draw down deposits in the financial system to meet its commitments and assume new domestic borrowing. Temporary investment certificates were issued to finance pension expenditure, and short-term debt (LETES) certificates were also issued. Government financing requirements for 2008 are expected to be some 6% of GDP, with 2.5% being financed through LETES.

1.6 Factoring in all new trust funds and liabilities inherited from the former social security system brought the country's NFPS debt to 43% of GDP in 2007. Given the medium term outlook for economic growth together with tight liquidity resulting from higher interest rates, NFPS debt is expected to remain around 44% of GDP despite the medium-term fiscal consolidation envisaged and assuming that the government agrees to the loans proposed by multilateral institutions.

2. Effects of the financial crisis and global economic slowdown

1.7 Four major channels of transmission of the financial crisis may be identified: trade, terms of trade, remittances, and capital flows. As regards the trade channel, El Salvador is a highly open country, with exports and imports accounting for 60% of GDP. Although its exports are more highly diversified than those of its neighbors in terms of destination, it is also extremely vulnerable. In the first nine months of 2008, 53% of exports, including maquila production, were shipped to the United States, and another 33% to neighboring countries that are likely to be affected by the slowdown in the United States. In the coming months, the slowdown in the United States and Europe is expected to have a negative impact on Salvadoran exports, especially given the forecasts of a soft Christmas season and a continuing slowdown into 2009. On the price side, declining world oil prices are expected to have a favorable impact on external accounts, since El Salvador's oil imports represent nearly 7% of GDP and accounted for 23% of all imports (excluding maquila production) in the first nine months of 2008.

1.8 As to the terms of trade, unlike other countries in the region, Salvador is unlikely to devalue its currency to enhance export competitiveness. Worse still, depreciation in neighboring countries (including Mexico) means a loss of competitiveness. The real exchange rate has been gradually appreciating, at an annual rate of 0.6% by end September. However, this trend may reverse. The recent decline in basic grain prices may lead to a reversal in the deteriorating terms of trade noted in recent years. This would mitigate inflationary pressures, which in August had reached an annual rate of 9.9%. November's 5.3% inflation rate points to price deflation. By year-end 2008, inflation is expected to decline still further and, in the medium term, to return to historical levels of around 4%.

1.9 Remittances have been rising more slowly since 2007 with incipient signs of slowing in the United States. Annual growth in remittances declined from an average of 14% in 2000-2006 to a cumulative rate of 4.1% in October 2008. The October decline was pronounced, with remittances down by 6% from the same

period the year before. In the months ahead, flows are expected to slow as economic activity in the United States contracts still further.

1.10 In recent years, despite inflows of remittances, the current account balance has been negative. Therefore, the balance of payments has been financed by foreign capital flows. In 2007, the current account deficit was financed primarily by foreign direct investment (FDI) resulting from the sale of the country's three largest banks. For 2008, a current account deficit of some 6.3% is expected, financed in part by FDI inflows equivalent to 2% of GDP. In addition, the events of recent months have had a singularly negative impact on the Salvadoran bond market. Salvadoran government bonds, although still receiving a positive rating, were recently downgraded to Baa3 (investment grade) by Moody's and to BB+ (one notch below investment grade) by both Standard & Poor's and Fitch. In mid-September 2008, Standard & Poor's downgraded its outlook from stable to negative, citing increasing risks from an uncertain political climate, with rising inflation and a weaker fiscal policy outlook. In mid-October, Fitch downgraded its outlook from stable to negative as well. On 5 December 2008, the spreads in the EMBI for El Salvador were 907 basis points, a 446% increase in one year.

3. Financial system: Institutional context and current situation

1.11 El Salvador's financial system is sound and well capitalized, owing to a series of regulatory and oversight reforms implemented in recent years and to the sector's increasingly stronger competitive structure.

1.12 The solvency of the system is adequate. At present the equity to risk-weighted asset ratio is over 14%, a figure that has been rising steadily since the beginning of the decade. Also, the at-risk portfolio ratio is extremely low (2.8% in September 2008), with more than enough provisions to cover it (over 100% of the portfolio outstanding at that date). The system's profitability ratios are positive (return on assets: 1.3% and return on equity: 12%), and some measures of liquidity, such as the current ratio is favorable, around 110%.

1.13 Despite the sturdier financial system, there are elements that make it vulnerable to the current global financial situation, and prudential measures are called for. The global economic slowdown, primarily in the United States, falling commodity prices, and higher financing costs have led to significant adjustments in IFI balance sheets. In 2007, some major international banks entered the Salvadoran market. During the year, the financial system's ownership structure changed with the sale of the leading local banks to international banks. Eleven of the system's 13 banks now have foreign ownership with the remainder government owned. This means that 96% of banking system is in foreign hands. Although these recent changes have enabled the system to offer more services and financial products, it has also increased the Salvadoran financial system's exposure to events in global capital markets.

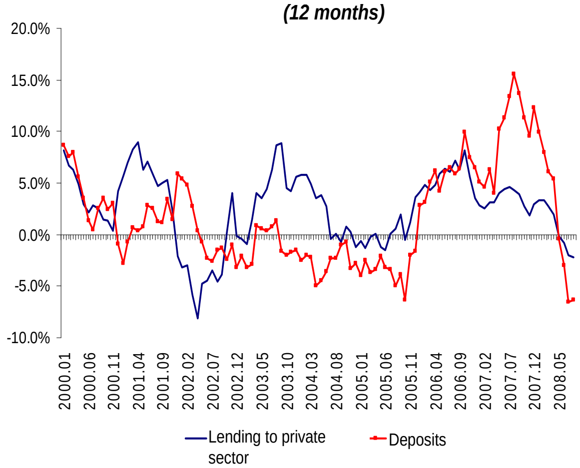
1.14 Private sector lending and banking deposits have declined in real terms. According to the IMF, in September 2008, bank lending to the private sector was 2.2% lower

than in September 2007. Similarly, deposits (current account and time deposits) declined by 6.4% (Figure 1). These changes are due to a contraction in the domestic economy and a sharp correction in world financial markets and the global real economy.

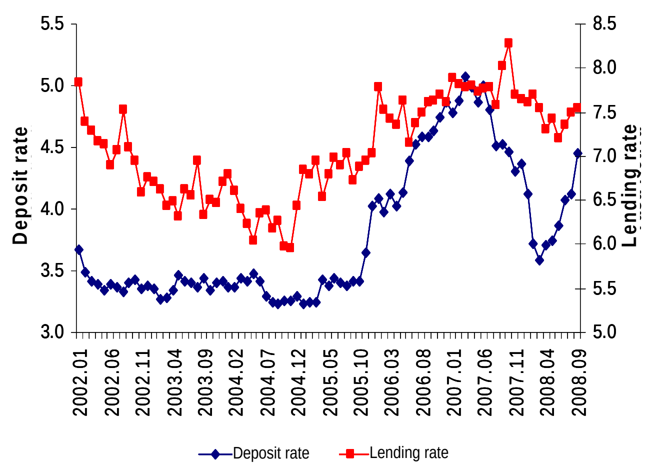
1.15 The contraction in domestic deposits and lending has been occurring in an environment of rising deposit and lending rates. In early 2008, the average deposit rate was around 3.6%, and by September 2008 had risen to nearly 4.5% (Graph 2). To cushion the impact on portfolio quality, financial intermediaries have refrained from passing the full effect of the increase on to borrowers, and have instead modified loan contracts (for instance, extending their term). Although such action may further exacerbate risk in the long term, for the time being portfolio quality has been spared the full impact of the adjustment.

1.16 Nonetheless, a slight deterioration in bank asset quality is now evident. Although the loan default rate remains relatively low and loan provisions are relatively high, we are now beginning to witness an uptick in the default rate and a steady downtrend in loan provisioning (Graph 3).

Graph 1: Real growth rate (lending and deposits)
(12 months)

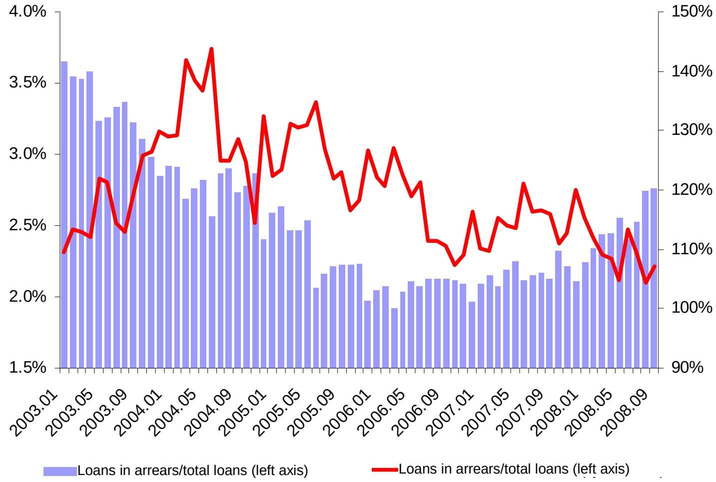


Graph 2: Interest rates



Source: Graphs 1 and 2 show own calculations based on IMF/IFS
Note: The series is deflated based on the consumer price index and calculations of inter-annual growth rates

Graph 3: Loan default rate and loss provisioning



Source: Own calculations based on information from the Superintendencia Bancaria de El Salvador [Bank Superintendency of El Salvador]

1.17 A further rise in the cost of global liquidity or stagnation in financial flows to El Salvador could exacerbate the present trend and put undesirable pressure on financial system stability. One of the concerns confronting financial system participants is that the global crisis will have repercussions for the banks' credit lines with foreign entities. El Salvador is heavily dependent on these sources of liquidity. According to the Bank for International Settlements (BIS), nearly 10% of the system's total liabilities are obligations with its reporting banks (US$1.191 billion). A slowdown in such flows could lead to a reduction in the liquidity available to banks and in credit flows to the real sector, accentuating the trends in the graphs above. In the context of a dollarized economy where the central bank does not have the authority to act as lender of last resort, this concern justifies the search for alternative sources of resources, such as those proposed in the present program, in order to prevent costly disruptions to financial intermediaries.

4. The problem to be addressed

1.18 In the current global crisis, the Salvadoran economy faces major challenges to ensure a sufficient supply of credit to the productive sector. The private sector is not only experiencing a widespread shutdown of global financial markets, but also, in an internationalized commercial banking system without a lender of last resort, has less access to domestic credit. Accordingly, the challenge for the authorities is to find alternative sources of financing to enable the productive sector to adjust gradually to the new global economic realities. This new facility being proposed by the IDB to member countries is an instrument that effectively seeks to address these needs.

5. Rationale for the Bank's support

1.19 *From a macroeconomic perspective.* A scenario of reduced capital flows, together with the likelihood of declining exports and remittances, would put additional pressure on international reserves and lead to less available liquidity, higher interest rates, and a contraction in economic activity in general. In November 2008, net international reserves were sufficient to cover just 2.9 months of imports.

1.20 *Productive sector financing requirements.* Although the financial system is sound, there exist major risks, associated with a possible reduction in funding to the system, that the slowdown will further deepen the weakness evident in the real economy. Accordingly, mechanisms that ensure access to system liquidity and maintain lending in real terms must be employed.

6. Coordination with other multilateral financial institutions

1.21 The rationale for the Bank's support supplements the IMF analysis of the soundness of the country's financial system appearing in the Board's most recent Article IV report (November 2008). The IMF's evaluation letter is one of the electronic links. The project team is in ongoing contact with the IMF and with representatives of the World Bank, thus ensuring close coordination.

B. Objectives and sizing of the project

1.22 The purpose of the program is to facilitate access by the private productive sector to financial resources in order to help sustain national economic growth. The goal is to provide the Central Reserve Bank (BCR) with the liquidity to purchase short-term portfolio receivables for working capital and trade financing, thus providing the country's financial institutions with funds for new short-term loans for working capital and trade credits in accordance with program requirements.

1.23 The program will have a single component, in a maximum amount of US$395.9 million, which will provide short term financing to mitigate the impact of the global financial crisis. At the end of October 2008, the total commercial bank working capital and trade financing portfolio, maturing in less than two years, was approximately US$1,770 million, or 19.5% of the banking system portfolio. The proceeds of the financing (US$395.9 million) represents 4.36% of the total banking system portfolio and nearly 22.5% of the target portfolio to be financed. The scaling of the program is based on the quantification of effective demand by the BCR, with input from all IFIs expressing interest in participating in the program.

C. Outcome indicators

1.24 The program will have a system for monitoring and evaluating the use of the IDB financing. To that end, the BCR (see paragraphs 3.1 and 3.6) will compile detailed information in the results matrix and information in the Credit Regulations, with the following indicators: (i) ratio of new eligible loans being financed under the program to effective amount of foreign credit lines; (ii) ratio of eligible loans to authorized (or outstanding) external credit lines; (iii) trends in working capital and trade financing portfolio with neighboring countries; (iv) portfolio (amount and

number of loans) for each area (working capital and trade financing) by month; (v) amount and number of new operations by month and area; (vi) ratio of working capital loans and trade financing to total portfolio; and (vii) monitoring of banks by source of financing (deposits, borrowing, and equity).

II. FINANCING STRUCTURE AND MAIN RISKS

A. Program financing

2.1 The operation is being financed under the Liquidity Program for Growth Sustainability (LPGS), approved by the Bank's Board of Executive Directors in October 2008 (document GN-2493-2). The purpose of the LPGS is to facilitate access by the private productive sector to financial resources in order to help sustain economic growth in the countries of Latin American and the Caribbean. The proposed operation will provide resources to accommodate the short-term financing requirements (up to two years) of private-sector companies for trade financing and working capital through portfolio purchases by the BCR from eligible financial intermediaries.

Table 1: Cost table (in US$)

	Financing	Counterpart	Total
Financing	395.900.000	-	395.900.000
Audits	100.000	-	100.000
Credit fee	-	-	-
Initial commitment fee	4.000.000	-	4.000.000
Total	**400.000.000**	**-**	**400.000.000**

B. Risks and environmental safeguard

2.2 In accordance with document GN-2493-2 and Directive B.13 of the Environment and Safeguards Compliance Policy (OP-703), the present operation does not require an environmental classification. Under the LPGS, financial intermediaries will make short-term loans in limited amounts to the private sector exclusively for working capital and trade financing. Although the nature and impact of such operations cannot be known in advance, they must adhere to the regulations of environmental systems and legislation in effect in El Salvador. Under its mandate, the BCR is not required to verify each loan, and it is up to financial institutions and environmental agencies to apply the law. Given these constraints and the ex post nature of BCR portfolio acquisition, an environmental management mechanism has been designed for the present operation. The mechanism: (i) provides a negative list of activities or products that may not be financed; (ii) provides a conditional negative list of activities that would only be eligible upon presentation of an environmental impact study and/or specific licenses or permits according to local environmental legislation; (iii) stipulates, in framework agreements with IFIs, that violations of environmental legislation will cause accelerated repayment of the

loan, with the borrower being no longer eligible for program financing from participating IFIs; (iv) requires a sworn declaration by borrowers that they will not engage in any of the activities on the negative list and will adhere to their environmental obligations; and (v) specifies that, among other objectives, loans for measures to improve environmental impact control are eligible program loans. The Bank will review periodically the list of LPGS loans to verify that they conform to these requirements, and if necessary, to request additional information from the BCR or the program auditors.

C. Fiduciary risk

2.3 The operation has some exposure to fiduciary risk insofar as it is intended to provide liquidity for companies in the real sector through IFI portfolio purchases. The risk of poor selection in terms of loan portfolio quality is mitigated by the requirement that participating IFIs provide guarantees. Another potential fiduciary risk is the degree of concentration in the financial and real sectors, making it essential that related-party loans be closely monitored. To this end, a maximum amount by subloan and business group has been included as an eligibility criterion for loans to be purchased and granted out of the financing.

2.4 Another fiduciary risk is that a systemic crisis could mean that participating IFIs will be unable to honor the guarantees backing portfolios acquired by the BCR, in which case, the latter would be exposed to credit risk. Such an event could incur the risk of BCR decapitalization, which is important, given its modest capitalization (US$254.5 million in late September 2008, against liabilities of US$3,526 million and US$3,781 in assets). Such a risk would only materialize, however, if an IFI became insolvent and the portfolio sold to the BCR went into arrears. The line is double the amount of BCR's capital. It should be noted that although the BCR's equity and balance sheet are less than are typical for a country of similar size, this is due to dollarization of the economy, which means legal tender is not issued by the BCR and therefore it does not have any deposits or reserves. Also, as explained later, the program as designed seeks to avoid the BCR assuming lending or reinvestment risks (interest rate risk). The Superintendency of Financial Institutions will participate in the program, and monitor the situation of IFIs and report any problems to the BCR.

2.5 **The Bank's exposure with El Salvador**. With the approval of the present operation and a fast-disbursing loan now before the country's Legislature (1782/OC-ES), the Bank's current exposure with El Salvador will increase from 2.5% to 4.6% of its total portfolio. It is estimated that, with these operations, El Salvador's debt with the Bank will amount to 8.6% of GDP in 2009, equivalent to an average of 65% of its multilateral debt in 2008 and 2009. However, despite the new borrowing from the multilateral banks, the country's public external debt is expected to decline from 26.7% of GDP in 2007 to 25% of GDP in 2009. Total public debt is projected to remain around 44% of GDP, because one of the government's objectives in raising this new debt is to improve its debt profile, with longer repayment terms and better financial conditions.

2.6 **Financial risk.** The financial vehicle to be utilized has been designed to minimize financial risk to the Bank and the BCR. The Bank has the BCR's repayment commitment as well as the implicit guaranty of the nation, according to the BCR legal opinion based on Article 11 of the Monetary Integration Act. For its part, the BCR will acquire actual portfolio and receive the guarantee of the financial intermediary concerned for each portfolio purchase. The BCR would only be at risk of not recovering the loan in the event of the bankruptcy of the borrower (private company) and the financial intermediary.

2.7 **Political risk**. In the recent past, El Salvador's sovereign public debt management has been criticized by the opposition political parties. More recently, however, an agreement was reached between the government and the opposition on unanimous approval in the first reading before the Legislature, of an IDB policy-based loan in the amount of US$500 million, granted to the Republic of El Salvador. In this particular program, however, financing is being granted to the Central Reserve Bank of El Salvador, an independent institution with legal standing and capital of its own. It is felt that any political risk is mitigated by the fact that the end use of the resources is explicit and transparent, while the end beneficiaries are businesses in the private sector and the economy in terms of production and employment. Additionally, the authorities and financial institutions have announced the operation and information has been released by the Bank. Also, the Bank has held a number of meetings to ensure that the present administration and the opposition are aware of the program's scope and usefulness. LINK 1

2.8 **Exogenous risks**. The current global financial crisis and the worldwide economic slowdown pose many different inherent risks. One such risk is that the current situation could deteriorate, in which case economic growth in Central America, and particularly economic activity in El Salvador, would be up against still greater challenges than those currently being faced. The program has been designed to assuage some of these problems and has mitigated the risks identified. Nonetheless, certain risks persist that cannot be fully quantified, which could impact the program objectives. One such risk is the possibility of capital flight, which would be partly mitigated by close monitoring of the use of program resources. This effort would be accompanied by internal audits of each IFI, an external audit of the program, and the monitoring of the Superintendency of Financial Institutions.

III. IMPLEMENTATION AND MANAGEMENT PLAN

A. Summary of implementation arrangements

3.1 The Central Reserve Bank of El Salvador (BCR) will be the borrower and executing agency. The BCR is an autonomous technical public institution, of indefinite duration, with legal standing and its own equity (BCR-LOBCR Charter). Its social purpose is to promote the development of an efficient, competitive, and solvent financial system, ensuring the stability of the system, with sufficient liquidity, and to regulate the expansion of credit. To accomplish this aim, the BCR

is authorized to purchase from banks and other financial institutions in the regulated financial system loans and investments from their portfolios on terms and conditions specified by the BCR's board of directors (Art. 55 LOBCR). In pursuing this objective, the BCR may, in any capacity, enter into agreements with external lenders for all types of credit (Art. 55 LOBCR). The BCR legal opinion confirms the institution's capacity to enter into an agreement with the IDB on the terms and conditions specified for the program. Moreover, the BCR administers the liquidity reserves of banks and other financial institutions, monitors liquidity, and performs macroprudential analysis to evaluate the soundness of the Salvadoran financial system. The BCR is recognized for its technical capacity and the competence of its staff. In administering the use to which the resources are put and in preparing reports for the IDB, the BCR will be assisted by the BMI and the Superintendencia del Sistema Financiero [Superintendency of the Financial System] (SSF).

3.2 In accordance with the Bank's guarantees policy, the present operation will not require the express guarantee of the nation since the executing agency is a central bank with the financial capacity to act as borrower and would be able to comply, on its own, with all the obligations arising out of the program. Furthermore, in accordance with the BCR legal opinion, since 2001 the year in which the present Monetary Integration Act took effect, any obligations that the BCR is unable to honor, are assumed by the Salvadoran State (Monetary Integration Act, Art. 11). To permit the BCR to carry out the activities required for program implementation, the administrative units that will participate in the application of these guidelines are: the Office of the Manager of the Financial System, the Office of the Manager of Financial Operations, the Financial Development Department, the Securities and Payments Department, and the Legal Department The BCR will, in turn, be assisted by the BMI in executing the agreements on behalf of the BCR and performing analysis, verification, eligibility, monitoring, information generation, and other actions necessary for the proper execution of the program. These obligations will be expressed in any agreement entered into for this purpose. Signature of such an agreement will be a condition precedent to the first disbursement of the financing. Any acquisition from the portfolios of participating IFIs and monitoring of their financial condition will need to be reviewed by the SSF, in accordance with legislation in force and the provisions of the Credit Regulations. In implementing the program, the BCR will be guided by Credit Regulations to be approved by its board of directors. Approval of the Regulations will be a condition precedent to the first disbursement. Such Regulations are consistent with the BCR-IFI portfolio purchase guidelines issued by the BCR.

3.3 The Bank will make disbursements to the BCR through a revolving fund, which will amount to 20% of the financing. The amount is justified because the volume of the first portfolio purchase will be significant, so that the IFIs may finance the generation of new operations within the established timeframe.

a. Financial intermediary eligibility criteria

3.4 Financial intermediaries will need to meet the following eligibility criteria to participate in the program: (i) be SSF-authorized and -supervised financial institutions and not be subject to any restriction imposed by the financial authorities of El Salvador; (ii) comply with liquidity, solvency, profitability, and asset quality ratios and remain in a stable financial situation to be able to continue to grant loans to the real sector under the stipulated terms. These ratios will be monitored to verify that participating IFIs whose portfolios are being acquired by the BCR are financially sound and able to continue lending to the real sector on program terms and conditions. The SSF periodically calculates these ratios as part of its normal financial supervision. These ratios, which are described in the program's Credit Regulations, will include: (i) loans in arrears to total loans; (ii) liquid assets to total assets; (iii) loan loss provisions to total assets; and (iv) equity to total assets. The IFIs that meet the criteria for participation in the program will be selected on a first-come first-served basis.

b. Resource transfer mechanism

3.5 Program resources will be channeled to IFIs under a portfolio purchasing arrangement to be managed by the BCR. The latter will enter into an agreement with the BMI to assess the eligibility and monitor the performance of the portfolio purchase. The BCR will establish quotas for IFIs based on their participation in the market for business loans. Each IFI will sign a framework agreement formally acknowledging its willingness to participate in the program. The agreement will set out the terms and conditions, including a commitment to sell new eligible loans, pursuant to the eligibility criteria set out in the Credit Regulations. Such new loans would replace previous loans acquired by the BCR as they are paid off within the periods set out in the Credit Regulations. This requirement will permit the cost of the Bank financing to be transferred entirely to the participating IFIs, since the BCR is not intended to assume any reinvestment risk (interest rate risk). The framework agreement will also stipulate the uses to which funds transferred to the IFI through portfolio purchases may be put. Such uses will be limited to those of the present program.

3.6 The transactions with each IFI will be formally acknowledged in portfolio purchase agreements, to include the following conditions: (i) the obligation of the financial intermediary to compensate the Central Bank, through a guarantee, for any loss incurred as a result of the purchased loan; (ii) the obligation to satisfy environmental requirements; and (iii) penalties to be imposed for any diversion of funds for purposes other than those specified in the framework agreements. The portfolio purchase agreement will also specify that when a financial intermediary sells its eligible portfolio to the BCR, it undertakes to administer the overdue portfolio, carrying out the respective collection actions.

3.7 **Loan portfolio ratings**. IFI loan portfolios acquired by the BCR must have the highest credit rating (A1 or A2). In exceptional cases, loans with a B rating may be

acquired with the Bank's no objection in writing. Any portfolio purchase in an amount exceeding 2.5% of the IFI's capital fund may be carried out, provided the SSF has no objections.

3.8 **Loan eligibility criteria**. To be eligible for portfolio acquisition, a loan must: (a) be a short-term loan for trade financing or working capital; (b) mature within the original period of no more than two years and have been disbursed within the previous six months, reckoned in each case from the date of the portfolio purchase agreement with the IFI, except for the initial acquisition, which may include loans for up to 12 months prior to the date of the signature of the agreement; (c) have an A credit rating. Participating IFIs will become the guarantors of the full amount of the underlying portfolio purchased. Loans will be sold at their face value. For the purposes of the program, loan eligibility will be certified by the external auditor of the IFI concerned and reviewed and audited by the SSF and the program external auditor. The Credit Regulations will contain details of the eligibility criteria for loans purchased from participating IFIs.

3.9 **Procedures for review and disbursement by BCR to financial intermediaries**. Once An IFI has signed the framework agreement and submitted a portfolio purchase agreement, the BCR will verify that the loans to be purchased meet the criteria of the Credit Regulations. If such loans represent over 2.5% of the IFI's capital fund, the latter will inform the SSF pursuant to the provisions of the law. Once the loans have been verified and approved, the IFI will transfer title thereto and sign the portfolio purchase agreement and guarantee. Once these procedures have been completed, the BCR will disburse to the IFI a sum corresponding to the book value of the portfolio purchase. The IFI will also sign a portfolio administration agreement.

B. Use of program resources

3.10 Program resources will be used to meet the short-term working capital and trade financing requirements (up to two years) of businesses in the private sector. As a contractual condition, each participating IFI will commit to replace eligible loans as they mature with new loans meeting the same portfolio purchase criteria in order to maintain an eligible portfolio in the amount agreed. Since the terms of eligible loans are relatively short, this obligation will mean that a substantial proportion of program resources will be recycled. The participating IFIs will present to the BCR eligible loans in the amount of the quota available to avoid any delay between the repayment of one loan and the purchase of another. With a view to avoiding extreme concentrations in the use of resources, the program will have a ceiling by individual and by business group for each loan operation equivalent to 3% of the total program amount (US$15 million), which may in no event exceed the 15% quota assigned to each IFI, unless, for special reasons, it obtains prior consent in writing from the Bank Similarly, IFIs must comply with the applicable restrictions on related-party loans, including entities in the same financial group. Any IFI wishing to withdraw from the program or reduce its participation therein will inform the BCR with the advance notice set out in the Credit Regulations, so

that the quota released can be reallocated to other IFIs in the system, to be selected according to the mechanism described in the Credit Regulations. Program resources transferred to IFIs for the purchase of eligible portfolio loans will be need to used for the same program purposes, and be subject to the same restrictions.

C. Program inspection and supervision

3.11 The borrower will allow the Bank to inspect at any time the status of program execution and to review all records and documents relating to its execution deemed pertinent by the Bank, cooperating fully in that activity. For program supervision, the executing agency will provide the Bank each month with a "resource utilization report," indicating: (i) the monthly flow of new loans granted, classified by destination and with a description of the characteristics of each operation, including identification of the beneficiary, the amount of the operation, the term, interest rate, amortization system, and use of resources; (ii) new portfolio acquisitions; (iii) maturity schedule and status of effective recovery and reuse of funds within the established timeframes; (iv) operations in arrears; and (v) the balance of program resources used by each IFI. The program will be audited once a year by an independent firm hired for this purpose. Program resources will be used to defray the cost of the audit, which will include verification that the resources were used as intended. The BCR will submit audited financial statements during the program execution period.

LIQUIDITY PROGRAM FOR GROWTH SUSTAINABILITY (ES-L1029)
RESULTS FRAMEWORK

Operation goal	The goal of the Liquidity Program for Growth Sustainability (LPGS) in El Salvador is to facilitate access by the private real sector to financial resources to help sustain the country's economic growth
Operation purpose	The purpose is to provide funding to the Central Reserve Bank (BCR) so that it can acquire short term loan portfolio receivables for working capital loans and trade financing, providing financial institutions with liquidity to grant new short-term loans for working capital and trade credits in accordance with program requirements.

INDICATORS						**Description**
	Base	**Year 1**	**Year 2**	**Year 3**	**Target**	
Sole component: The Central Reserve Bank acquires short-term working capital and trade finance portfolio to enable local banks to grant new loans for the same purposes.						
Output						
Local banks can access BCR credit lines and place the resources in new eligible loans as the loans in the portfolio purchased by the BCR mature.	0%	Not less than 50% of the resources allocated	100% of the resources allocated	100% of the resources allocated	100% of the resources allocated with a reduction to reflect amortization of loans with the Bank	This percentage indicates the capacity of the BCR and IFIs to use program funds from portfolio purchases, for new eligible working capital and trade financing portfolio loans.
Outcome: Local banks obtain funds to lend to companies as working capital and trade credit lines. The BCR purchases portfolio from intermediaries and the latter use the resources for new eligible portfolio loans, avoiding sudden disruptions in the supply of credit to the private sector.						
Intermediate outcome						
The banks sell eligible loans to the BCR (A-rated working capital loans or trade credits) for the total amount of program resources	0%	Not less than 50% of the resources allocated	100% of the resources allocated	100% of the resources allocated	100% of the resources allocated with a reduction to reflect amortization of loans with the Bank	The BCR allocates funds from the amount of the eligible portfolio loans to financial intermediaries and sets a portfolio purchase quota for intermediaries and supervises the process to ensure new loans are granted as stipulated, as purchased portfolio is amortized

INDICATORS						Description
	Base	Year 1	Year 2	Year 3	Target	
Outcome						
Intermediaries grant new working capital loans or trade credits up to the amount of the quota utilized in the BCR, provided macroeconomic and financial conditions so require.	0%	Up to 100% of the portfolio sold to the BCR in accordance with the established quota.	100% of portfolio sold and recoveries from loans sold to the BCR in accordance with the established quota.	100% of portfolio sold and recoveries from loans sold to the BCR in accordance with the established quota.	100% of the portfolio sold to the BCR in accordance with the established quota and demand for credit, which reflects the amortization of loans with the Bank.	Each month, intermediaries will report to the BCR the number of new loans supplied to the private sector, which must be consistent with the quota purchased by the BCR. Intermediaries wishing to reduce their quotas must give the BCR at least one month's advance notice.

To increase the amount of data in order to quantify the operation's impact, and, in addition to the Table of Indicators, a survey of the following indicators will be carried out ex post:

GOAL: The credit level in the system is maintained					
INDICATORS	**Year 1**	**Year 2**	**Year 3**	**Target**	**Description**
Level of program activity by: • Trade finance portfolio • Working capital portfolio					This indicator shows the level of program activities as a percentage of resources disbursed from lines opened by the BCR for portfolio purchases. Portfolio balances by area and amount and number of new loan operations.
Real sector companies receiving new working capital loans and trade credit.					This indicator quantifies businesses receiving loans from program resources.
Trend in the working capital and trade finance portfolio with respect to neighboring countries.					This indicator sets out for comparison the eligible portfolio by country.

Portfolio (amount and number of loans) by area (working capital and trade finance) at the end of each period, including portfolio outstanding held by BCR.					This indicator shows an amount at the end of each period by area.
Working capital and trade finance portfolio as a percentage of the total portfolio.					This indicator sets out for comparison the eligible portfolio by period.
Monitoring of sources of bank financing (deposits, borrowing, and equity).					

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE-__/__

El Salvador. Loan ____/OC-ES to the Banco Central de Reserva de El Salvador
Liquidity Program for Growth Sustainability

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with the Banco Central de Reserva de El Salvador, as Borrower, for the purpose of granting it a financing to cooperate in the execution of a liquidity program for growth sustainability. Such financing will be for the amount of up to US$400.000.000, from the resources of the Bank's Ordinary Capital for the Emergency Facility Program – Liquidity Program for Growth Sustainability, and will be subject to the Financial Terms and Conditions and the Special Contractual Conditions of the Executive Summary of the Loan Proposal.

(Adopted on ____________)

LEG/SGO/CID/IDBDOCS#1794767
ES-L1029