DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK
MULTILATERAL INVESTMENT FUND
NOT FOR PUBLIC USE

BOLIVIA

CAPITAL MARKET ACCESS FOR THE MICROFINANCE INDUSTRY
PRODEM FFP

(TC-98-10-48-4)
(TC-99-07-00-1)

DONORS MEMORANDUM

This document was prepared by the project team consisting of: Gabriela Torres (COF/CBO), Nobuyuki Otsuka (MIF), Juan Carlos Pérez-Segnini (LEG/OPR), Nybia Laguarda (SDS/MIC), Alexandra Santillana (SDS/MIC), and Fernando Lucano Urioste (SDS/MIC), Team leader.

CONTENTS

APPENDIX

INFORMATION AVAILABLE IN THE TECHNICAL FILES

Letter setting out the terms and conditions of the operation.
Contract between the stockbroker and PRODEM for the initial issue.
Comparative analysis of the main microcredit institutions.
Analysis of the market potential for microcredit.
Organizational structure of the PFF.
Curriculum Vitae of the main directors and executives.
Financial analyses: historical (1994-1998) and projected (1999-2003).
Reference rates.

ABBREVIATIONS

AFP	Pension Fund Manager
BBV	Bolivian Stock Market
CAF	Andean Development Cooperation
CII	Inter-American Investment Corporation
FMO	Financierings Maatschppy Ontwikkelingslanden
GDP	Gross Domestic Product
LTN	Treasury Bill
MFI	Microfinance Institution
MIF	Multilateral Investment Fund
NGO	Non-Governmental Organization
PFF	Private Financial Fund
SBEF	Superintendency of Banks and Financial Entities

CAPITAL MARKET ACCESS FOR THE MICROFINANCE INDUSTRY

(TC-98-10-48-4)
(TC-99-07-00-1)

EXECUTIVE SUMMARY

Executing agency:	PRODEM S.A. – Private Financial Fund
Beneficiaries:	Rural and Urban Microententerprises in Bolivia
Objectives:	The general aim of the operation is to persuade private investors to help finance the development of the microfinance industry in Bolivia. The project's specific goal is to enable PRODEM-PFF to gain access to local financial markets through the issue of stock market instruments. The achievement of these goals is expected to serve as a demonstrative pilot experience that can be repeated in other countries of the Region.
Description:	The project has two components. The first is a financing line for stock market operations extended in favor of PRODEM-PFF. The Multilateral Investment Fund (MIF) will extend to the private financial fund (PFF) a financing line amounting to US$2 million, to be used exclusively in taking minority shares of securities issued on the stock market by the PFF during its first three years of operation. An initial US$3 million bond issue has already been structured by the PFF as advised by its stockbrokers. This issue will constitute the first use of the financing line in an amount equal to US$500,000 (16.67% of the issue), on a pari-passu basis with respect to amount and conditions with the PRODEM Foundation (the PFF's shareholder of reference). The initial bond issue will not be covered by guarantees, thereby setting the precedent of private investors accepting risk in the microfinance industry. The presence of the Multilateral Investment Fund (MIF) and the sound structure of the issue are crucial elements for encouraging private investors to take up these bonds (to a value of US$2 million in this initial issue).

Subsequent uses of the line would be for securitization of part of its portfolio and to attract investors into its equity capital through convertible bonds.

The second component of the project is a non-reimbursable technical cooperation grant for the institutional strengthening of PRODEM-PFF, intended to: (i) cover part of the costs of access to the stock market, including legal fees and risk classification on the initial bond issue; (ii) strengthen the PFF's financial management via a specialized risk management advisory service; (iii) develop new products and financial services; and (iv) appraise and report on each security issue, so that the experience gained in this innovative project can be disseminated and applied.

Financing:

Modality:	Financing line
Beneficiary:	US$2,220,000
MIF–Window IIIB:	US$2,000,000
MIF–Tec.Coop.– Window IIIA:	US$ 250,000 (non-reimbursable)
Total:	US$4,470,000

Execution timetable: Disbursement period: 3 years

Terms and conditions:

a. General, for all uses of the financing line.

The MIF Stock Market Operations Financing Line, amounting to US$2 million, will have a 3-year period of use. The securities acquired therewith shall not be renewed or exchanged for other securities, nor may they expire later than 31/12/2005. In order to achieve the catalytic effect of private investment, the MIF may not take up more than 33% of any issue.

Each security issue must be risk-classified, and at least 50% of the total issue must be underwritten. For issues to be eligible for the financing line, the PFF must be able to show levels of currency balance and capital adequacy in compliance with those established by the Bolivian Superintendency of Banks. In addition, loans overdue by more than 30 days must account for less than 5% of the total portfolio and the return must exceed 10%.

Subsequent uses of the financing line will depend on all preceding issues being fully subscribed and on an analysis of each operation by the MIF team.

b. Specific to the initial PFF issue.

The initial US$3 million bond issue will have a maturity of 3 years. MIF and the PRODEM Foundation will each take up bonds

amounting to US$500,000, at the issue rate, and will hold them to maturity. The issue rate will be equal to the rate on one-year Bolivian State Treasury Bills, plus a premium to be defined at the time of launch, which will not be less than 300 basis points. The minimum annual rate on the bonds will be 10%. The issue will not be guaranteed.

If the US$2 million of bonds placed on the stock market are not fully subscribed after the 30-day placement period, the stockbroker will buy up the remaining amount at a price not below that agreed with the MIF. The bonds may be redeemed in advance if the PFF falls into arrears on coupon payments, or if the risk limit is reached. This occurs when over 10% of the portfolio is overdue by more than 60 days and/or the capital value has been eroded by 40% (unless the PRODEM Foundation makes an immediate replenishment of equity capital).

The Bank's strategy:

The Bank's actions in Bolivia are mainly directed at supporting efforts to reduce poverty and to promote sustained growth in productive infrastructure, microenterprise and rural development. The country document on the line of activity relating to economic growth and the creation of opportunities, stresses the importance of promoting services for rural development and microenterprise in the following areas: (i) access to credit; (ii) access to non-financial support services; and (iii) rural development and environmental protection.

Similarly, the Bank's strategy for microenterprise development (Micro 2001) states that in order to broaden the scope of services supplied to microenterprise, a larger amount of resources must be provided by the private sector. This operation is compliant with the aims of the Micro 2001 strategy.

Risks:

Country risk. There are no reference prices for setting interest rates and expected rates of return, since neither the State nor Bolivian firms issue securities on international financial markets. ***Mitigating element:*** *Country risk perceptions are favorable. Political risk is considered moderate (Ref. Political Risk Services Inc.) and sovereign debt was upgraded by Bankwatch from B- to B in December 1998.*

Systemic risk. Despite the free setting of interest rates in Bolivia, there is a structural imbalance in the way the system operates: lending rates are fixed, while deposit rates with financial institutions are variable. In other words, in the event of systemic risk and a consequent rise in rates, financial intermediaries will be unable to shift the higher financial cost to the borrower. ***Mitigating element:*** *PRODEM has set up a protection mechanism in its loan contracts with active clients in order to compensate for possible mismatches in system rates.*

Market risk. Default rates among microcredit institutions have been rising, and the main urban markets are probably saturated. ***Mitigating element:*** *PRODEM is the only microfinance institution with a combined urban and rural portfolio. This enables it to offset risks between geographic zones and so not have to depend on growth in the best urban markets. For example, PRODEM has no agency in Santa Cruz, an area of Bolivia that has high default levels. PRODEM has also learnt from the bad experience of disproportionate portfolio growth and the consequences of unrestrained competition in urban agencies. The new operating strategy favors client quality over growth with high arrears rates.*

Risk associated with the management of the financial institution. Most NGOs that sponsor a financial institution find it hard to adapt their vocation of service and social impact to the logic of risk/return analysis in its structure and financial operations. ***Mitigating element:*** *This risk is mitigated by the banking background of the members of the PRODEM Foundation (the PFF's main shareholder), and PRODEM can also draw on experience it acquired in the creation and development of Bancosol. The management team from the Foundation also has the capacity to adapt to the discipline of running a financial institution in a competitive market.*

Legal risk. As this is the first bond issue in Bolivia containing an early redemption clause defined in terms of a risk limit (risk of insolvency beyond a level that can be assumed by an investor), there is no jurisprudence available to support its enforcement. ***Mitigating element:*** *According to current legislation, in the event of failure to repay the bonds in advance, the early redemption clause becomes legally enforceable. In other words, the representative of the bonds' purchasers may apply to the stock market and the Superintendency of Securities, who have the necessary mandate to order the blocking of current accounts and the freezing of assets.*

Reimbursement capacity in the event of the risk limit being reached. In the event of the risk limit being reached, the firm might not have the liquidity needed to honor advance redemption. ***Mitigating element:*** *the risk limit established makes it possible to recover the investment, always providing the PFF decides to reduce its portfolio (see paragraph 5.6).*

Environmental and social review: In its meeting of 20 November 1998, the Committee on Environment and Social Impact (CESI) reviewed this operation and made recommendations, which the project team has built into its design. PRODEM will publicize the contents of the Bank's guidelines on environmental protection, in order to raise awareness among its employees and clients of the importance of environmental protection.

Special contractual conditions:

The institution will tailor its security issues to conform with the terms and conditions of the contract it will sign with the Bank, as set out in the corresponding letter. It will also adhere to the terms of the contract to be signed with the stockbroker. Presentation, to the Bank's satisfaction of the contract duly signed with the stockbroker, will be a condition precedent to the use of line resources (see paragraph 3.9).

The project envisages an appraisal following each PFF bond issue subscribed to by the MIF. The last assessment will include a final report on the operation, which will analyze the execution of all stock-market operations and the impact of technical cooperation (see paragraph 3.11).

Prior to the initial disbursement of technical cooperation, the PFF will present, to the Bank's satisfaction, a detailed timetable of activities to be carried out, along with the terms of reference of the consultants to be hired (see paragraph 3.14).

I. ELIGIBILITY

1.1 The eligibility of Bolivia to receive resources from the Multilateral Investment Fund (MIF) was approved by the Donors Committee in its meeting of 6 October 1993.

II. FRAME OF REFERENCE

A. Macroeconomic context

1. Economic policy and current situation

2.1 Thanks to a far-reaching reform program, Bolivia has managed to balance its economic fundamentals during the 1990s, which has enabled it to enter a new era of sustained growth. In 1998, Bolivia's Gross Domestic Product (GDP) grew by 4.7%, very much in line with the average growth of 4.1% achieved over the last ten years. Despite the recession predicted for the Region in 1999, the Bolivian economy is not expected to slow down noticeably, and its annual rates of inflation and devaluation should be maintained.

B. The financial system

1. Financial policy and regulatory framework

2.2 The structural changes made in the country's economic policy have led to a liberalized financial system. This essentially means the abolition of controls on interest-rate ceilings and a drastic reduction in direct intervention by the State in the business of financial intermediation.

2.3 Current legislation promotes free competition, prudence and the expansion of financial services throughout the country. As regards prudential standards, the Superintendency of Banking and Financial Entities (SBEF) adheres to the Basle Committee regulations. The minimum equity capital requirement for setting up a bank is currently set at US$8 million.

2. Type of institutions and size of the system

2.4 Bolivia's financial system is composed of 11 national banks, four foreign banks, 30 regulated cooperatives and credit unions, five private financial funds (see paragraph 2.9) seven warehousing companies and one leasing company. The banking system accounts for 88% of all assets, or US$5.69 billion, and grew by 11.8% relative to 1997. In 1998, the system's gross consolidated portfolio amounted to US$4.1 billion, with public deposits and net worth amounting to US$3.5 billion and US$480 million respectively

3. Rates, yield and efficiency of the banking sector

2.5 Interest rates are continuing to fall, as they have done for a decade. In 1998 the reference interest rate in US dollars came down to 8.3%. However, the climate of financial instability in the Region, together with the liquidity needs of the system and an increase in defaults, are putting lower interest rates in danger, and they have actually risen slightly over the last six months. The net consolidated result of system in 1998 was US$37.8 million, representing an average yield of 9.6%, compared to 1997 when the figure was on the order of 13.9%. This fall in profitability is explained by: (i) new regulations that are more stringent on the coverage of provisions, (ii) a rise in the system's arrears levels, (iii) losses absorbed by certain banks as a result of mergers, and (iv) the economic downturn during the 1998 crisis. Nonetheless, the Bolivian banking system is progressively consolidating, thanks to (i) a constant improvement in efficiency, as revealed by the ratio of administrative expenses to assets, which currently stands at 3.7%, (ii) the fact that in 1998 deposits from the public grew by US$410,000, and had an average maturity of 345 days (which is an expression of public confidence), and (iii) the capacity of the system to attract foreign financing, which increased from US$70,000 in 1988 to US$760,000 in 1998.

4. Mergers and acquisitions

2.6 The favorable course of the national economy in general, and of the financial sector in particular, has encouraged incursions by foreign banks and subsequent alliances and mergers between some of the system's main players. Three major operations were finalized in 1998: Citibank took over BHN Multibanco S.A., Banco Central Hispano of Spain purchased a majority stake in Banco de Santa Cruz S.A., and the Peruvian financial group Credicorp consolidated its presence by taking over Banco de La Paz.

5. The stock market

2.7 The securities market in Bolivia consists of the Superintendency of Securities, and the Bolivian Stock Market (BBV), together with dealers and 14 Mutual Funds. The BBV is a joint-stock corporation set up in 1989, with shares owned by the country's main financial institutions and a group of private individuals. Trading in 1998 totaled US$4.3 billion, up by 68% from the previous year's figure. Fixed income operations (interest-bearing securities) represented 99.78% of all transactions, the most widely traded securities being fixed-term Certificates of Deposit (CDs) (67%) and Treasury Bills (LTN) (26%). Owing to the negligible trade in variable yield securities (shares), firms and financial entities register their securities with the BBV mainly for reasons of transparency and to maintain a healthy presence in the market, rather than to attract investors interested in the speculative value of their securities. The new regulations in Bolivia's securities legislation makes it possible to set up risk-classifying firms, and, as a result, Pension Fund Managers (AFPs)

will be authorized to buy private company bonds with a classification of C or better. AFPs are expected to spend up to US$200 million per year in buying bonds.

C. The microfinance industry

1. Characteristics

2.8 The Bolivian microfinance industry is the pioneer and one of the most dynamic in the Region. Features of the industry include: (i) its high index of market penetration, (ii) the formalization of microfinance institutions (MFIs), (iii) a competitive climate for microcredit provision, (iv) portfolio quality, and (v) the yields achieved.

2. Microfinance regulation

2.9 The legislation establishing private financial funds (PFFs) was passed in 1995 in order to provide the system with a new generation of regulated financial entities specializing in small-scale portfolios. The SBEF set up a technical team specializing in the supervision of microfinance institutions and pushed through the regulations needed to exercise its controlling role (for example rules on provisions and requirements for accepting a solidarity group guarantee). The SBEF manages a "risk center" enabling microcredit institutions to verify the state of their clients' debts with similar institutions.

3. Typology of microfinance institutions (MFIs)

2.10 In Bolivia there are three types of MFI: (i) *conventional financial institutions:* these are mostly commercial banks, consumer finance houses and savings and loan cooperatives, which have only marginal dealings with the microenterprise segment; they do not necessarily have a specific methodology, (ii) *financial institutions specializing in microenterprises:* regulated banks and finance houses that put together exclusively microcredit portfolios, and (iii) *loan-granting NGOs* which engage in unregulated lending activities generally catering to very low-income populations in remote areas.

4. Market penetration

2.11 An analysis made in 1995 estimated the number of microenterprises in Bolivia at 1.2 million, of which 53% are in rural and 47% in urban areas. Unsatisfied demand for credit was estimated at 57% in rural zones and 47% in urban areas. In other words, microcredit institutions as a group would be catering to around 200,000 clients in both zones, and unsatisfied demand would amount to nearly 600,000 clients, around 60% of whom would be in the rural area.

5. Volume of microcredit provision

2.12 The largest supply of credit is provided by the following *specialist financial institutions* (portfolios in US$ million as of December 1998): Banco Solidario S.A. (US$74.1), Los Andes-PFF (US$28.6), PRODEM-PFF being set up (US$24.5), FIE-PFF (US$16.7), and Fondo de la Comunidad-PFF (US$15.9). The total consolidated portfolio of these entities as of December 1998 amounted to US$160 million, equivalent to 85% of the total microcredit portfolio outstanding.

6. Asset quality

2.13 Quality indicators in microcredit portfolios are generally higher than in the conventional banking system. Up to 1997, overdue loans (> 30 days) were less than 2% of the total portfolio in the best MFIs, and were fully covered by accumulated provisions. However, portfolio quality in the Bolivian microfinance industry deteriorated in 1998 as a result of excess supply in the main urban markets, and the overdue (> 30-days) portfolio, after write-offs for uncollectables, had grown to around 3% by the end of that year. As result, microfinance institutions have significantly pared down their growth projections for 1999, in order to control risk exposure.

7. Efficiency

2.14 As a result of competition in the supply of microcredit, Bolivian microfinance institutions (MFIs) have lowered their annual lending rates in US dollars from 33% to 30%. At the same time, operators have become more sensitive to the quality of services provided to clients (diversity of products, frequency of disbursements and installments, hours of business, etc.). In the main microcredit institutions, operating costs as a percentage of average portfolios have dropped from 21% to 15% over the past three years.

8. Profitability

2.15 Yields remain at 25 - 30% of average asset values. Despite the increase in portfolio provisions and the lowering of lending rates, MFI profitability indices have been maintained because of a gradual increase in productivity that has made it possible to curb the high operating costs involved in managing small portfolios. The rate of return among microcredit institutions is 2.5 times higher than the average ROE in the Bolivian banking system.

9. The need for the operation

2.16 The growth of MFI portfolios necessarily means an increase in their sources of assets and debt. As portfolio volumes continue to grow, borrowing from multilateral agencies will be insufficient and also unsuited to the structure of their liabilities. Although accepting personal savings helps to bond the client with the

financial institution and reduces the danger of volatility in the event of systemic risk, deposit-taking small in amounts is costly and generally short-term. MFIs must therefore generate an appropriate mix of deposits including those from institutional investors. This requires microcredit institutions to develop relationships of trust with the local financial market, using the conventional mechanisms of risk perception and operational structuring. As a way of achieving this, the operation described in this document proposes the entry of PRODEM-PFF into the Bolivian capital market by issuing stock market securities.

2.17 This method was chosen by the project team and the counterpart because it fits the structure of the liabilities in the system. For the PFF to move into capital markets requires rigorous financial discipline, and this is consistent with the expansion challenges facing the microfinance industry in Bolivia. It is worth emphasizing that the initial bond issue will not be covered by guarantees, thereby setting the precedent of private investors accepting risk in the microfinance industry. The possibility of the Multilateral Fund (MIF) buying PFF shares was ruled out since the institution already has a sufficient level of capitalization. Moreover, the new Bolivian regulations on subordinate debt do not allow interest rates to be adjusted according to the risk of the instrument.

D. IDB support for microenterprise

2.18 In the period 1990-1998 the Bank provided US$9.9 million of support for 17 microfinance and microenterprise development projects through its former Small Projects Program. The Bank, through the MIF, holds an interest in the equity capital of Los Andes-PFF, the country's second largest microcredit institution. The MIF is also providing support to the Superintendency of Banking in its efforts to specialize and improve its efficiency in supervising microfinance institutions. In addition, an SDS/MIC activity line financed with MIF funds has three projects for institutional strengthening in microfinance institutions in the process of approval. In 1992, the Inter-American Investment Corporation (IIC) participated as a founding shareholder in the Banco Solidario S.A., the Region's largest specialist microfinance entity. These shares were sold in 1998. In the latter part of the same year, the Bank approved a "Comprehensive program to support small business and microenterprise" amounting to US$35 million, to help small businesses and microenterprises gain access to the financial system, and enhance their competitiveness, as well as provide institutional strengthening for the Vice Ministry of Microenterprise in Bolivia.

E. The Bank's strategy in Bolivia

2.19 The Bank's activities in Bolivia are mainly in support of efforts to reduce poverty and promote sustained growth in productive infrastructure, microenterprise and rural development. The country document on the line of action relating to economic growth and the creation of opportunities, stresses the encouragement of services for

rural development and microenterprise in the following areas: (i) access to credit; (ii) access to non-financial support services; and (iii) rural development and environmental protection.

2.20 Similarly, the Bank's strategy for microenterprise development (Micro 2001) states that in order to be able to broaden the scope of services supplied to microenterprise, a larger amount of resources must be provided by the private sector. The operation described in this document is compliant with the goals of both strategies.

III. THE PROJECT

A. Aims

3.1 The general aim of the operation is to persuade private investors to help finance the development of the microfinance industry in Bolivia. The project's specific goal is to enable PRODEM-PFF to gain access to local financial markets through the issue of stock market instruments. The achievement of these goals is expected to serve as a demonstrative pilot experience that can be repeated in other countries of the Region.

B. Description

3.2 The project has two components, the first of which is a Stock Market Operations Financing Line extended in favor of PRODEM-PFF. The second component is a technical cooperation grant to support the institutional strengthening of PRODEM-PFF, which will be used to cofinance the following: (i) costs of stock market access; (ii) a specialized advisory service in risk management; (iii) the development of new products and financial services; and (iv) the preparation of appraisals and reports.

1. Stock Market Operations Financing Line

a. Description of the financing line

3.3 The MIF will extend to the PFF a financing line of US$2 million to be used exclusively in the minority subscription of securities issued on the stock market by the PFF during its first three years of operation. An initial bond issue for US$3 million has already been structured by the PFF in conjunction with its stockbrokers. This issue will see the first use of the financing line for an amount equal to US$500,000 (16.67% of the issue), on a pari-passu basis in amount and conditions with the PRODEM Foundation (the PFF's main shareholder). The presence of MIF and how well the issue is structured are crucial elements for encouraging private investors to take up these bonds (for an amount equal to US$2 million in this initial issue). Subsequent uses of the financing line will depend on preceding issues being fully subscribed, and on an analysis of each operation by

the MIF team. In order to achieve the catalytic effect of private investment, in no case may the MIF take up more than 33% of any issue. Subsequent PFF issues are expected to involve the securitization of part of its portfolio and attract investors into its equity capital through convertible bonds.

b. Impact on the executing agency

3.4 This form of financing will help PRODEM-PFF gain access to local private financial markets. The PFF's expected entry into capital markets should help to (i) reduce its dependency on funds arising from international cooperation; (ii) appropriately structure its liabilities; (iii) improve the fluency and quality of its operations and reduce transaction costs; (iv) benefit from the discipline of transparency and the publication of its financial and operating data in accordance with market standards; and (v) generate wider opportunities for marketing its securities and shares to quality financiers and investors, thanks to the market reference the operation will provide it with.

c. Expected results

3.5 The financing line is expected to encourage management transparency and discipline, since it can only be drawn on if PFF security issues comply with the established standards and market practices for stock exchange operations. Making subsequent uses of the financing line dependent on having successfully sold the preceding issues, limits the risk faced by MIF/IDB when subscribing for the corresponding securities. In the same way, the possibility of early redemption of the initial bond issue makes it possible to generate interest among key local investors who, bearing in mind market bond rates, also seek quality in their contracts and in controlling the risk limit on their investments. The initial bond issue will not be guaranteed, and this will serve as a reference and set a precedent in terms of private investors accepting risk in the microfinance industry.

d. Terms of financing

3.6 The stock market operations financing line will adhere to the following terms and conditions:

(i) The MIF extends to the PFF a Stock Market Operations Financing Line of US$2 million.

(ii) The financing line will have a term of three years and is non-renewable.

(iii) The financing line will expire at the end of its term or when fully drawn, if earlier.

(iv) The stock market securities acquired using the financing line may in no case have maturities extending beyond 31 December 2005, nor may they be renewable or exchangeable for new bonds.

(v) The financing line can only be used to acquire up to one third (1/3) of the securities in each issue.

(vi) Each financing line operation will require participation by the Bolivian private sector to underwrite at least 50% of the corresponding issue.

(vii) All security issues under the financing line must be duly risk classified.

(viii) PRODEM-PFF undertakes not to issue securities with shorter maturities than those to be issued under the auspices of this project. Similarly, MIF will not give financial support to issues by other Bolivian institutions, except those carried out under similar (i.e. market) conditions.

(ix) The MIF commitment to the first stock market issue will amount to US$500,000.

(x) PRODEM-PFF expects to issue new securities to securitize its portfolio flows, as well as convertible bonds, which will enable it to tap new sources of long-term financing and investment in its equity capital.

(xi) The PFF must be able to display the following minimum performance indicators for MIF to consider participating in any issue: overdue loans (> 30 days) must be below 5% of the total portfolio, and the return on assets must be above 10%. The PFF must also maintain a currency balance between assets and liabilities and a capital adequacy level acceptable to the Bolivian Superintendency of Banks.

3.7 The initial bond subscription must adhere to the following parameters:

Table III-1

Amount of issue:	US$3 million
Currency:	US$ dollars
Term:	3 years
Series:	Single
Nominal value:	US$1000
Coupons:	Half-yearly (182 days), negotiable (tradable)
Payment of principal:	On expiry
Place of issue and interest payment:	La Paz
Issue rate:	National Treasury Bills (LTN) currently at 8%, plus a premium of not less than 3% per year, to be defined in accordance with market conditions at the time of issue.
Floor or minimum rate:	10% per year
Early redemption:	By lots at PFF discretion
Guarantee:	Unsecured
Mode of placement:	The initial purchasers of the bonds will be MIF and PRODEM subject to the amounts and conditions detailed below. The subsequent buyers will be investors in a position to buy securities on the La Paz stock exchange.
Early redemption:	In the event of reaching the risk limit. This is defined as loans overdue by more than 60 days being greater than or equal to 10% of the total portfolio, and/or a reduction in asset value of 40% unless the PRODEM Foundation immediately makes a capital replenishment.
Stockbrokers:	"Pro-bolsa S.A." which undertakes to buy any bonds remaining unsold at the end of the placement period at a price not less than that paid by MIF.
Placement period:	30 days from registration on the La Paz stock exchange
Risk classification:	Any company authorized by the *Intendencia de Valores* (so far only Duff & Phelps)
Custody:	Held by the stockbroker, in its safety deposit at Citibank, La Paz, which will issue a custody certificate.
MIF position:	Buyer at the issue rate for an amount equal to US$500,000, with no selling position during the term of the bond and pari-passu in amount and conditions with the PRODEM Foundation. The interest payable on the bonds taken up by MIF and the PRODEM Foundation will be the issue rate.
PRODEM Foundation position:	The same as the MIF.
Amount to be sold to the public:	US$2 million

3.8 The basis for any subsequent subscriptions will be as follows:

(i) The preceding security issues must have been fully subscribed.

(ii) The PFF will continue to provide microcredit as a priority activity (at least 50% of its assets).

(iii) Issues must comply with national laws on security issues and any other applicable legislation or regulations.

(iv) The issue will be committed to the aim of the stock market operations financing line: namely breaking into the Bolivian capital market.

3.9 The institution will tailor its security issues to conform with the terms and conditions of the contract it will sign with the Bank, as set out in the corresponding letter, which is attached as Annex I to the present document. It will also adhere to the terms of the contract to be signed with the stockbroker. Presentation, to the Bank's satisfaction, of the contract duly signed with the stockbroker, will be a prior condition for making use of the financing line.

3.10 PRODEM will publicize the contents of the Bank's environmental protection guidelines, in order to raise awareness among its employees and clients of the importance of environmental protection.

2. Technical cooperation for institutional strengthening

3.11 The second component is a non-reimbursable technical cooperation grant for the institutional strengthening of PRODEM-PFF, intended to (i) cover part of the cost of stock market access, including legal costs and risk classification in the initial bond issue; (ii) strengthen the financial management of the PFF through an advisory service specializing in the identification, control, instrumentation, organization and management of risk; (iii) develop new products and financial services to ensure the expansion and profitability of the PFF; and (iv) prepare appraisals and reports on each security issue, to enable the experience of this innovative project to be capitalized on and disseminated. The final report will include an assessment of the impact of technical cooperation activities.

3.12 The degree of institutional strengthening achieved by this component will have a direct impact on the successful placement of PRODEM bonds on the Bolivian stock market. Private investors will upgrade their risk perception if the quality of PFF management improves.

3.13 Apart from reports and appraisals, the project will finance up to 50% of each technical cooperation activity. The purchase of machinery or equipment is not envisaged. The contribution made by the PFF will be in cash, as all the categories involve the hiring of specialist professional services.

3.14 Prior to the initial disbursement of the technical cooperation grant, the PFF will, to the Bank's satisfaction, present a detailed timetable of activities to be carried out with the funds, and the terms of reference of the consultants to be hired.

Table III-2

ESTIMATED COST OF TECHNICAL COOPERATION IN US$

Activities	PRODEM	MIF	TOTAL
1. Security issues:			
Rating	30,000	30,000	60,000
Promotion	10,000	10,000	20,000
Legal	40,000	40,000	80,000
Structuring	40,000	40,000	80,000
2. Risk management	20,000	20,000	40,000
3. Product development	80,000	80,000	160,000
4. Appraisal		30,000	30,000
TOTAL	220,000	250,000	470,000

IV. THE FINANCIAL ENTITY

A. Its partnership origin

1. Origin and aims

4.1 The founding shareholder of the new PRODEM financial entity is the "Foundation for the Promotion and Development of Microenterprise" (PRODEM) a non-profit entity constituted under Bolivian law that was set up in 1987 by a group of Bolivian entrepreneurs and sponsored by Acción Internacional. The aim of the entity is to promote the development of microenterprises and their access to credit. After setting up the private financial fund (PFF), the PRODEM Foundation will be responsible for managing its investment portfolio and will enter into private health-sector projects in support of low-income populations.

2. The Foundation's backers

4.2 PRODEM's founders include three financial groups: the Banco Industrial, the Banco Boliviano Americano and the former BHN Multibanco (now taken over by Citibank). Individuals involved in the Foundation include entrepreneurs and professional people, who, from the vantage point of their different functions and political positions, promote free enterprise as a source of economic development. Two international agencies are also members of the Foundation – Acción Internacional of Boston, USA, and the Calmeadow Foundation, of Canada. Both are specialists in Latin American microfinance, and partners with IDB-MIF in a number of projects.

3. Launch phase

4.3 Between 1988 and 1992 the Foundation opened a branch in each of Bolivia's main cities: La Paz, El Alto, Santa Cruz and Cochabamba. In late 1992 the Foundation had an active portfolio worth US$4.5 million, composed of 23,000 clients with an average balance of US$200. The partnership nature of the Foundation's support to lending activity made it impossible to give a broader scope to its services, since its status as a non-financial entity precluded it from raising capital from the public, thereby rendering the institution unattractive to private financial markets.

4. Institutional development

4.4 Because of this, in 1992 the Foundation set up the Banco Solidario S.A.(Bancosol), the first and largest bank in the western hemisphere specializing in microcredit. This bank started up with an institutional mystique inherited from PRODEM, together with a staff of 116, operating experience, systems, procedures, four agencies and a portfolio of US$3.2 million with 14,300 active clients. In 1993 and 1994 portfolios and agencies continued to transfer to Bancosol, which since 1992 has grown to a total of US$8.7 million, with 9 agencies and 34,518 clients. Portfolio transfers were exchanged for cash and Bancosol shares, and this gave the Foundation a controlling interest, as by the end of 1997 it owned 35.4% of bank's shares. In 1998, the Foundation began to sell its entire stake in Bancosol, in order to raise liquid funds and gain complete freedom to set up a new financial institution as the result of growth in its lending activities in rural Bolivia.

Table IV-1
PRODEM Foundation – main indicators

	1994	1995	1996	1997	1998
Total assets (US$ thousand)	9.075	11.333	14.125	25.272	33.527
Gross portfolio (US$ thousand)	2.616	4.516	8.353	18.501	24.553
Average ROA	15%	6.6%	16.1%	12.3%	9.3%
Average ROE	34%	14.6%	30.2%	24.8%	21.8%
Portfolio >30 days overdue	0.57%	0.09%	0.97%	0.47%	2.73%
Accumulated provision/ Portfolio >30 days overdue	434%	1129%	135%	395%	147%
No. of clients	9,974	18,309	27,484	38,248	47,130
Average loan US$	262	247	304	484	521
No. of branches	12	27	33	40	50
Clients per loan officer	145	170	202	233	218
Operating costs/average portfolio	48%	51%	33%	24%	23%

5. Target clientele

4.5 The institution's client base mainly consists of informal enterprises and own-account workers. Economic agents of this type are characterized by: (i) high yields on sums invested and low levels of investment in fixed assets; (ii) a low level of schooling among entrepreneurs and workers; (iii) an absence of accounting and financial information; and (iv) low productivity due to negligible use of technology in production and high transaction costs in the marketing of goods and services. Nonetheless, this vibrant economic sector in Bolivia accounts for 40% of the economically active population. In rural areas, PRODEM mostly finances craft and commerce activities, which provide a back-up to agricultural activities that are severely exposed both to the vagaries of the weather and to the poor sanitary conditions of those areas.

B. Setting up the PFF

1. Legal framework

4.6 The financial entity is a private corporation, set up as a Private Financial Fund (PFF). In April 1999 PRODEM S.A. obtained authorization from the SBEF to set up a private financial fund in its capacity as a local non-bank financial institution. The PFF is expected to begin activities on 1 September 1999.

2. Ownership structure

4.7 As controlling shareholder, the Foundation plans to steadily reduce its holding to allow the entry of institutional investors. In about five years' time, the PFF should be predominantly owned by its executives and staff together with institutional investors.

3. Equity capital and transfer of client portfolios

4.8 The articles of association state that the PFF is set up with an authorized share capital of US$10 million consisting entirely of ordinary shares. Subscribed and paid-up capital during the first year will be US$4.95 million. Capital is not generated from portfolio transfers, which will be built up progressively over a one-year period as new loans are granted to clients of good credit standing with the Foundation. The composition of equity is as follows:

Table IV-2
Equity capital
(US$ thousands)

	SET UP Year 1		LAUNCH Years 2 - 3		CONSOLIDATION Years 3 - 5	
	Amount	%	Amount	%	Amount	%
PRODEM-NGO	3,550	72	2,250	45	1,250	25
Individual investors	1,100	22	1,150	23	1,150	23
Executives	300	6	300	6	300	6
Staff	-	-	300	6	300	6
CAF[a]	-	-	500	10	500	10
FMO[b]	-	-	500	10	500	10
Institutional investors	-	-	-		1,000	20
TOTAL	4,950	100	5,000	100	5,000	100

Notes: a) Andean Development Corporation. b) Financierings Maatschppy Ontwikkelingslanden (Holland).

4. Strategic position in the market

4.9 The PFF's strategy confirms its leading position in the financing of small rural businesses in Bolivia. The institution is in this market niche because (i) it understands the risks in this segment and is efficient at managing them; (ii) its urban-rural portfolio combination affords it protection from temporary saturation in the best markets in either zone; and (iii) it offers comparative advantages compared to other microfinance institutions in the system.

5. Organization

4.10 In compliance with legal norms, the PFF has three levels of decision-making and control, connecting to the institution's owners: the general assembly, the board of directors and an internal control unit. As regards the management of the PFF, there is a general management team on which the departments of human resources and systems directly depend, as do two management divisions: administrative and financial, and operational. In addition, the executive team will set up three technical committees dealing with risk management, assets and liabilities.

6. Mode of operation

4.11 The financial entity mostly uses the solidarity group technique. Individual loans are granted to clients that have a satisfactory repayment record. PRODEM is studying the possibility of launching other instruments, such as leasing and credit lines, as its client base develops.

4.12 The PFF will launch four types of instruments for receiving funds: (i) savings; (ii) certificates of deposit (CDs); (iii) short- and medium-term debt lines; and (iv) bonds. Within three years, funds taken in through savings accounts and CDs should make up 45% of the PFF's financial resources.

7. Development of the portfolio

4.13 In 1997 PRODEM carried out a feasibility study using a complete battery of simulations involving optimistic and extreme scenarios, and in early 1999 it updated two of the scenarios on the basis of its 1998 financial operating results. Our analysis makes use of the pessimistic scenario, which reflects the following hypotheses: (i) asset growth declining from 47% in the first year just to 10% in the fifth; (ii) an overdue portfolio of 6.3% in the fifth year; (iii) leverage declining from 6.6% to 5.4% over the same period; (iv) average portfolio expenses which fail to decrease substantially but stabilize at 15% (compared to 17% in 1998) after five years; and (v) a drop of about 550 basis points in the lending rate.

4.14 In this pessimistic scenario the PFF yields a five-year internal rate of return on the order of 15% and an ROE that drops from 23.5% in the first year to 14.6% in the fifth. Liquidity indices are appropriate for the sector, since short-term investments in near-liquid securities account for between 26% and 30% of deposits by the public. The level of adequacy of assets indicates prudence in the management of the capital structure, settling at 15%, equivalent to a leverage of six times the value of assets. An analysis of the composition of the lending rate and the portfolio's profit margin suggests that the most sensitive variables are the provision for non-performing loans and operating costs. Cumulative results after five years are on the order of US$8.3 million, or 10% on the gross portfolio. Cost control is fundamental for generating a return, as the portfolio's profit margin in the fifth year is equal to the improvement in operational efficiency over the same period.

Table IV-3
Evolution of the main management indicators
Pessimistic scenario

	PRODEM-NGO			PRODEM-PFF		
	1996	**1997**	**1998**	**1999**	**2000**	**2001**
Total assets (US$ thousand)	14,125	25,272	33,527	43,787	60,141	71,636
Gross portfolio (US$ thousand)	8,353	18,501	24,553	38,195	54,358	65,802
Average ROA	16.1%	12.3%	9.3%	3.0%	3.2%	2.6%
Average ROE	30.2%	24.8%	21.8%	23.5%	24.0%	18.0%
Overdue > 30 days	0.97%	0.47%	2.73%	1.72%	1.76%	1.81%
Accumulated provision/ overdue > 30 days.	135%	395%	147%	233%	228%	221%
No. of clients	27,484	38,248	47,130	63,426	80,520	90,842
Average loan	304	484	521	602	675	724
No. of branches	33	40	50	51	58	63
Clients per loan officer	202	233	218	303	304	306
Operating costs/Ave. Portfolio	33%	24%	23%	17%	15%	15%

V. MAIN RISKS OF THE PROJECT

A. Country risk

5.1 There are no reference prices for setting interest rates and expected rates of return, as neither the State nor Bolivian firms issue securities on international financial markets. ***Mitigating element:*** *Country risk perceptions are favorable. Political risk is considered moderate (Ref. Political Risk Services Inc.) and sovereign debt was upgraded by Bankwatch from B- to B in December 1998.*

B. Systemic risk

5.2 Despite the free setting of interest rates in Bolivia, there is a structural imbalance in the operation of the system. Lending rates are fixed, while deposit rates with financial institutions are variable. In other words, in the event of systemic risk involving a rise in rates, financial intermediaries will be unable to shift the higher financial cost to the borrower. ***Mitigating element:*** *PRODEM has set up a protection mechanism in its loan contracts with active clients in order to compensate for possible mismatches in system rates.*

C. Market risk

5.3 Default rates among microcredit institutions have been rising, and the main urban markets are probably saturated. ***Mitigating element:*** *PRODEM is the only*

microfinance institution with a combined urban and rural portfolio. This enables it to offset risks between geographic zones and so not have to depend on growth in the best urban markets. For example PRODEM has no agency in Santa Cruz, an area of Bolivia that has high default levels. PRODEM has also learnt from the bad experience of disproportionate portfolio growth and the consequences of unrestrained competition in urban agencies. The new operating strategy favors client quality over growth with high arrears rates.

D. Risk in the management of the financial institution

5.4 **Operationg strategy.** Most NGOs that sponsor a financial institution find it hard to adapt their vocation of service and social impact to the logic of risk/return analysis in its structure and financial operations. ***Mitigating element:*** *This risk is mitigated by the banking background of the members of the PRODEM Foundation (the PFF's main shareholder), and PRODEM can also draw on experience it acquired in the creation and development of Bancosol. The management team from the Foundation also has the capacity to adapt.*

E. Legal risk

5.5 As this is the first bond issue in Bolivia containing an early redemption clause defined in terms of a risk limit (risk of insolvency beyond a level that can be assumed by an investor), there is no jurisprudence available to support its enforcement. ***Mitigating element:*** *According to current legislation, in the event of failure to repay the bonds in advance, the early redemption clause becomes legally enforceable. In other words, the representative of the bonds' purchasers may apply to the stock market and the Superintendency of Securities, who have the necessary mandate to order the blocking of current accounts and the freezing of assets.*

F. Reimbursement capacity in the event of the risk limit being reached

5.6 The PFF might not have the liquidity needed to honor early redemption in the event of the risk limit being reached (i.e. the risk of insolvency not assumable by an investor). ***Mitigating element****: reaching the risk limit because of a deterioration of the portfolio leads to the suspension of lending and therefore a shrinking of the portfolio. The increase in liquidity achieved thereby can be used to reimburse the most demanding and costly debts, or those, such as stock market bonds, which collectively affect the financial institution's reputation. If the entire financing line is placed (US$2 million) for a total issue amounting to US$6 million, portfolio reductions on the order of 16%, 11% and 7% would be required in the first, third and fifth year respectively, to meet reimbursement obligations arising from to early redemption. These levels of reduction, to generate liquidity for bond redemption, are satisfactory since they can be achieved rapidly thanks to the short average maturity of microcredit portfolios. In addition, the PFF will generate resources*

(cash flow) equivalent to 19%, 32% and 36% of the total issue during the first, third and fifth year respectively.

PROPOSED RESOLUTION

BOLIVIA. FINANCING FACILITY AND NON-REIMBURSABLE TECHNICAL COOPERATION FOR MICROFINANCE ACCESS TO CAPITAL MARKETS – PRODEM FFP

The Donors Committee of the Multilateral Investment Fund

RESOLVES:

1. That the President of the Inter-American Development Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Multilateral Investment Fund, to enter into such agreements as may be necessary with Fundación PRODEM ("PRODEM"), a Bolivian not-for-profit organization, and Fondo Financiero Privado PRODEM S.A. FFP ("FFP"), a Bolivian financial intermediary, or their respective subsidiaries and affiliates, and to take any other necessary measures for the execution of the operation referred to in Document AT- , in order to:

(a) Establish a facility dedicated exclusively to the financing of securities issued by the FFP, the proceeds of such issues to be used to finance said institution's small and micro-enterprise credit portfolio; and

(b) Provide a non-reimbursable technical cooperation to assist in the institutional strengthening of the FFP.

2. That up to two million United States of America dollars (US$2,000,000) is authorized for the purpose indicated in paragraph 1(a), chargeable to the Small Enterprise Investment Fund of the Small Enterprise Development Facility of the Multilateral Investment Fund, and up to two hundred and fifty thousand United States of America dollars (US$250,000), on a non-reimbursable basis, is authorized for the purpose indicated in paragraph 1(b), chargeable to the technical cooperation resources of the Small Enterprise Development Facility of the Multilateral Investment Fund.