GLOBAL MULTISECTOR CREDIT PROGRAM

(ES-0130)

EXECUTIVE SUMMARY

Borrower:	Multisector Investment Bank (BMI)	
Guarantor:	Republic of El Salvador	
Executing agency:	Banco Multisectorial de Inversiones [Multisector Investment Bank] (BMI)	
Amount and source:	IDB: (OC, dollar window) Local counterpart: Total:	US$42.4 million US$10.6 million US$53.0 million
Terms and conditions:	Amortization period: Grace period: Disbursement period: Commitment period: Interest rate: Inspection and supervision: Credit fee: Currency:	20 years 5 years 42 months 36 months variable 1.00% 0.75% dollars of the United States of America

Objectives: The objective of the operation is to support the development of the private sector, especially small and medium-sized enterprises, by increasing the supply of medium- and long-term financing.

Description: The program will provide funds to the BMI to finance lending to private enterprises by eligible intermediary financial institutions (IFIs) (credit component) and to provide technical assistance (technical assistance component).

The resources for the credit component will be used only for BMI operations with supervised, formal IFIs that meet the eligibility criteria for the program and the Credit Regulations. The subloans will be extended to startups and existing private firms in all economic sectors—manufacturing, trade, and services—in both urban and rural areas, in order to meet their credit needs in the following areas: (i) procurement of fixed assets; (ii) working capital for the expansion, restructuring or modernization of production facilities; and (iii) hiring

of technical and managerial services to support investments in fixed assets.

The resources for the technical assistance component will be used to finance three subcomponents, the purpose of which is to: (i) expand the BMI's capacity; (ii) strengthen the IFIs in risk analysis; and (iii) promote an increase in financing for rural enterprises. Execution of the technical assistance component will be governed by a technical assistance action plan, which will set forth the specific objectives of the component together with its goals, activities and resources.

The Bank's country and sector strategy: The proposed operation is fully consistent with the Bank's strategy for cooperation with El Salvador, as defined in the country paper, in that it will help reactivate economic growth and boost competitiveness by supporting private-sector efforts to expand production capacity. The operation will also support the BMI and the financial sector as they make the transition towards greater integration with international financial markets under the provisions of the recently enacted Monetary Integration Act.

Environmental and social review: The program's direct environmental impact will be neutral, since it will be financing second-tier banking operations. It is possible, however, that the individual investments financed may have an adverse environmental impact. In order to mitigate this risk, all credits to be financed with program funds will be required to have the applicable environmental certifications, issued in accordance with Salvadorian law by the respective authorities of the Ministry of the Environment and Natural Resources. The Credit Regulations for the program will include environmental monitoring mechanisms and will stipulate that end-borrowers must comply with the applicable labor and social legislation.

The Committee on Environment and Social Impact approved the operation on August 31, 2001.

Benefits: The proposed program will be part of the support provided by the Bank to assist the Salvadorian authorities in their efforts to achieve sustainable economic growth by increasing the productivity and competitiveness of private enterprise in the context of an open economy. Achieving this goal will require an ongoing process of industrial modernization and restructuring, together with the replacement and expansion of production assets, for which access to a stable flow of medium- and long-term financing is necessary. Given the domestic capital markets' incipient stage of development and the substantial obstacles that impede access to these markets, especially for small and medium-sized enterprises, the primary source of financing is the banking sector, which is also subject to constraints

with respect to long-term financing. The program will provide a stable supply of long-term resources, thereby supporting the development of the private sector while also helping the BMI adapt to the challenge of financial market integration.

Risks: The program's success will largely depend on whether a stable macroeconomic policy is maintained and leads to an increase in economic activity and in the demand for credit in the private sector. Implementation of the National Reconstruction Program should greatly stimulate economic activity in the country, and the government has indicated that it is committed to maintaining its policy for monetary and fiscal discipline, which has been in place during the current and preceding administrations. Nonetheless, there is a risk that economic activity may decline more sharply than is indicated by the current revised projections in the event of a slowdown in the economies of the country's major trading partners and a further deterioration in its terms of trade.

The stability and development of the financial system may also pose a potential risk for the operation. This risk will be substantially mitigated by the progress made in El Salvador over the past few years in introducing prudential standards, strengthening financial regulation and improving the capacity of the supervisory authorities to enforce those standards properly and to oversee the system.

Special contractual clauses: As a condition precedent to the first disbursement for the credit component, evidence must be submitted that the Credit Regulations have been approved by the board of directors of the BMI, on the terms previously agreed upon with the IDB.

As a condition precedent to the first disbursement for the technical assistance component, a technical assistance action plan must be submitted, previously approved by the BMI board of directors and acceptable to the IDB.

As a special condition precedent to program execution, a management-level official must be appointed to act as permanent liaison with the Ministry of the Environment and Natural Resources so that the application and efficiency of the program's environmental protection regulations can be evaluated on a regular basis (see paragraph 3.7).

Poverty-targeting and social sector classification: This operation does not qualify as a social-equity enhancing project as described in the key objectives for Bank activity under the Eighth General Increase in Resources (document AB-1704), nor does it qualify as a poverty-targeted investment.

Exceptions to Bank policy: A revolving fund equivalent to 10% of the amount of the loan will be established to cover the need for liquid resources for the credit and technical assistance components and to limit the administrative expenses incurred by the Bank and the executing agency in implementing this operation (OA-345).

Procurement: Procurement of goods and services will be conducted in accordance with Bank policies and procedures. International competitive bidding will be required for the awarding of contracts for consulting services in the amount of US$200,000 or more. The program does not call for the construction of any works.

I. Frame of Reference

A. Socioeconomic framework

1.1 The objective of this operation is to support the development of private enterprise in El Salvador by providing medium- and long-term financing, through a global multisector loan, the proceeds of which will be channeled through eligible financial intermediaries. Special emphasis will be placed on targeting small and medium-sized enterprises that lack access to long-term financing. The program was developed in response to a request by the Salvadorian authorities on 10 September 2000 and is designed as a continuation of the support provided to the sector under loans 612/OC-ES and 885/OC-ES. The proposed program is conceived as a transitional operation, to be conducted over a period of three years. It will assist with the adjustment that the financial sector and the Banco Multisectorial de Inversiones [Multisector Investment Bank] (BMI) will have to make in the medium term in response to the implementation of the Monetary Integration Act, which will open up access to resources on the capital markets, and to changes in the regulatory framework, which will reduce the banks' maturity mismatches.

B. Macroeconomic environment

1.2 In 1989, after the armed conflict had ended, El Salvador embarked upon a stabilization and structural adjustment process designed to eliminate its macroeconomic imbalances and lay the foundation for sustainable growth. This policy remained essentially unchanged throughout the 1990s. The fiscal deficit, which had reached nearly 5% in 1992, was lowered to below 3% by the end of the decade, inflation was reduced from 14% in 1991 to 2% by 1998 and to 0.5% the following year, and the country improved its external sector's position substantially, quintupling its net international reserves to US$2 billion by 1999. Average real annual GDP growth during the 1990s was 5.1%, although the growth rate did decline during the second half of the decade, slipping to 3.4% by 1999.

1.3 In 2000, the Salvadorian economy continued to slow, posting a growth rate of 2%. The main reasons for this performance were a deterioration in its terms of trade due, in particular, to significant changes in oil and coffee prices, and a decrease in public investment. Despite this situation, El Salvador maintained its macroeconomic stability policy and succeeded in meeting the main targets of its monetary and financial program. Annual inflation was 3.3%, exports climbed by 20%, and imports by 16%, and, thanks to abundant remittances from Salvadorians residing abroad, international reserves totaled more than 100% of the monetary base.

1.4 GDP growth had been estimated at between 3.5% and 4.5% for 2001, but these projections were revised downward to 3% after two earthquakes hit the country early in the year. Although manufacturing activities and most sectors producing goods and services sustained only minor damage, there were significant losses in

the housing, agricultural, and small business sectors, and the utility and road infrastructure suffered major damage. Total damage is estimated at the equivalent of 12% of GDP. During the first quarter of 2001, GDP grew by 1.7% with respect to the same period in 2000, and a similar growth rate is expected for the second quarter.

1.5 In view of the damage caused by these earthquakes, in the short and medium terms the performance of the Salvadorian economy will be closely linked to the progress of the National Reconstruction Plan. The plan provides for a total investment of US$2 billion over the next six years, mostly in the form of public-sector investment in the rehabilitation of physical infrastructure affected by the natural disaster. A substantial part of it will be financed with resources from international cooperation, limiting the fiscal impact of the program. The second-most important factor for economic performance will be the economic environment, including both the trend in the terms of trade and the economic performance of El Salvador's main trading partners. The *maquila* and export sectors are expected to benefit from the Caribbean Basin Initiative and free trade treaties, although the economic slowdown in the U.S. and in other trading partners could have a negative impact on the above trends. The *maquila* industry and remittances are especially prone to such effects, as may be seen from the first indicators available on the economy's behavior during the third quarter and early part of the fourth quarter of 2001. In order to maximize the potential benefits of trade and economic integration for El Salvador, however, the country's levels of competitiveness, particularly those of its small and medium-sized enterprises, will have to be improved.

1.6 The Monetary Integration Act was approved on November 30, 2000 and entered into force in January 2001. The Act introduces a dual currency scheme under which the U.S. dollar serves as a means of payment and an official unit of account, in parallel with the colón, at a fixed exchange rate of 8.75 colones to the dollar. Under this legislation, economic agents can conduct transactions in either of the two currencies, but the U.S. dollar is the obligatory unit of account for the financial system. The introduction of the Monetary Integration Act was expected to help reduce interest rates and, in point of fact, rates in the financial system have declined considerably since the end of 2000, with average deposit rates falling from 10.25% in January 2000 to 6.01% by May 2001, and average lending rates dropping from 15.18% to 10.15%. In more general terms, over the medium term this law will facilitate greater competition in the financial sector and greater access to external resources, thus helping to make the Salvadorian economy more competitive.[1]

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[1] As demonstrated by other examples in the hemisphere, the elimination of exchange-rate risk is one, but not the only, step required in order to foster greater competition in the financial system and in production sectors.

C. Trends in the financial sector

1.7 El Salvador's financial sector encompasses a wide range of financial institutions, including both supervised agencies in the formal sector and unsupervised organizations. As of the end of 2000, the first group included fourteen private banks, two State-owned banks, two finance companies, various public-sector credit institutions[2] and foreign banks that are not authorized to hold deposits by the general public, eighteen insurance and bonding firms, and sixteen currency-exchange bureaus. Supervised financial institutions are generally governed by the Banking Act of 1999.[3] Unregulated, unsupervised financial intermediaries include cooperatives, workers' banks, savings and loan associations, and financial non-governmental organizations (NGOs). Following the entry into force in July 2001 of the Non-Bank Financial Intermediaries Act[4] of February 2000, unregulated financial institutions that fulfill certain conditions set forth in the Act were to come under the supervision of the Superintendency of the Financial System (SFS).

Table I-1
COMPOSITION OF THE FINANCIAL SYSTEM
December 2000
(in millions of dollars and percentages)

	Banks	"Big 3" [2]	Financial institutions	Loan associations	Workers' banks	Total[1] US$
Assets	97.6	67.7	0.4	1.4	0.6	8.500
Portfolio	97.0	67.5	0.5	1.8	0.7	5.480
Liabilities	98.0	68.1	0.3	1.1	0.5	7.716
Deposits(3)	n.a.	69.5	n.a.	n.a.	n.a.	n.a.
Equity	93.2	64.2	0.9	4.3	1.6	784
No. of institutions	14	-	1	50	7	72

Source: Beatriz Marulanda/Mariana Paredes. Superintendency of the Financial System
(1) Total estimate for the system.
(2) Concentration in the three largest banks within the banking system.
(3) Deposits in the banking system totaled US$6.174 billion and deposits in the financial system amounted to US$14.1 million; data are not available for other types of institutions.

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[2] The Central Reserve Bank (BCR), the Multisector Investment Bank (BMI) and a number of public trusts.

[3] Legislative decree 697.

[4] Legislative decree 86 of February 2000.

1.8 Although El Salvador does have a wide variety of financial institutions, private banks represent more than 90% of the financial market when measured in terms of the main variables (assets, portfolios, deposits and capital). Moreover, the banking sectors activity is highly concentrated in three institutions which together account for between 63% and 70% of the main variables (see Table I-1). These three institutions, as well as the market as a whole, exhibit a high degree of competitiveness, however. As of March 31, 2001, the private banking system's total assets amounted to US$8.523 billion, the loan portfolio balance was US$5.4 billion and deposits amounted to US$6.4 billion, representing increases over the end of December 2000 of 2.3%, 0.99% and 3.3%, respectively. A small increase in the banking sector's portfolio in the first quarter of 2001 marked a contrast with the zero growth seen in 2000[5] and bolstered expectations of moderate growth in credit demand, especially in the case of longer-term loans for the renovation and replacement of production assets. Table I-2 illustrates the trends seen in the main banking and financial systems' accounts between 1997 and June 2001.

Table I-2
TRENDS IN MAIN BANKING AND FINANCIAL ACCOUNTS
1997 – June 2001
(in millions of dollars)

	1997	1998	1999	2000	03/2001
ASSETS	7.012	7.693	6.864	8.329	8.523
Portfolio	4.564	5.052	4.397	5.348	5.158
Liabilities	6.436	7.092	6.281	7.591	7.785
Deposits	5.146	5.651	5.109	6.189	6.400
Equity	574.9	601.1	582.2	738.0	729.4
Profits	56.6	29.7	3.5	20.8	18.6
Annual growth (in percentages)					
ASSETS	-	9.7	-10.8	21.3	2.3
Portfolio	-	10.7	-13.0	21.6	-3.5
Liabilities	-	10.2	-11.4	20.9	2.6
Deposits	-	9.8	-9.6	21.1	3.4
Equity	-	4.6	-3.1	26.8	-1.2
Profits	-	-65.2	-82.3	496.6	n.a.

Source: Beatriz Marulanda/Mariana Paredes. Superintendency of the Financial System (SFS).

[5] The banking system's loan portfolio registered negligible growth in 2000 (0.64%) as a result of the economic slowdown.

1.9 No recent evaluation of the financial sector is available, but preliminary reports indicate that the system is fairly sound, thanks in part to the steps taken to strengthen supervision and introduce new prudential standards. Overall, the standards reflect the Basle Principles and are considered adequate. Moreover, the authorities have substantially improved implementation and application of the standards since 1997. As of March 2001, the banking system's average capital adequacy ratio was 11.73%; all the institutions were in compliance with the liquidity reserve requirement;[6] the total non-performing portfolio amounted to 5.28%, with average provisioning coverage of 84.4%; and profits over equity were 10.37%. Nevertheless, the composition of the system's assets and liabilities reveals a major area of vulnerability which stems from the sharp mismatch between the maturities of funding sources (deposits) and those of resource use (assets) (see Table I-4), with the former generally being short term and the latter having lengthened during recent years. Although the mismatch does not represent any immediate danger for the system, it may make it more vulnerable in the event of sudden substantial cash withdrawals, and the lack of regulation is inconsistent with the Basle Principles.

1.10 The main source of financing in the system is deposits made by the general public, and 95% of these deposits are for terms of less than one year. By the same token, nearly half of the financing received by the system (equivalent to 12% of liabilities as of March 31, 2001) is for terms of less than one year. This structure stands in contrast to its lending profile, which has been moving toward increasingly longer maturities in recent years, with something more than 50% of these operations having terms greater than five years at the present time. The following table depicts the maturity structure of the financial system's deposits and loans as of March 2000 and March 2001.

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6 In the first quarter the system displayed an average in this index of between 0.6% and 1.08%.

Table I-3
MATURITY STRUCTURE OF
THE FINANCIAL SYSTEM'S DEPOSITS AND LOANS
March 2000 and March 2001
(in millions of dollars and percentages)

	2000	%	2001	%
Current account	673.2	9.8	886.1	12.2
Savings and other deposits for less than one year	4,903.6	71.1	5,117.1	70.6
Deposits for more than one year	289.8	4.2	254.1	3.5
Other (inactive, blocked)	128.6	1.9	127.8	1.8
Loans for less than one year	342.0	5.0	389.4	5.4
BMI[1]	26.4	0.4	23.2	0.3
Loans for more than one year	378.2	5.5	311.4	4.3
BMI[1]	317.7	4.6	266.6	3.7
Loans for more than five years	184.0	2.7	158.2	2.2

Source: Superintendency of the Financial System (SFS).
[1] Multisector Investment Bank (BMI)

1.11 ***Regulation of maturity mismatches.*** In order to reduce the potential risk for financial system stability resulting from the practice of financing long-term assets with shorter-term funds, the SFS is in the process of developing prudential standards that will set limits on the permitted extent of such mismatches. Information provided by the SFS during the development of this operation indicates that the first draft of those standards was to be ready by late October. This draft will then be circulated among financial intermediaries and other interested parties for their comments. The final version of these standards is expected to be approved and introduced late this year. The implementation of these standards is expected to boost the system's demand for longer-term resources and especially for financing having a more stable maturity profile.

1.12 Preliminary information provided by the SFS indicates that the degree of mismatch to be permitted will be less than what is currently being seen and will be compatible with international best practice. A certain period will be established for gradual adjustment of asset/liability mismatches as of the cut-off date, which will relieve the pressure on the financial system for adjustment. The standards will be mandatory for all new operations. The introduction of these standards will have a strong influence on the demand for long-term funds since, as of December 30, 2000, only about 30% of assets having terms of over one year were being financed with liabilities having matching maturities. As is shown in the following table, the mismatch as of the time of writing amounted to US$2.824 billion. Given the magnitude of the mismatch, this change in standards is likely to generate a great deal of demand for resources from the BMI to refinance financial intermediaries

short-term liabilities with long-term funds; this will reduce the institutions current levels of liquidity, which account for a mere 10% of the posted mismatch.[7]

Table I-4
REDUCTION OF MATURITY MISMATCHES FOR SELECTED BANKS[1]
AS OF DECEMBER 2000
(in millions of dollars)

	Assets		Liabilities	Mismatch	Mismatch/assets > 1 year
	> 1 year	Total	> 1 year	> 1 year	%
Banco Agrícola	1,107.3	2,479.2	238.6	-868.7	78.5
Cuscatlan	1,009.7	1,808.1	261.7	-748.1	74.1
Comercio	469.7	902.9	120.2	-349.5	74.4
Salvadoreño	710.7	1,331.3	171.8	-539.0	75.8
Ahorromet	227.1	399.9	126.0	-101.1	44.5
System total	3,937.1	8,295.8	1,112.8	-2,824.3	71.7

Source: Beatriz Marulanda/Mariana Paredes; unaudited bank data.
[1] The selected banks account for 83% of total assets and liabilities and for 85% of the system's total deposits.

D. Credit supply and demand

1.13 The Salvadorian financial system has traditionally served a large sector of the country's economy, with banks generally gearing their services to medium-sized and large firms, and the smaller businesses being served primarily by non-bank financial institutions and NGOs. More recently, the banking sector has begun to broaden its market by placing more emphasis on medium-sized and small firms, launching pilot projects to serve the needs of microenterprises, and moving into consumer loans. Sources of credit for smaller businesses have also been strengthened, and their coverage is expanding. Nevertheless, the supply of credit from the formal financial system has stagnated during the past two years owing to the downturn in economic growth. It was not until the first quarter of 2001 that lending began to increase again, with loan balances rising by approximately 1% (to US$5.4 billion) and the system's number of borrowers growing by 4% (to 532,000). The largest increase in the system was seen in medium- and long-term loans, with the mounting demand for financing for fixed assets driving up the balance of such loans by about 3%.

1.14 A detailed analysis of credit demand and projections of its future behavior are not available at the present time, but the evidence provided by the first and second quarters of 2001 generally points to a recovery of economic activity and, consequently, an upturn in private-sector credit demand. For example, at the end of

[7] The funds involved in this operation will not be used to refinance IFI liabilities; they will only be used to finance new loans.

March the economic activity index showed a decline of 0.37%. This was a considerably slower rate of decrease than had been posted in the preceding months, thanks to a 2.5% increase under the heading of total industrial activity that offset the stagnation or declines registered by the sub-indices for commerce, agriculture and construction. The encouraging results for the industrial sector were also reflected in the industrial output index, which exhibited an upward trend that strengthened from an increase of 0.51% in February to one of 3.34% in May. The implementation of the National Reconstruction Plan is expected to boost construction and act as a stimulus for the economy in general. Projections prepared by the International Monetary Fund indicate that the public sector alone will invest the equivalent of 1.1% of GDP in reconstruction work in 2001 and 2002. The application of the Monetary Integration Act will also probably lead to an increase in the number of borrowers as exchange risk is eliminated.

1.15 In view of these factors, the authorities are projecting that the demand for financing will expand during the coming years, especially in the case of medium- and long-term credit for the reconstruction, replacement, and modernization of production assets. These projections tally with private-sector expectations as well. The business growth survey conducted by the Salvadorian Foundation for Economic and Social Development (FUSADE) indicates that expectations of moderate growth in 2001 were increasing in all business sectors during the first quarter of the year. The survey for the second quarter yielded the same results, although in June the monthly survey showed a slight deterioration in expectations. Nonetheless, the slowdown in the economies of the United States and other trading partners that was seen in the third quarter of 2001 could have a negative impact on private-sector expectations.

1.16 The financial system's ability to meet this demand is, however, constrained by its limited supply of stable long-term resources. With the introduction of prudential standards that limit the allowable degree of maturity mismatches, financial institutions will have to expand their term funding through the use of domestic and external debt instruments or refinancing. Although in the medium term the Monetary Integration Act is likely to increase financial institutions' access to international markets, if genuine integration is to take place and maturities are to be lengthened, the perceived level of country risk and the system's vulnerability to fluctuations in the availability of international capital will have to be reduced.[8] In the meantime, the availability of a stable supply of long-term domestic funds is thus a highly important element in providing financing for the financial sector and in meeting the demand for the credit needed to acquire fixed assets. Given these circumstances, in the immediate future the most important single source of such

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[8] The banks in the system currently have limited access to external financing. Most of the external financing that is available to them is for short terms and is for the most part confined to lines of credit for international trade. In addition, some first-tier banks have reportedly issued limited amounts of securities having maturities of no more than 5-7 years.

resources will probably be the BMI, which currently provides 86% of the banking system's loans having terms of more than one year (see Table I-3).

1.17 ***Rural financial services.*** Rural financial services in general and financing for agriculture, in particular, are one of the shallowest segments of the financial market. Rural financial services have traditionally been dominated by specialized formal and informal sources –such as the Banco de Fomento Agrícola, or BFA (a State-owned agricultural development bank), credit unions, NGOs, and commercial lenders– and the operation of these services has been the object of both direct and indirect State intervention. As a result of financial repression and the institutional shortcomings of the rural financial sector, it has been estimated that in the mid-1990s no more than 12% of rural households had access to credit, while 20% held debt balances. A breakdown by financing source shows how important semi-formal and informal credit services are in the rural sector, especially in terms of the number of operations conducted. A 1995 market study estimated that 49% of all credit operations in that year and 62% of the number of existing loans involved informal lenders. An analysis of the volume of credit operations, on the other hand, highlights the importance of formal lenders in the sector. Such sources provided 76% of the total volume of credit, with the BFA accounting for two thirds of that sum, which indicates that formal lenders tend to serve the larger clients in this sector. The rest was provided by semi-formal institutions, such as credit unions (6%) and NGOs (1.1%), and by informal sources, including various sorts of commercial lenders.

1.18 Agricultural credit has decreased substantially since the start of the 1990s, with net disbursements to this sector shrinking from 21% of total disbursements at the beginning of the decade to less than 10% by the mid-1990s. Almost three fourths of the total sum of credit supplied to agricultural activities came from the commercial banking system, and the vast majority of this went to medium-sized and large firms in traditional export and agribusiness sectors. In 1995, 64% of the total amount of credit placed in the agricultural sector was used to finance coffee and sugar-cane production. The remainder was provided by specialized lenders, including the BFA; these lenders accounted for a large majority of the operations, however, and therefore maintained a market focus that was diametrically opposed to that of commercial banks.

1.19 No study is currently available that provides detailed information on the number of rural or agricultural borrowers served by the different types of formal and informal lenders. The available data do indicate, however, that the total number of rural and agricultural borrowers does not exceed 50,000. The lack of access to suitable financial services negatively influences competitiveness since, in open economies, this reduces the affected sectors' ability to adapt or change their production patterns. Institutional weaknesses on the part of lenders and the market also reduce the possibilities for expanding supply in the medium term. In view of the above, it

is felt that in order to promote the development of the credit market in El Salvador's rural sector, an up-to-date analysis is required of the supply of credit and, in particular, of the status and efficiency of its distribution channels. This operation's technical assistance component will contribute to such an analysis and to the design of a viable rural credit strategy.

E. The Multisector Investment Bank

1.20 The Multisector Investment Bank (BMI) is a stand-alone public financial institution which is subject to SFS inspection and oversight. The BMI, whose mandate is to promote the development of the private sector, was created by executive order in April 1994[9] and functions as a second-tier bank for the Banco Central de Reservas, or BCR (the country's central bank). The BMI's institutional objective is to "promote the development of private-sector investment projects" in order to contribute to job creation by furthering the development of all production sectors and promoting the competitiveness of businesses of all sizes, with particular emphasis on small and medium-sized enterprises.[10] By law, the BMI can extend financing only through eligible financial institutions[11] and must charge market interest rates that cover its costs and that are equal to or higher than the reference rate for bank deposits. The law also prohibits any real increase in its administrative expenditures, which must be held down to 0.6% of its total assets as of the end of the immediately preceding fiscal year. Although the BCR provided the start-up capital for the BMI when it was founded and supplied additional capital after that time, neither the BCR nor the Republic of El Salvador acts as a guarantor for the BMI, and the BMI is not allowed to borrow from the BCR.[12]

1.21 ***Financial statements – overall balance.*** The BMI was founded with US$34.29 million in seed capital from the BCR's first-tier portfolio and with an additional US$59.97 million in new funds from the BCR, which is its only shareholder. These resources, together with the fact that it has retained earnings since it began operating, have helped the BMI to build up a strong capital base (US$155.07 million as of the end of the first quarter of 2001) which permits it to maintain a capital/assets ratio of 27.43% and a capital/risk-asset ratio of

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[9] Order No. 856, published in *Diario Oficial* No. 98 of May 27, 1994, as amended in October 1996.

[10] Its charter also sets forth the objective of contributing to the improvement of education and health services.

[11] Eligible institutions are defined as those supervised by the SFS and that meet specified quality requirements relating to capital adequacy, liquidity, profitability, and management.

[12] To capitalize the BMI, the BCR basically transferred the assets and liabilities associated with its second-tier banking activities. During a three-year transition phase after establishing the BMI, the BCR was granted the special authority under the Basic Law to grant credit to the BMI and guarantee its borrowings, thereby allowing the BMI, for example, to have resources transferred to it under the second phase of the IDB global multisector credit program.

approximately 39%. As of December 31, 2000, the BMI's total assets amounted to US$548 million, with US$302 million, or 55%, of these assets corresponding to its loan portfolio (a 24% decrease since 1999). As of the same date, the BMI's total liabilities amounted to US$396 million. The following table shows the balances of the BMI's main accounts for the period from 1998 to 2001.

1.22 As of December 31, 2000, the BMI's gross loan portfolio totalled US$329.4 million: US$324 million in active credits and US$5.83 million in non-performing loans, all of which corresponded to the portfolio it had received from the BCR in 1994. The BMI classifies loans as "past-due loans" if they are in arrears by more than 90 days, even though its charter empowers it to charge maturing obligations against the relevant intermediaries' accounts with the BCR. As of the end of 2000, the BMI had US$27.2 million in loan-loss reserves, composed of a 100% reserve on non-performing operations and generic provisions covering the rest of its portfolio. The BMI's portfolio risk as of December 2000 was rated as moderate, with 76.5% of its exposure corresponding to intermediaries in the top two internal counterpart risk rating categories (see Table I-9 and paragraph 1.32). Based on the probabilities of default over a one-year period for each rating category, its potential risk is estimated at US$4.2 million, which is covered by its existing provisions.[13]

[13] Default probabilities are estimated on the basis of a statistical model developed by Nacional Financiera de México.

Table I-5
MAIN BMI ACCOUNTS AND INDICATORS
1998 - 2001
(in millions of dollars and percentages)

	03/01[1]	12/00	12/99	12/98
Total assets	565.33	548.06	573.30	575.21
Liquid funds and temp. investments	259.09	229.08	165.66	177.62
Portfolio (net)	294.14	302.18	395.25	386.31
Active loans	314.60	323.57	409.71	391.36
– **Non-performing loans**[2]	5.83	5.83	5.83	5.83
– **Provisions**	-26.29	-27.22	-20.29	-10.88
Other assets	12.10	16.80	12.39	11.28
Total liabilities	410.26	396.00	427.03	435.96
BCR	327.78	330.42	363.76	376.48
Foreign institutions	74.55	60.00	57.44	55.84
Other liabilities	7.93	5.58	5.83[3]	3.64[4]
Equity	155.07	152.07	146.26	139.25
Liquid assets / Total assets	45.83	41.80	28.90	30.88
Net portfolio / Total assets	52.03	55.14	68.94	67.16
Net portfolio / Liabilities	71.70	76.31	92.56	88.61
Equity / Total assets	27.43	27.75	25.51	74.21
Solvency margin	39.10	30.60	32.27	31.18
Increase in net worth	1.97	3.97	5.03	-

Source: BMI

1) Unaudited figures.
2) Refers to an operation undertaken with FIGAPE which was arranged prior to 1994 by the BCR and assumed by the BMI upon its creation.
3) Includes US$914.000 in issues of its own securities.
4) Includes US$2.057.000 in issues of its own securities.

1.23 The following table gives indicators of the quality of BMI credit assets for the period from 1998 to 2001. As may be seen from the table, the institution's exposure to credit risk is low, whether this is measured on the basis of its non-performing portfolio or by its exposure to intermediaries having lower ratings. Potential losses on its non-performing portfolio are amply covered by its loan provisions. In addition, its coverage of portfolio risk corresponding to intermediaries having lower ratings has improved over the last three fiscal years, with this portfolio decreasing from 94.4% of provisions and reserves in 1998 to 42.6% in March 2001.

Table I-6
INDICATORS OF THE QUALITY OF BMI CREDIT ASSETS
1998 - 2001
(in percentages)

	03/01	12/00	12/99	12/98
Non-performing portfolio / Gross portfolio	1.82	1.77	1.40	1.47
Provisions / Gross portfolio	8.20	8.26	4.88	2.74
Provisions / Non-performing portfolio (times)	4.5	4.7	3.5	1.9
Non-performing portfolio / Equity + provisions	3.21	3.25	3.50	3.88
Portfolio B1 + B2 [1]/ Gross portfolio	24.12	24.89	23.98	35.68
Portfolio B1 + B2 [1]/ Equity + provisions	42.62	45.73	59.83	94.40

Source: BMI

[1] See paragraph 1.32.

1.24 The loans made to financial intermediaries are secured by the intermediaries' institutional guarantee, and the rediscounted credits and their guarantees are pledged to the BMI as collateral. Furthermore, in addition to the counterpart risk assessment that is conducted to help reduce credit risk, the BMI **monitors the rediscounted portfolio** so that it can obtain an independent, objective, up-to-date opinion on its quality. Under the BMI's risk policy, an internal review of each intermediary's portfolio must be carried out once per year or more, depending on its size, the rating of the financial intermediary in question, etc. This analysis involves the following tasks: (i) evaluate the degree of delinquency, loan-loss reserves, risk ratings of secondary borrowers, and the status and quality of the collateral they have provided to the intermediary institutions; (ii) in cases where the level of risk has increased, ensure that BMI lending policies and procedures are being followed and that relevant legal provisions and loan contracts are being complied with; and (iii) provide evidence to substantiate the use being made of the resources, both by financial intermediaries and by secondary borrowers. These internal appraisals of the quality of the intermediaries' rediscounted portfolios are supplemented with BMI assessments when deemed necessary.

1.25 By the end of 2000, the BMI was holding a considerable percentage of its assets in liquid resources or as temporary, short-term investments, thanks to an increase of over 44% in this category's share of total assets during the year. The expansion of the institution's percentage of liquid assets is a reflection of the weakening of credit demand caused by the country's economic slowdown in 2000 and of the BIM's policy of permitting intermediary institutions to make advance amortization payments on their loans at no extra cost to them, which led to a shift in liquidity risk from intermediaries to the BMI. In early 2000 the BMI modified its policy in this area and began to levy a charge for early amortization payments. Nevertheless, during the first quarter there was a further increase in liquid resources as the

demand for credit contracted immediately following the earthquakes that hit the country at the start of the year. A substantial reduction in liquidity is anticipated in the medium term, however, in view of the increase in credit demand that has been projected on the basis of the expected upswing in economic activity and intermediary institutions' need to reduce mismatches in maturities, funding sources and resource use.

1.26 The largest portion of the BMI's liabilities consists of resources provided by the BCR for startup of the BMI during its first three years of operation, although the relative share of those liabilities has been declining in the past few years. The reduction in BCR resources has been offset by access to other bilateral and multilateral public institutions and to the international private financial sector. As of the end of 2000, US$111 million of its financing was being supplied by the Bank under its global microfinance and multisector II programs, US$31.5 million came from the Central American Bank for Economic Integration (CABEI), US$28.5 million from commercial sources, and the remainder from the BCR.

1.27 Much of the BMI's financing is in the form of long-term funds, especially in the case of the resources provided by bilateral and multilateral lenders. The financing obtained from international commercial institutions is generally for shorter terms. These asset and liability maturity profiles have helped the BMI to maintain a considerable degree of liquidity, which enables it to cope with fluctuations in the demand for credit and maturing liabilities. The following table provides an overview of the terms and maturities of credits from its main sources.

Table I-7
TERMS AND MATURITIES OF MAIN BMI CREDITS
December 2000

	Balance (US$ billion)	Contract (date)	Term (years)	Maturity (last payment)
BCR	219.34	1994 – 1997	15 – 30	2009 - 2029
IDB - Global Microenterprise	20.64	1994	24, 39	2005, 2034
IDB – Global Multisector II	90.43	1995	10, 20	2005, 2015
CABEI	31.49	1997	10	2008
Dresdner Bank Lateinamerika	10.48	1999	1	-
Banco Santander Central Hispano	7.99	n.a.	1	-
Kreditanst. für Wiederaufb. (KFW)	2.29	1997	31	2028
Barclays Bank	2.22	n.a.	1	-
Other	5.53	n.a.	1	-

Source: BMI

1.28 ***Financial statements – Profit and loss statement.*** The BMI has turned in increasingly positive results in recent years. For 2000, it reported profits of

US$5.8 million, which enabled it to achieve return on assets (ROA) and return on equity (ROE) indicators of 1.05% and 3.77%, respectively. The ROA and ROE for 2000 fall within the average range registered since 1997 and are regarded as reasonable levels for an institution such as the BMI.

1.29 The BMI's profitability is chiefly attributable to an adequate gross financial spread, the quality of its assets and strict spending controls which have kept expenditure within the limits specified in the BMI's charter. An analysis of the BMI's profit and loss statements for the last four years shows that its gross financial spread widened from 2.2% in 1997 to 3.3% in 2000. This permitted it to cover its loan-loss provisions, which amounted to 1.6%, and its operating expenses (0.6%), while still leaving an operating margin of 1.3%. Since the results of the past few years were achieved at a time of declining credit demand, which caused income from lending activities to fall, an increase in lending during coming years would allow the institution to widen its spreads and consolidate its earnings position. The following table shows the main accounts included on the BMI's profit and loss statements together with selected financial performance indicators for 1998-2000.

Table I-8
MAIN ACCOUNTS ON BMI PROFIT AND LOSS STATEMENTS AND OTHER INDICATORS
1998 - 2000
(in millions of dollars and percentages)[1]

	12/2000		12/1999		12/1998	
	US$	%	US$	%	US$	%
Financial income	55.63	9.9	59.16	10.3	52.69	9.6
Interest on loans	35.50	6.3	44.76	7.8	37.87	6.9
Interest on investments	18.38	3.3	10.70	1.9	10.23	1.9
Commissions and other financial income	1.65	0.4	3.70	0.6	4.58	0.8
Financial expenses	37.32	6.3	40.32	7.0	40.99	7.4
Gross financial spread	18.31	3.3	18.83	3.3	11.70	2.1
Loan-loss provisions	7.61	1.4	9.41	1.6	3.01	0.5
Net financial spread	10.70	1.9	9.42	1.6	8.69	1.6
Operating expenses	3.36	0.6	2.82	0.5	2.68	0.5
Operating margin	7.33	1.3	6.60	1.1	6.01	1.1
Taxes	1.71	0.3	0.74	0.1	0.32	0.1
Profits	5.78	1.0	5.40	0.9	5.15	0.9
Return on assets (ROA)	-	1.05	-	0.94	-	0.93
Return on equity (ROE)	-	3.77	-	3.68	-	3.79

Source: BMI

[1] Of mean assets.

1.30 Based on its financial stability and risk profile, at the start of 2000 the BMI was given a Baa3 investment grade rating as an issuer of foreign-currency securities by Moody's Investor Services, which characterized its outlook as stable, this being the same rating as that of the country. In its report, Moody's recognized that the BMI did not have a sovereign guarantee, but cited its ownership structure and status as a preferred creditor, along with its conservative risk management, as decisive factors. The award of this investment-grade rating is an important step for the BMI which will help it, in the medium term, to gain greater access to domestic and international capital markets, conditions permitting, once it has developed the necessary institutional and technical capabilities. Thus far, the BMI has confined its activities to two domestic issues. In 1996, the BMI issued US$4.5 million in three-year negotiable investment certificates. Since 1998 it has also been conducting annual issues of exchange securities –negotiable zero-coupon bonds— to provide short-term and treasury financing. The peak volume of annual issues and balances is approximately US$22.86 million in short-term securities having maturities of between 7 and 364 days. In late 1998 the BMI explored the possibility of undertaking an international issue, but those plans were put aside in view of the crisis which subsequently engulfed emerging markets.

1.31 ***Operating capacity.*** Upon its creation the BMI took over the BCR's private-sector lending operations, including those undertaken prior to that time with the Bank,[14] and in 1995 it was designated as the executing agency for Global Multisector Credit Program II (885/OC-ES). Its participation in these operations and the technical assistance provided by the Bank within the framework of operation ATN/JF-5125 have permitted the BMI to develop second-tier banking systems and procedures, especially in the areas of counterpart risk analysis, establishment of exposure limits, risk control, and rediscounting.

1.32 *Counterpart analysis and exposure.* The BMI has developed a methodology and institutional capacity for **counterpart risk analysis** and, based on that analysis, for determining the maximum exposure it should maintain with each intermediary. Under the BMI's risk policy, its assessment system is based on the valuation, using both quantitative and qualitative criteria, of intermediary institutions' financial and economic performance and their management. The quantitative assessment is conceptually based on a CAMEL-type evaluation system. It starts off with an examination of financial and statistical criteria that carry a weight of 65% in the final rating. Based on an evaluation and weighting of four areas, an institution is then given a consolidated rating. This analysis covers performance indicators for: (i) liquidity, (ii) portfolio and risk-asset quality, (iii) earnings, and (iv) equity. The results for the first three of these areas are assigned a weight of 20% each; the

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[14] Global Multisector Credit Program I (612/OC-ES and 850/SF-ES): Global Microenterprise Credit Program (780/OC-ES and 915/SF-ES).

fourth carries a weight of 5%. The qualitative evaluation, which carries a weight of 35% in the final rating, focuses on management, including the quality of portfolio management, risk control, and internal control systems, and is primarily based on the appraisals made by the credit analyst and the Loan Committee of the BMI. Based on its evaluation of these quantitative and qualitative criteria, the BMI assigns each intermediary one of five possible ratings, the highest being "A1" and the lowest, "B3".

1.33 By the end of 2000, the BMI had rated sixteen (16) intermediaries, including fourteen (14) private banks, one public-sector sectoral development bank, and three non-bank intermediaries. Approximately half of these institutions were classified in the lowest-risk groups (A1 and A2). Four institutions—two private banks, the BFA (the State-owned development bank), and a microfinance fund—were given B2 risk ratings. The following table shows the ratings of intermediary institutions as of December 2000, debt balances, and the BIM's equity exposure, as well as the corresponding lines of credit.

Table I-9
INTERMEDIARY INSTITUTIONS' RATINGS AND LINES OF CREDIT
December 2000
(in millions of dollars)

Risk rating	Number of intermediaries	Intermediaries' debt balances			Line of credit	
		US$	% BMI equity		Authoriz.	Avail.
			Group	Average		
A 1	4	169.77	111.6	27.91	270.97	101.19
A 2	3	88.06	57.9	19.30	140.44	52.39
B 1	5	54.79	36.0	7.21	83.79	29.01
B 2	4	24.57	16.2	4.04	11.66	0.17
B 3	0	0.00	0.0	0.00	0.00	0.00
Total	16	337.19	221.7	13.86	506.86	182.76

Source: BMI

1.34 Ratings are assigned semi-annually on the basis of information provided by the SFS, but the conversion of this procedure into an ongoing evaluation process is planned. In addition, although BIM's system is comparable to counterpart evaluation systems used by other second-tier financial institutions in the hemisphere, it does not at present include any independent assessment component based on market signals or other means of benchmarking. As a result, the system may not provide sufficient advance notice of systemic declines in the sector. As part of the technical assistance component of the program, the counterpart risk evaluation system will be reviewed and refined.

1.35 The BMI ratings are then used to determine the **exposure limit** for each intermediary. To calculate this ceiling, the BMI looks at all its risk operations with intermediaries, including standby arrangements, and defines the limit as a multiple of the intermediaries' equity. The maximum level of exposure is equivalent to a 2.5 leverage ratio for top-rated intermediaries and one of 1.5 for mid-rated intermediaries. Intermediary institutions in the two lowest rating categories are not eligible for financing. Furthermore, BIM's exposure with any intermediary may in no case exceed 25% of its own capital. Nonetheless, in late 2000 the BIM's exposure with three intermediary institutions had overshot that limit by a significant degree (32%-53%), and its exposure with a fourth amounted to 21%, the four institutions being the largest private banks in the system. Three of these intermediaries had A1 ratings and the other had an A2 rating. It is important to note that this exposure overage is attributable to the portfolio that the BMI inherited from the BCR; a gradual adjustment plan has been established to deal with this situation which has succeeded in reducing the BIM's exposure significantly from the levels of over 100% that it registered in 1994 and 1995. The board of directors has also authorized, on a temporary basis, an increase in the BIM's equity exposure with A1- and A2-rated intermediaries to 60%, although the BMI remains committed to reducing its exposure levels in accordance with its exposure policy, through an absolute reduction in exposure and an increase in resources channeled to other intermediaries. In this context, the BMI expects the development of nonbanking financial intermediaries, such as leasing companies, to help reduce its dependence on the large banks in the system.

1.36 *Financial products and portfolio development.* Since it began operations in August 1994, the BMI has financed approximately 132,000 loans totaling more than US$1.22 billion. The BIM's lending activities encompass eight basic finance programs which cover the economic sectors that have been defined as being of strategic importance from an entrepreneurial standpoint. The BMI also has various special lines and programs, such as those established to aid in reconstruction works following the earthquakes of early 2001. Its basic finance programs focus on such sectors as: (i) agriculture and agribusiness, (ii) construction and housing, (iii) exports, and (iv) manufacturing, microenterprises, and small businesses. The sectors served by the BMI reflect its strategic focus as defined in its charter, but the BMI does not "target" certain sectors as such, and its interest rates are determined by the market rather than being adjusted according to the line of business concerned.

1.37 Three lines of reconstruction credits that were opened following the earthquake of early 2001 constitute a partial exception to the above. These credits have an initial term of six months but may be extended up to the end of February 2002. The loan proceeds are being used to: (i) rebuild housing, (ii) rebuild production facilities, and (iii) provide credit to microenterprises. These funds are being loaned under the same eligibility requirements as those used for intermediary institutions, and they

are priced in the same way as ordinary BMI resources, but the BMI does set a fixed interest-rate spread for on-lending as well as placing limits on the terms of operations for this sector. In addition, lines of credit for reconstruction works can be used to refinance subloans. As of September 2001, a total of 2,480 loans amounting to US$88.7 million had been placed in these three lines (1,851 housing loans totaling US$27.7 million, 594 reconstruction loans totaling US$60.9 million, and the remainder for microenterprises). Six IFIs have drawn on these lines of credit, with FEDECREDITO having placed 68% of the loans and the Banco Agrícola Comercial 53% of the funds.

1.38 Apart from its second-tier banking operations, the BMI administers a number of trust funds, activities, and initiatives, most of which are connected with microenterprise and small business development and with the expansion of financial and non-financial services in general and for this sector in particular. The organization, management, and financing of these activities are conducted independently of the BIM's second-tier banking operations. They include the administration of the Microenterprise and Small Business Development Trust (the Fideicomiso de Desarrollo para la Micro y Pequeña Empresa, or FIDEMYPE), which was founded with financing from the European Community. FIDEMYPE funds are channeled to microenterprises and small businesses, with the BMI serving as a second-tier bank for regulated and unregulated non-bank intermediary institutions specializing in service to this sector. The FIDEMYPE has its own administrative and equity structure and assumes all the costs and risks of its lending activities. The fund's operation is governed by its own regulations, which specify its eligibility criteria, maximum exposure limits, and lending terms and conditions. In defining the eligibility requirements for intermediary institutions, exposure ceilings, and loan prices, the BMI applies criteria similar to those it employs in its commercial operations. The cost of loan funds is set at 200 basis points over the BIM's reference rate, and the terms and conditions are established at the discretion of the on-lenders.

1.39 A sectoral breakdown of BMI lending between 1997 and 2000 shows that the services sector had a 18.2% share, followed by agriculture (16.4%) and microenterprises and small businesses (12.1%). The construction, manufacturing, and export sectors each received between 8% y 9%. Approximately 3% of total lending was channeled into environmental investment projects. A breakdown of the number of loans extended since the BIM's founding shows that the greatest share has gone to microenterprises and small businesses; 86% of these loans have been for sums of less than US$5,000, 11% have been for between US$5,000 and US$50,000, and 3% have involved larger sums. An analysis of the distribution of these funds by volume, however, reveals that they have been fairly heavily concentrated in a small number of large loans, with over 80% being placed in loans of over US$50,000; in addition, 24% of the loans and 60% of the total loan funds were granted for terms of over 36 months.

1.40 The BMI has extended loans to almost all of the country's financial institutions, but the distribution of its portfolio over the last three years displays an increasing concentration of loans in a limited number of institutions, most of which are among the larger banks in the system. In 1998, the four banks having the greatest exposure received 49.3% of total lending, and in 2000 their share had risen to 71.1%. This is partly a reflection of the financial system's consolidation and of the market position maintained by three of those four institutions. It is important to note, however, that the relative share of BMI resources in these four institutions' liability structures and loan portfolios has declined, as has also been the case in the system as a whole. On average, BMI resources in the system totaled 4.4% of the system's liabilities and 6.2% of the total loan portfolio in 2000, as compared to 9.3% and 6.5%, respectively, in 1999.

1.41 *Pricing and disbursement*. The **pricing of BMI** funds is conducted in accordance with its charter, which explicitly prohibits the institution from lending funds to intermediaries at rates below their real cost or the cost of its own funds. Until December 2000, the BMI was offering variable or fixed rates, depending on the loan program concerned, without reference to the term of the operation. In 2001, the BMI began to determine interest rates solely on the basis of the term of the loan in an effort to achieve a positive yield curve and therefore ceased to offer variable rates. Rates are reviewed on a quarterly basis.

1.42 The BMI generally bases the determination of its lending rates on an analysis of the cost of funding, depending on maturities, and of the financial sector's loan rates, adjusted for the cost of maintaining liquidity reserves; these figures are then further adjusted on the basis of the projected net profit margin. When pricing funds for intermediaries, the highest rate resulting from this analysis is applied. Under the current pricing system, the BMI has established a benchmark rate for intermediaries for five- to seven-year loans, which constitute the bulk of its portfolio. Once the benchmark is established based on empirical analysis, the BMI adjusts it according to the term of the loan, currently 25 basis points for each of eight established terms. The spread is based on a review of the variations in rates depending on terms in the financial markets and again a comparison with the cost of funding.

1.43 In the absence of an established benchmark that could be used as an "anchor" to set its lending rate for the financial sector, the BMI system uses a rate that is close to the market rate by analyzing the intermediaries' historic average financial cost for medium-term deposit-taking operations (especially the cost of lines of credit, debt paper issues, and time deposits) and then adjusting them in the light of BCR reserve requirements. This analysis is supplemented with estimated rate changes for the following period, considering market trends and other macroeconomic variables. However, the analytical process, and therefore the assurance of proper pricing at all times for all the different terms, has been severely limited by the lack of depth in the financial market, especially for long-term financing. Individual deposits are the

primary source of financing for the sector, of which long-term deposits represent only a tiny fraction (see Table I-3). Lines of credit and debt paper issues account for just 16% of sector liabilities and less than a third of them are for terms of more than five years (see Table I-10). Because lines of credit dominate that segment, there is currently no substantial liquid bond market in the private sector that could be used for pricing purposes. Consequently, lending rates for longer maturities generally do not tend to vary with interest rate fluctuations and accordingly represent a mismatch in the marginal cost of funds. In the context of implementation of the Monetary Integration Act, the mismatch is all the more important, given the decline in general rates since January 2001. For example, from January to October 2001, the basic interest rate for deposits of over 180 days, defined by the BCR as the benchmark rate, dropped by more than 250 basis points, from 6.48% to 4%.

1.44 As of July 1, 2001, the BIM's short-term rate was 5.75%, down from 7.25% at the start of the year. Its rate for loans from five (5) to seven (7) years has been set at 6.5% and the rate for loans having terms of over twenty (20) years is 7.50%, with both of these rates having decreased by the same proportion since the beginning of the year. The BIM's lending rates may be compared with financial-sector costs, as estimated in mid-2001, of between 4.92% for savings and deposits and 7.2% for claims having terms of more than five years, which is generally in line with the provisions of its charter.

Table I-10
BMI LENDING RATES AND
BENCHMARK RATE OF THE FINANCIAL SYSTEM
June 2001

BMI lending rate		Financial-system benchmark rate		
Term	**Rate**	**Type/Term**	**Percentage [1)]**	**Adjusted rate[2)]**
< 1 year	5.75	Savings	31.4	2.90
1 - 3 years	6.00	Time deposit	52.7	6.64
3 - 5 years	6.25	Savings/Time deposit (weighted)	84.1	4.92
5 - 7 years	6.50[3)]	Lending[4)] < 1 year	4.3	5.16
7 - 10 years	6.75	Lending[4)] 1 - 5 years	6.5	6.49
10 - 15 years	7.00	Lending[4)] > 5 years	5.1	7.23
15 - 20 years	7.25	Lending[4)] (weighted)	15.8	6.37
> 20 years	7.50			
Average portfolio	6.45	Deposits/ Lending (weighted)		5.68[5)]

Source: BMI, independent calculations.
1) Relative share in financial sector deposits and borrowings, in percentage of total
2) Adjusted on the basis of legal liquid reserve requirements.
3) BMI benchmark rate.
4) Loans received and own debt issues
5) Excludes sight deposits; including sight deposits: 5.14%.

1.45 BMI lending rates are usually based on the six-month LIBOR plus a spread that varies depending on the creditor. As of June 30, 2001, the average weighted deposit rate was about 5.00% (see Table I-11).

Table I-11
BMI FUNDING STRUCTURE
MAIN SOURCES
June 2001

Source	Rate	Reference
BCR	5.82	Libor 6M + 200 bp
IDB (855/OC-ES)	4.44	Libor + bp adjustments
CABEI	5.99	Libor 6M + 230 bp
Dresdner	4.31	Libor +62.5 bp
Barclays	4.39	Libor +70 bp

Source: BMI
bp: Basic points

1.46 In contrast, the BIM's average weighted lending rate, based on its term loan balance as of June 30, 2001, was 6.45%, which can be seen as an initial indication that the BMI is fulfilling the mandate set forth in its charter. During the last few fiscal years, the institution has also consistently maintained gross spreads that have amply covered its estimated credit risk and management costs, thus giving it a positive operating margin.

1.47 The BIM's current system for costing loans incorporates elements of established systems being used in other markets and of various IDB programs that anchor the

rate to the cost of funds in the financial system, adjusted for reserve requirements. The system also includes an innovative element whereby term-based adjustments are made in the cost of funds for financial intermediaries. As yet, however, the system only approximates the exact cost of funds, and situations have in fact arisen where rates have been set above or below the market. As part of the technical assistance component of this operation, the BMI will review and fine-tune the existing system. An effort will be made to introduce more transparent means of linking BMI lending rates with international reference rates and to offer the option of using auctions as mechanisms for determining market costs.

1.48 The **disbursement system** is a rediscounting mechanism under which the BMI receives copies of loan applications and the supporting documentation after the credit has been approved but before its disbursement by the corresponding intermediaries. Only operations that have previously been submitted to the BMI treasury department in the course of the loan programming process are rediscounted. The disbursements and payments of rediscounted BMI loans are structured in accordance with the corresponding intermediaries' funded credit operations. For smaller operations, the BMI rediscounts transactions in batches using the weighted term of the loans as the criterion on which to base its determination of rediscounting conditions. In these cases, the borrowers' eligibility is checked after disbursement. Rediscounting operations are formalized via submission of the corresponding promissory notes.

1.49 An efficiency review of the existing system indicates that it has an average processing time of from two to three days, and this finding has been corroborated by various intermediaries. The BMI is now looking into the possibility of automating this process, however, as part of an effort to modernize its back office operations and procedures and thus boost its institutional efficiency. The technical assistance component of this operation will provide support for the definition and design of an automated rediscounting system and for the review of back office systems and functions.

F. Past experience and lessons learned

1.50 The proposed operation has been designed on the basis of successful experiences with the execution of other programs in the past, the lessons learned from those experiences, and best practices derived from similar operations undertaken by the Bank. This learning process is specifically reflected in: (i) the definition of eligibility requirements aimed at ensuring that the participating intermediaries are solvent and maintain low levels of risk exposure; (ii) the need to have a motivated executing agency that is well equipped to function efficiently as a second-tier bank; (iii) the design of mechanisms for setting second-tier banking interest rates that will permit suitable, flexible procedures for costing loan resources; and (iv) the importance of giving intermediary institutions full discretion in determining loan

terms and conditions as a means of encouraging a rational, broad-based allocation of resources.

1.51 ***Global credit operations.*** Since 1990 the Bank has financed three global credit programs: two multisector operations, and one microfinance initiative. The BMI has been involved in the execution of all three operations; it was the recipient of the funds provided under the first multisector operation and the global microfinance program of the BCR following its creation, and it was the executing agency for the second multisector program. The program evaluations indicate that their objectives were achieved and that the funds were disbursed within the stipulated time periods, under the established terms and conditions, to the targeted economic sectors.[15] The two multisector operations placed 378 and 509 loans for US$66 million and US$110 million, respectively, not counting reflows, while the microfinance operation furnished a total of US$30 million in more than 40,000 loans to approximately 16,200 firms.

1.52 An independent analysis of the Global Multisector Credit Program II and the BIM's *ex post* program evaluation report[16] both indicate that 85.1% of the credit that was provided was extended in the form of loans for less than US$114,000 and another 13.8% took the form of loans amounting to between US$114,000 and US$1.1 million. This latter range accounted for 50.6% of the total sum placed under this program. Larger loans (i.e., of over US$2.3 million) represented 0.6% of the operations and accounted for 19.2% of the total sum. An analysis by sector indicates that the manufacturing and construction sectors received 43.4% and 32.0% of the total sum, respectively. The largest number of operations, however, corresponded to the agricultural sector (44.1%), followed by transport (25.4%). The program's operations were heavily concentrated in a small number of financial intermediaries, with just three institutions placing 63% of the loans and of the total sum that was lent.

1.53 The project completion report for the Global Multisector Credit Program II describes the BIM's performance as the operation's executing agency as very satisfactory and takes note of the progress it has made in the area of institution-building.[17] In particular, the program succeeded in strengthening the BIM's technical capacity for counterpart risk assessment and facilitated the establishment

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[15] The funds from Multisector Program 885/OC-ES were disbursed over a period of 24 months, which was half as much time as had been provided for the operation's execution.

[16] Under the provisions of the contract covering this operation, the BMI and IDB agreed upon the methodology and criteria to be used for its final evaluation. The BMI submitted the final draft of the evaluation report to IDB in September 2001.

[17] The report notes some shortcomings in relation to the application of standards and the monitoring of the program in its early stages, but indicates that these problems were overcome as the operation proceeded.

of policies and procedures for second-tier operations, including Credit Regulations and rediscounting systems.

1.54 ***Environment.*** Implementation of the Global Multisector Credit Program II made it possible to develop and launch a system of environmental procedures. This system was necessary because, given the absence of specialized national institutions, the BMI had to perform the necessary environmental monitoring tasks on its own. A specialized technical consultancy, which was designed and funded by the Bank under operation ATN/JF-5125-ES, developed an environmental tracking and classification system for fundable activities. This system identified four groups of environmental impacts, ranging from Group I, composed of environmentally beneficial activities, to Group IV, composed of activities having severely adverse environmental impacts. Environmental impact assessment and mitigation requirements were then established for each group as a precondition for financing. The BMI has also implemented a system of credit "filters" for identifying and monitoring ventures and projects requiring the implementation of environmental mitigation measures. Failure to fulfill such obligations have led to the reversal of credit operations and the denial of subsequent loans.

1.55 Based on the ratings assigned by credit analysts, eligibility for financing and required prevention measures have been determined. Firms and projects classified as belonging to the group with the most serious negative environmental impacts (Group IV) were not provided with financing. A review of the environmental rating of 485 active credits extended under Multisector II as of end-December 1997 shows that 34% of the loans were classified in Group I, 56% in Group II and the remainder in Group III. In terms of the balance of these portfolios, however, Group III was the biggest (42%) owing to the larger number of loans made to manufacturing and industrial enterprises.

Table I-12
ENVIRONMENTAL CLASSIFICATION OF LOANS – 885/OC-ES
December 1997
(in percentages)

	Loans	**Balance**
Group I	33.6	6.5
Group II	55.9	51.3
Group III	10.5	42.1
Group IV	0.0	0.0
Total (#, US$)	485	103.6[1)]

Source: BMI.
1) Millions of US$.

1.56 The BMI *ex post* program evaluation report analyzes a randomly selected sample of firms being financed under this operation by each of the participating IFIs. This study indicates that mitigation measures were recommended for 52% of the operations being funded. In 85% of these cases, the study found that the recommended measures were being implemented at the time the program's loan

placements were completed in 1997, while in the other 15% of the cases, the firms had yet to implement or complete these measures. Despite these very encouraging findings, the BMI *ex post* program evaluation report notes that at the time these mitigation measures were recommended and implemented pursuant to the system of environmental procedures that had been established, the country had no water- or air-quality, chemical waste or other standards, and it cannot, therefore, be determined whether these measures actually comply with the Environment Act that is now in place, which establishes specific parameters for emissions and waste.

1.57 With the passage of the Environment Act and the creation of the Ministry of the Environment and Natural Resources in 1997, the BMI handed over responsibility for monitoring environmental aspects to that body. The Ministry has made progress in the implementation of a broad-based environmental control and monitoring system and has further developed the regulations provided for under the existing legislation, together with environmental technical standards. The Ministry is now developing and implementing an environmental assessment system consisting of three main components: (i) environmental baseline analyses of existing firms and activities, (ii) environmental impact assessments of new firms and activities, and (iii) strategic environmental assessments. Within this framework, rules and standards have been established for the preparation of environmental impact assessments (EIAs), baseline environmental analyses and environmental improvement programs. In addition, a registration and review system for monitoring environmental compliance by all the country's small, medium-sized and large formal-sector firms and an "no environmental objection" list has been published for the various business categories and activities. Firms have been given a period of four years in which to comply with these environmental assessment and registration requirements.

1.58 As of June 2001, 7,210 firms were registered with the Ministry of the Environment and Natural Resources; 5,362 of these firms are in operation and have already carried out baseline environmental analyses or are in the process of doing so, while the other 1,848 firms are new enterprises that have submitted environmental registration forms and EIAs. The introduction of environmental measures is conducted as part of the corresponding environmental improvement program, and their implementation, together with the accuracy of the information contained in the EIAs and the baseline environmental analyses, are checked by means of environmental audits. The Ministry also requires that performance bonds be posted to ensure implementation of the mitigation measures specified in the EIAs, baseline analyses and environmental improvement programs. As of June 2001, such performance bonds totaled approximately US$10 million.

1.59 ***Financial Sector.*** The Bank has cooperated extensively with the Salvadorian authorities in their effort to modernize and deepen the country's financial sector. Its cooperation in this area has taken the form both of sectoral reform operations and

technical assistance. Bank programs have provided support, *inter alia*, for post-privatization measures to strengthen the banking system and for the establishment of a legal and institutional framework for a modern supervisory system. A program designed to strengthen this sector was approved by the IDB on March 3, 1999 and is now awaiting ratification by the Legislative Assembly.

1.60 The Financial-Sector Support Program for El Salvador (Loan 1173/OC-ES) will provide assistance in such areas as the strengthening of the Superintendency of the Financial System, along with the Securities Exchange Superintendency and the Pensions Superintendency, and the establishment of a deposit guarantee institute. This program is currently awaiting ratification by the Legislative Assembly. Although no direct link exists between the implementation of operation 1173/OC-ES and the successful execution of the Global Multilateral Credit Program, and although the former is by no means a precondition for the implementation of the latter or vice versa, the execution of 1173/OC-ES would have a positive overall effect on the financial sector –and, hence, on the context for the present operation– by contributing to the financial sector's consolidation and supervision. Nonetheless, the main thrust of 1173/OC-ES is to upgrade information management and processing in the various superintendencies, to enhance coordination among them, and to improve human-resources and other management aspects. In addition, a subcomponent of the program will strengthen specific aspects of banking regulation and oversight, even though in general terms the current situation is deemed reasonable and has improved substantially since 1997.

G. Bank strategy

1.61 The proposed operation is fully aligned with the Bank's strategy for cooperation with El Salvador, as defined in the Country Document, as it relates to the objective of facilitating the reactivation of economic growth and boosting competitiveness by backstopping the private sector's efforts to expand production capacity. The operation will also support the BMI and the financial sector as they make the transition towards greater integration with international financial markets under the provisions of the recently enacted Monetary Integration Act. The operation will provide a stable source of long-term resources for productive investments that will serve as a foundation and as a "cushion" for the gradual development of international commercial sources of stable, long-term financing. Within this framework, the reliability of the program's financing is expected to help smooth out any variations in commercial resource flows that may be caused by changes in El Salvador's perceived level of country risk.

II. OBJECTIVE AND DESCRIPTION OF THE PROGRAM

A. Objective

2.1 This operation's objective is to support the development of the private business sector, especially small and medium-sized enterprises,[18] by increasing the supply of medium- and long-term financing. To this end, the program will provide funds to the BMI to finance loans by eligible intermediary financial institutions (IFIs) to private firms. A second component of the program will provide technical assistance in strengthening the BMI and IFIs and in increasing the financial system's ability to meet the demand for credit in rural areas on a sustainable basis.

B. Description

2.2 **Multisector Credit Component (US$51,076,000)**. The program will provide resources to expand the BMI's capacity to finance the extension of loans by eligible financial intermediaries to private-sector firms. The program funds will be used to meet the borrowing requirements of new and existing firms in the following areas: (i) procurement of fixed assets; (ii) establishment of a working capital base for the expansion, restructuring or modernization of production facilities; and (iii) acquisition of technical and managerial support services for investment in fixed assets.

2.3 The program's execution will be governed by the provisions set forth in the Credit Regulations. These resources will be used only for BMI operations with supervised, formal-sector IFIs that meet the program's eligibility requirements. The subloans will be extended to private firms in all economic sectors—industry, trade, and services—in both urban and rural areas. The Credit Regulations will contain incentives aimed at ensuring the resources are used in a way that will be of particular benefit to small and medium-sized businesses which lack access to capital markets and that they will be employed to finance long-term operations. Intermediary financial institutions will be given full discretion in setting the terms and conditions of loans financed by program resources (including the loans' repayment terms, amortization profile and interest-rate structure) and will assume the full credit risk associated with these operations.

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[18] The BMI classifies business firms based on the number of permanent employees on the payroll and annual sales volumes. In terms of number of employees, a "small firm" is defined as having between 11 and 49 employees; a "medium-sized firm" may have up to 199 employees. The Program will employ this classification as a frame of reference for monitoring purposes, but firm size is not a criterion used to determine ineligibility for financing.

2.4 **Technical Assistance Component (US$1.5 million)**. The specific objective of this component is to strengthen and expand the institutional capacity of the BMI and of intermediary financial institutions to serve the long-term financing needs of private firms in all sectors on a sustainable basis. This component will be composed of three subcomponents designed to expand the BMI's capacity, strengthen IFIs' risk-analysis capabilities, and promote an increase in financing for rural enterprises

1. **Strengthening the BMI's institutional capacity.** Under this subcomponent, a technical assistance program will be developed and set up. The program's aim will be to enhance the BMI's institutional and technical capacity for accessing domestic and international capital markets. The subcomponent will finance market research and the development of a funding and product strategy, together with the associated mechanisms, as well as legal and technical advisory services to assist with the development of the relevant systems and procedures. In order to support market expansion efforts, the subcomponent will finance activities directed at developing new BMI financial products and strengthening non-bank sources of finance. As part of this subcomponent the BMI will receive assistance in reviewing and upgrading its systems for pricing the funds to be provided to IFIs. This will include an analysis of the use of auctions for price determination purposes and for the allocation of financial resources, counterpart risk analysis, and the modernization of back office operations and systems, especially with respect to the automation of the rediscounting system; specialized consulting services will be secured for this purpose.

2. **Risk analysis technology**. This subcomponent will primarily involve activities designed to strengthen IFIs' ability to conduct a suitable analysis of the credit risk associated with the program's operations. Special emphasis will be placed on improving IFIs' small-business analysis capabilities. Under this subcomponent, IFIs will also be provided with advisory assistance concerning the development of institutional capabilities and methodologies for analyzing environmentally-related credit risk. The BMI will cooperate in the design and implementation of training activities in this area and will seek to engage the active involvement of the Ministry of the Environment and Natural Resources.

3. **Expansion of financial services in rural areas**. This subcomponent will provide support for the definition of sustainable rural and agricultural **financing** mechanisms based on: (a) a technical baseline study of the BFA and alternative institutions, (b) the development of a strategy and plan of action for implementing the recommendations made in that study, and (c) the identification of sources of private capital that could be used to enhance the rural credit supply. This subcomponent will also finance specialized technical and legal advisory assistance for the preparation of baseline studies, strategy development and action-plan formulation.

C. Scale of the program

2.5 The proposed program has been budgeted at US$53 million, with US$51,076,000 allocated to the credit component and US$1.5 million to the technical assistance component). The sum allotted for the credit component is based on experiences with the BMI in previous programs, a projected funding flow for the institution based on its financial projections for the coming years, together with estimates of the incremental resources required to meet the real and financial sectors' potential demand and of the financial sector's long-term credit absorption capacity. The cost of the technical assistance component is based on an estimate of the resources needed to carry out the planned activities.

D. Cost and financing

2.6 The cost of the program is estimated at US$53 million. Of this sum, US$42.4 million is to be provided by the Bank's dollar window at a variable rate; the other US$10.6 million will take the form of a local contribution by the BMI and the intermediary financial institutions taking part in the program. The cost of the global multisector credit component will be US$51,076,000 and that of the technical assistance component will be US$1.5 million. A total of US$40,476,000 of the funding to be provided by the Bank will be applied to the global credit component; the remainder will be used to fund the technical assistance component and to cover the cost of inspection and supervision. In view of the enactment of the Monetary Integration Act, the operation does not require hedging of currency risk.

Table II-1
PROGRAM COST
(in thousands of US$)

	IDB	Counterpart	Total	%
Credit component	40,476.0	10,600.0	51,076.0	96.37
Technical assistance component	1,500.0		2,258.0	2.83
Inspection and supervision	424.0		424.0	0.80
Fee		318.0	318.0	0.60
Total	**42,400.0**	**10,600.0**	**53,000.0**	**100.00**

2.7 The financial terms and conditions of the proposed operation are as follows:

Resources:

Financing source:	Ordinary Capital of the Bank
Window:	Dollars

Terms:

Amortization:	20 years
Grace period:	5 years
Commitment:	36 months
Disbursement:	42 months

Finance costs:

Interest rate:	Variable
Inspection and supervision:	1%
Credit fee:	0.75%

III. PROGRAM EXECUTION

A. Executing agency

3.1 The Multisector Investment Bank (BMI) will be the program lender and executing agency and will be backed by a guarantee from the Republic of El Salvador. The BMI has the legal capacity to enter into loan agreements with international institutions, provided that such operations are authorized by the BMI board of directors and are included in the institution's BCR-approved annual financial program.[19] The BMI's various line units are to be in charge of the program's execution; the BMI will also designate a management-level executive as program coordinator. The coordinator and line units involved in executing program activities will be backstopped by specialized consultants who will be engaged to meet technical support requirements using funds from the program's technical assistance component.

3.2 The BMI has the necessary capital backing, solvency and liquidity to assume the credit obligations associated with this program. The institution's audited financial statements up to December 31, 2000 show net equity amounting to US$152 million and a liquidity ratio of 190% of the balance of its obligations having maturities of less than five years. The institution has consistently generated positive gross financial and operating spreads in recent fiscal years and has therefore had positive ROEs and ROAs, all of which indicates that it possesses the necessary financial and operational management capacity to handle the credit risk associated with its operations and to perform the related financial management functions.

B. Commitment and disbursement periods

3.3 The program's commitment period will be thirty-six (36) months in duration; disbursements will be made over a period of forty-two (42) months.

C. Multisector credit component

3.4 The credit component will be executed in accordance with the program's Credit Regulations, participation agreements, and the loan agreements that the BMI signs with each eligible financial intermediary. The Credit Regulations will reflect the experience gained in the course of the Global Multisector Credit Program II and current BMI policy. These regulations will specify: (i) eligibility requirements for intermediaries, including exposure limits, (ii) eligibility requirements for sub-

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[19] Arrangements for this operation with the Bank have been approved, pursuant to the relevant legal provisions, by the BMI Board of Directors, and its cost is included in the 2002 financial program that is to be approved by the BCR.

borrowers and subloans, (iii) terms and conditions of BMI and intermediary loans, and (iv) requirements applying to sub-borrowers to ensure compliance with the country's environmental and labor laws.

(i) ***Eligibility requirements.*** All supervised IFIs that have been duly established in El Salvador, that are authorized to engage in financial activities within the country's territory, and that meet the eligibility requirements set forth in the BMI charter and the relevant Credit Regulations will be eligible to take part in the program. The BMI will be responsible for determining which IFIs are eligible based on the most recent information published by the SFS, the BCR, and other relevant regulatory, control, and supervisory bodies.

In order to be eligible, IFIs must:

a. Be subject to SFS supervision;

b. Be in compliance with banking and financial laws, national banking regulations, and prudential standards;

c. Not be subject to any sanction, special supervision, intervention or plan to restore financial soundness required by the SFS, the BCR or other relevant regulatory, control or supervisory bodies; and

d. Carry a B1 or higher BMI risk rating based on an examination of: (a) capital adequacy, (b) asset quality, (c) liquidity, (d) profitability, and (e) management quality.[20]

(ii) ***Sub-borrowers.*** All private firms, regardless of their size or economic sector, which have been legally founded in El Salvador and which are not part of a business group that has been formally established under Salvadorian commercial law will be eligible to participate in this component as sub-borrowers. The following firms will not be eligible to participate as sub-borrowers:

a. Firms whose stock or debt instruments are listed on the exchange;

b. Firms that are classified as related-party borrowers with regard to the BMI and the IFI in question;

c. Firms that are rated as "D" or "E" borrowers in any IFI within the system; or

[20] Out of a total of 16 financial intermediaries that had been rated as of December 31, 2000, twelve (12) had received a minimum rating of B1 and four (4) had been assigned a B2 rating (see Table I-7).

d. Firms that are using production technologies that pose a threat to the environment, public health or the observance of labor laws.

(iii) ***Loan eligibility.*** Program resources may be used to finance investment projects of new or existing firms in any sector of the country's economy, provided that they meet the general standards of the BMI and the IDB and do not use production technologies that pose a threat to the environment or to public health and safety. The program will finance:

a. Procurement of fixed assets;

b. Increases in a firm's working capital base in connection with the expansion, restructuring or modernization of production facilities; and

c. Acquisition of technical and managerial support services for investment in fixed assets, including preinvestment studies and environmental impact assessments.

(iv) ***Terms and conditions of BMI financing and placement mechanisms.*** The BMI will use program resources to grant loans to IFIs in accordance with the Credit Regulations, loan agreement, general BMI regulations, and the applicable legal provisions. The loans will be denominated in United States dollars. The amortization period will be twenty (20) years or less, and the intervals at which amortization payments and disbursements will be made will be specified in the terms and conditions of the corresponding sub-loans. The interest rates charged on the loans made to IFIs may not be below their real deposit-taking costs or the BMI's funding costs (see paragraph 1.41 et seq.) and will be reviewed at least once per quarter. The base rate will be adjusted according to the term of the rediscounted loans. Loans will be placed using the rediscounting system that the BMI has used for earlier programs and for its general resource management functions.

(v) ***Terms and conditions of subloans.*** IFIs will be free to determine the amount, interest rates, and fees for the subloans they extend, as well as their disbursement modalities, terms, grace periods, and the frequency of amortization payments based on a credit analysis of the subloans and the terms of the corresponding investments. The IFIs will assume the entire credit risk of the subloans and will be solely responsible for ensuring the recovery of the subloans financed by the program. The subloans may not be guaranteed in part or in whole by guarantee funds furnished by the BMI.

The credits will be used to finance long-term investments, with the simple average term for the portfolio being not less than sixty (60) months and with a maximum term of twenty (20) years. The simple average sum of the IFI credits to be financed with program resources will be US$150,000 or less. Compliance with

the ceilings placed on median sums and terms will be checked quarterly. Any deviations from the allowed ranges will have to be rectified within thirty days.[21]

The program's maximum exposure to any one borrower or related group will not exceed US$500,000.

Sub-borrowers will be responsible for the payment of all taxes and levies, fees, duties or charges provided for or that may be provided for under the laws of the country.

(vi) ***Environment.*** In order for eligible subloans to be financed by the program, the relevant firms and investments must be in compliance with the country's environmental laws and must have been issued the corresponding certificates by the Ministry of the Environment and Natural Resources. In the case of subloans for investments classified as having negative environmental effects by the national environmental rating system, prior to the disbursement of the subloan the IFIs or the BMI must have on file a copy of all the corresponding documentation issued by the country's environmental authorities to attest to the operations of the firm and its compliance with the environmental standards applying to the proposed investment. In the case of ventures that have been rated as "high risk" activities by the country's environmental authorities, the IFIs or the BMI will need to have copies of all the authorization certificates, environmental assessments, and approved mitigation plans required by the Ministry of the Environment and Natural Resources during the subloans execution. Failure to implement the mitigation plans ordered by the Ministry will constitute sufficient cause for moving forward the expiration date of the IFI subloan and financing.

(vii) ***Sanctions and suspensions.*** Non-compliance with the standards set forth in the Credit Regulations by an IFI or a sub-borrower will render that party subject, following an adjustment period, to the withdrawal of the corresponding operations and suspension of its eligibility for financing.

3.5 The establishment, by agreement with the Bank, of the Credit Regulations and their approval by the BMI board of directors is a prerequisite for the first disbursement from the credit component.

D. Technical assistance component

3.6 This component will be executed in accordance with the Technical Assistance Action Plan, which will specify the component's exact objectives, goals, activities, and resources. This component will primarily involve securing the services of

[21] The BMI feels that this procedure for setting such limits gives the IFIs greater flexibility in using these resources without jeopardizing the Program's objective.

specialized consultants, but resources will also be allocated for training in specific areas and for dissemination activities. The formulation of an action plan agreeable to the Bank will be a prerequisite for this component's first disbursement.

E. Environmental and social aspects

3.7 The program's direct environmental impact will be neutral, since it will be financing second-tier banking operations. There is a possibility, however, that negative environmental impacts may result from the financing of individual investments, and if this occurs, the program will work to mitigate such impacts. To that end, all firms and investments to be financed with program funds will have to have the applicable environmental certifications, issued in accordance with Salvadorian law by the corresponding authorities of the Ministry of the Environment and Natural Resources. The Credit Regulations will stipulate that the BMI and intermediary institutions will be responsible for setting up mechanisms to monitor such firms' compliance with environmental regulations established by the Ministry and will prohibit lending to firms that have not complied with such provisions. In addition, the credit analyses prepared by intermediary firms will examine any environmental risks that may exist and will facilitate the dissemination of information on the subject.[22] It is recognized, however, that primary institutional authority and responsibility regarding the definition, introduction and implementation of regulations and standards relating to environmental protection and improvement lie with the Ministry of the Environment and Natural Resources or other agencies so designated by the Executive. In order to facilitate the program's establishment and regular review of environmental protection measures, the BMI will appoint a management-level officer to serve as a permanent liaison with the Ministry.

3.8 Loan agreements and the Credit Regulations will prohibit discrimination by gender or any other social characteristic in lending activities involving program resources. End-borrowers will also be required to comply with the relevant labor and social laws.

3.9 The Committee on Environment and Social Impact approved the operation on August 31, 2001.

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[22] Determinations concerning environmental aspects of the operation reflect the considerations and recommendations set forth in the project completion report on Loan 885/OC-ES, which indicate that institutional responsibility for these matters should be borne by the Ministry of the Environment rather than by the BMI.

F. Revolving fund

3.10 It is proposed that a revolving fund equivalent to 10% of the loan should be established to cover the credit and technical assistance components' liquidity requirements. The size of the proposed revolving fund will be such as to permit efficient implementation of the program while limiting the associated administrative expenses of the executing agency and the Bank.

G. Procurement of goods and services

3.11 Procurement of goods and services will be conducted in accordance with Bank policies and procedures. The award of consultancy contracts for US$200,000 or more will be conducted by means of international competitive bidding. The program does not call for the construction of any works.

H. Use of repayments

3.12 Repayments of loans granted to IFIs which exceed the sum required to meet the borrower's obligations to the Bank, with the exception of those resources used for short-term liquidity management, may only be used to grant new loans to IFIs under the terms and conditions established in the program loan contract and the corresponding Credit Regulations. Five years after the program's last disbursement, the Bank and the borrower may agree upon alternative uses for program loan recoveries provided that they are in keeping with the program's general objective.

I. Inspection

3.13 The borrower will permit the Bank to conduct inspections at any time in order to determine the status of the program's execution and to review any files or documents relating to its implementation which the Bank deems relevant. The borrower will cooperate fully in these activities. The amount of US$424,000 will be deducted from the loan proceeds for this purpose. All activities relating to the supervision and monitoring of the program's execution will be carried out by the Bank's Country Office in El Salvador.

J. Monitoring

3.14 The program will provide for approximately 500 loans over a disbursement period of three years; the median loan sum will not exceed US$150,000 and the average term will be five years. The program will place emphasis on evaluating the operation's impact on the financial market and on private-sector finance, considering the methodological and statistical constraints. To this end, based on the information provided by the IFIs, the data compiled by the BMI, and statistical and analytical information from other sources, the BMI will submit semiannual summary project performance monitoring reports no later than thirty (30) days after

the end of each six-month period. These reports will include information on the status of financing and the use of the revolving fund. The BMI will submit a final report on the program within ninety (90) days after the program disbursements have been completed.

3.15 Program monitoring will cover the following elements: (i) number of firms served and loans granted; (ii) sectoral distribution and characteristics of the firms served; (iii) sectoral distribution and characteristics of the loans granted, including their amount, term, and interest-rate ranges; (iv) a listing of the investments and firms that receive financing, broken down by the environmental ratings assigned to them on the basis of the criteria employed by the Ministry of the Environment and Natural Resources, to include an indication of what environmental assessments have been conducted and what mitigation measures have been required; (v) number of participating IFIs and distribution of resources; (vi) progress made in expanding the BMI's and IFIs' long-term funding base in terms of capital-market products and instruments; and (vii) fulfillment of the technical assistance component's objectives and activities.

3.16 The executing agency will set up accounting and internal control systems for the program that meet with the Bank's satisfaction. Regular external audits of the program and its executing agency will also be carried out in accordance with previously established terms of reference by an independent auditing firm which is found to be acceptable by the IDB. These audits will cover managerial, operational, financial and technical aspects of the program's execution.

K. Ex post evaluation

3.17 The borrower has not chosen to conduct an evaluation of the operation in accordance with Bank policy (OP-305). Nevertheless, the above-mentioned regular evaluation and monitoring mechanisms, including the final report, will furnish the necessary information to evaluate the program's impact and to draw lessons from this operation.

3.18 The borrower is currently designing a system for evaluating the impact of its programs, including those to be financed by the current operation, and has indicated its willingness to share the information it compiles with the IDB. It will be recommended that the IDB carry out its own evaluation of the program's impact once the total sum covered by the program has been disbursed and 50% of the subloans' amortization periods have been completed. Any effort to determine the program's impact on the various potential variables will, however, be subject to both methodological limitations and constraints in terms of the proposed operation's volume, and the development of suitable indicators will therefore be analyzed in cooperation with the BMI.

IV. JUSTIFICATION AND RISKS

A. Justification

4.1 The proposed program will constitute part of the support provided by the Bank to the Salvadorian authorities in their efforts to achieve sustainable economic growth by increasing the productivity and competitiveness of private enterprise within the framework of an open economy. Achieving this goal will require an ongoing process of industrial modernization and restructuring, together with the replacement and expansion of production assets. This, in turn, requires access to a stable flow of medium- and long-term financial resources. Given the domestic capital markets' incipient stage of development and the substantial obstacles that impede access to those markets, especially for small and medium-sized enterprises, the primary source of financing to meet borrowing requirements is the banking sector. This sector is also faced with long-term funding constraints, however, given the nature of domestic resources and the regulatory limitations affecting the transformation of maturities.

4.2 The recent enactment of the Monetary Integration Act has made international financing for private-sector investment more accessible, but if genuine integration is to take place and if a substantial, stable increase in funding terms is to be achieved, the perceived level of country risk will have to be lowered and stabilized. The program will provide a steady supply of long-term finance during this transition process, thereby facilitating the development of the private sector. The program will also furnish resources that can be used to help the BMI gear up for the challenge of financial integration and to provide all sectors of the country's economy with greater access to credit.

B. Risks

4.3 The program's success will largely depend on the maintenance of a stable macroeconomic policy that will be conducive to increased economic activity in the country and to the growth of demand for credit in the private sector. The implementation of the National Reconstruction Program should give a major boost to economic activity in the country, and the government has indicated that it is committed to continuing with the implementation of the monetary and fiscal discipline policy that has been in place during the current and preceding administrations. Nonetheless, the program does face the risk that economic activity may decline more sharply than is indicated by the existing revised projections in the event of a slowdown in the economies of the country's major trading partners and a further deterioration in its terms of trade. This could have a particularly strong impact on the *maquila* sector and on the level of remittances, which could in turn have a negative effect on investment and, hence, on the demand for the program's resources and the pace of disbursement. The program's main means of mitigating

this risk is by taking a conservative approach in determining the scale of the credit component and the time-frame for its implementation.

4.4 The outlook as to the stability and development of the financial system could also pose a potential risk for the operation from the standpoint both of the demand for credit (since the program will only finance credits for eligible intermediaries that meet its requirements in terms of their financial status and compliance with banking regulations) and of counterpart credit risk. This risk has been mitigated to a substantial degree by the progress made by El Salvador during the past few years in introducing prudential standards and strengthening financial regulation and in improving the authorities' ability to apply those standards properly and to supervise the system. In addition, the introduction of the Monetary Integration Act will tend to heighten competition in the sector, thereby increasing the market's demand for compliance with international standards and regulations. With respect to the first element of risk, it should be noted that the number of financial institutions in the country is expected to rise in response to the introduction of legislation for the creation of specialized, non-bank sources of finance; this will mitigate the risk of failing to find an adequate number of eligible institutions.

4.5 There is no major risk for the program on the operational front, given the BMI's successful experience with the implementation of similar operations, with the most recent example being the Global Multisector Credit Program II. In the course of this operation, the BMI set up and refined the necessary policies and systems in order to function efficiently as a second-tier bank, and the intermediary institutions had the opportunity to adapt to the demands of the program. The BMI and the intermediary financial institutions also have sufficient leverage to absorb the funding to be provided by the proposed operation.

GLOBAL MULTISECTOR CREDIT PROGRAM III
LOGICAL FRAMEWORK

OBJECTIVES	VERIFICATION INDICATORS	MEANS OF VERIFICATION	ASSUMPTIONS
I upport the development of the te sector, especially small and um-sized enterprise	Indices that measure economic activity in the private sector Indices that measure employment and investment in the private sector	Central bank statistics and FUSADE reports	Continued macroeconomic stabili A normally operating financial sy
RPOSE rovide medium- and long-term s to IFIs through the BMI in order eet private-sector firms' long- borrowing requirements	Long-term credits furnished by the program, measured as a percentage of total IFI credit	Statistics of the central bank, the Superintendency of the Financial System, the BMI and the banking sector	An increase in IFIs' demand for c
MPONENTS isector credit	Placement of program resources with IFIs Characteristics of firms receiving financing, disaggregated by size, branch of activity, and region Characteristics of discounted credits: number of operations and number of firms Implementation of technical assistance action plan	Biannual program progress reports	Eligibility and selection of IFIs to participate in the program
nical assistance MI institution-building sk-analysis technology xpansion of rural financial rvices		Biannual program progress reports	Availability of specialized technic resources

OBJECTIVES	VERIFICATION INDICATORS	MEANS OF VERIFICATION	ASSUMPTIONS
TIVITIES			
isector credit ediscounting operations	Number of rediscounting operations 500 rediscounted credits 375 firms served	Biannual program progress reports	Efficient application of Credit Regulations and of rediscounting procedures by operational and risl analysis units of the BMI
nical assistance MI institution-building Access to capital market New products and sources Automated back-office and rediscounting processes Fund pricing methodology Counterpart risk assessment sk-analysis technology Credit risk analysis for smaller firms Environmentally-related credit risk analysis xpansion of rural financial rvices	Technical studies and plan of action Number of sources and products Systems developed and functioning Technical studies: revised methodology Technical studies: implementation of revised methodology Development of methodology: design and introduction of manuals and procedures Development of environmental risk-analysis manual Baseline analyses of sources Baseline analyses and strategy for the BFA Action plan For each bank, training of 4 analysts in assessment of credit risk and 2 in assessment of environmental risks	Biannual program progress reports	Availability of specialized technic resources

RGII-ES284P
ES-0130
Original: Spanish

PROPOSED RESOLUTION

EL SALVADOR. LOAN No. _____/OC-ES TO THE BANCO MULTISECTORIAL DE INVERSIONES.

(Multisectorial Global Credit Program)

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with the Banco Multisectorial de Inversiones, as Borrower, and the República de El Salvador, as Guarantor, for the purpose of granting the former a financing to cooperate in the execution of the Multisectorial Global Credit Program. Such financing will be for the amount of up to US$42,400,000, from the resources of the Dollar Window of the Bank's Ordinary Capital, and will be subject to the "Special Contractual Conditions" and the "Financial Terms and Conditions" of the Executive *Summary* of the Loan Proposal.