MULTISECTOR GLOBAL CREDIT PROGRAM II

(ES-0057)

EXECUTIVE SUMMARY

BORROWER:	Central Reserve Bank (BCR)	
EXECUTING AGENCY:	Banco Multisectorial de Inversiones (BMI)	
AMOUNT AND SOURCE:	IDB:	US$100 million (OC)
	Local counterpart funding:	US$ 25 million
	Total:	US$125 million
FINANCIAL TERMS AND CONDITIONS:	Execution period:	4 years
	Amortization period:	10 years
	Disbursement:	OC dollar window: for the first two years of execution OC currency pool: for the following two years
	Interest rate:	variable
	Inspection and supervision:	1%
	Credit fee:	0.75%

OBJECTIVES: The basic objectives are to: (i) provide medium- and long-term funds for profitable investment projects in the private sector; (ii) promote the financing of projects through duly qualified financial institutions; and (iii) contribute to the institutional strengthening of the executing agency, Banco Multisectorial de Inversiones (BMI).

DESCRIPTION: Program resources will be used to finance medium- and long-term credit needs for private sector investment projects in: (i) the acquisition of fixed assets, including permanent working capital associated with the project; and (ii) the hiring of technical and managerial services to support the investment. The operations to be financed will comply with the environmental regulations in force in El Salvador and will meet the provisions of the program's Credit Regulations.

The Bank financing will be granted to the BCR, which in turn will onlend the resources under the same conditions to BMI. The BCR will charge a 0.1% fee for this operation. The program will be documented

through a loan contract between the IDB and the BCR and a funds transfer contract between the BCR and BMI.

As the executing agency, BMI will discount loans presented by credit intermediaries qualified to participate in the program. The intermediaries will grant loans to the subborrowers under terms and conditions freely agreed upon by the two parties, and will bear the full credit risk emanating from the loans granted.

In tandem with this operation, a technical-cooperation operation is being processed for the equivalent of US$340,000, to be financed with resources from the Japan Special Fund, for the institutional strengthening of BMI.

ENVIRONMENTAL CLASSIFICATION: The Environment Committee, at its meeting of March 31, 1994, classified this as a Category III operation.

BENEFITS: The economic program of the Government of El Salvador is aimed at positioning the country's economy in international markets. This program will be an important tool in the industrial retrofitting process by providing the country with stable, long-term financial resources to supplement available domestic sources of financing. The program thus seeks to promote the modernization and diversification of the productive base, which will yield benefits in terms of the competitiveness of companies, the production of goods and services, and the creation of jobs. In addition, BMI will play an important role as an active participant in the development of capital markets.

RISKS: The proposed program requires a stable macroeconomic environment, in which monetary policy and interest rates make for appropriate development of credit supply and demand. The current economic policy, structural reforms, and deregulation of the financial system are fundamental elements in creating the environment needed for the program to meet its objectives. As long as the current economic policy continues, the viability of the proposed operation will be assured. However, one must consider that some of the elements of the Government of El Salvador's new economic policy, particularly the dollarized economy, are not free of risks that could hamper execution of the program. Although the increasingly dollarized economy will probably result in lower inflation and interest rates, monetary

policy will lose its effectiveness as an instrument of economic policy, leaving the economy more vulnerable to external shocks. In addition, the capacity of the BCR to intervene to correct variations in the system's liquidity would be substantially diminished. However, the dollarization plan is envisaged as a gradual process in which the necessary adjustments could be made along the way.

Startup of BMI's administrative and operational systems may be delayed, which could negatively affect execution of the program. However, the likelihood of this would be significantly reduced by the Bank's technical-cooperation operation for institutional strengthening in the areas of management, finance, and monitoring.

Concentration of the system's assets in a few intermediaries could limit broad access to program resources. This risk has been reduced by limiting the cumulative amount of loans that BMI can grant through the intermediary financial institutions (IFIs) to one company or economic group.

In spite of the progress achieved in recent years, the Salvadorian banking system is still relatively small. The rapid growth of the banks has led them to maintain a level of borrowing very close to the legal limit. Projections were made to evaluate the system's capacity for intermediation. Even considering adequate growth in deposits in real terms, the intermediation capacity necessary to place the program resources within the periods required by the dollar window conditions was found to exist. In addition, the high profitability attained by the financial institutions is encouraging new companies to enter the market and existing ones to be capitalized.

THE BANK'S COUNTRY AND SECTOR STRATEGY:

The operating strategy of the Bank for the 1993 to 1996 period is consistent with the Salvadorian government's stabilization program and the 1992 National Reconstruction Program (PRN) and with the objectives of the Eighth Increase in the Resources of the Bank.

The objectives of the Bank's strategy are to: (i) improve the social and economic infrastructure in the most neglected regions, particularly those affected by the war; (ii) support economic reform, improve the climate for investment, and reactivate the country's agricultural production; (iii) increase the involvement of the Bank in meeting the basic social needs in education and health; (iv) support the improved

development of environmental protection in the country; (v) support the modernization of the public sector and the training of human resources in light of the needs of the labor market; and (vi) strengthen those government mechanisms that assure the active participation of the community in local government and the active involvement of women in the reconstruction of the country.

This program directly complements the efforts of the Bank aimed at supporting the private productive sector through multisector lines of credit to finance investment projects.

SPECIAL CONTRACTUAL CONDITIONS:

In addition to the standard conditions in the Bank's loan contracts for this type of operation, the loan contract will contain the following provisions:

A. Disbursements: Advances of up to 30% of program resources will be made. These funds will be available to BMI for use according to the conditions established in this program. In addition, outlays using program funds for operations that satisfy all the provisions of the loan contract and were duly approved after November 10, 1994, will be recognized, in an amount not exceeding 30% of the program resources (paragraphs 2.19 and 2.20).

B. Conditions precedent to the first disbursement: The borrower must present, to the satisfaction of the Bank, evidence that:

(i) it has put into effect the Credit Regulations for the program, whose draft was agreed upon by the Bank; (ii) at least four IFIs have signed an agreement to participate in the program, and they have sufficient operating capacity to allow disbursement of at least 30% of the loan resources during the first year of execution, according to the dollar window conditions; (iii) a timetable for placement of the resources has been agreed upon by the IDB and BMI, has been incorporated into BMI's lending program for the first year of execution, and has the approval of the BCR; (iv) BMI has undertaken to apply the same eligibility criteria for the IFIs set forth in the Credit Regulations of this program to all the operations it conducts once the loan contract for multisector credit program II is signed, except in instances of commitments assumed before the contract date. Likewise, BMI will submit evidence that it has placed a ceiling on the

total of operations with entities that do not qualify under the eligibility criteria contained in the attached Credit Regulations, as a percentage of its capital, and will submit a program for reducing said operations in real terms; (v) BMI has in place a mechanism acceptable to the Bank to coordinate with the SSF to obtain information needed to readily ascertain the aggregate cumulative amount of loans granted to related individuals and companies, and to keep this amount below the limits required by the program; (vi) the BCR has signed an agreement with BMI under which resources are transferred to BMI under the same terms and conditions established for the loan from the IDB to the BCR (paragraph 2.22); and (vii) BMI has engaged a consultant, using funds from the technical-cooperation operation, to advise the IFIs on instituting environmental procedures (paragraph 3.19).

C. Other conditions. The borrower undertakes to submit to the satisfaction of the Bank:

(i) within 90 days of the end of each calendar year, a report certified to by the executing agency's external auditors that includes detailed information on the flows and balances of the loan, the number and type of entities participating, the characteristics of the subloans broken down by IFI, information on the total portfolio of the IFIs for the subborrowers using BMI resources, and the pattern of interest rates being charged to the subborrowers. Additionally, evidence will be submitted that BMI has neither granted subsidies nor financed operations that incur losses, either with resources from the program or other resources, including its own resources, except in those cases permitted by law. However, the cumulative amount of the loans granted at below-market rates cannot exceed 3% of BMI's assets (paragraph 3.22); (ii) within 12 months of the signature of the loan contract, a methodology for ex post evaluation of the program (paragraph 3.24); (iii) within 12 months of the signature of the loan contract, a proposal for the mobilization of domestic resources using securities and stock market transactions, in order to promote the development of the capital market (paragraph 2.11); and (iv) within 24 months of the final disbursement of the loan resources, an ex post evaluation report prepared according to the methodology agreed upon by the

Bank. This report will include, among other things: (a) an analysis of the institutional efficiency of the IFIs that participated in the program; (b) an analysis of the final placement of the subloans, including information on the size of the operations, cost of operations, and use of resources; (c) analysis of the effectiveness of the environmental control mechanisms; (d) analysis of the level of concentration of resources among groups of related subborrowers; and (e) for the first meeting after signature of the loan contract, an evaluation of environmental procedures for the project will be prepared (paragraph 3.22).

D. Credit Regulations. In addition to the usual conditions, the Credit Regulations contain the following provisions:

(i) The rate on the loans will be in line with market costs so as to prevent the creation of distortions in the national financial market, and it will be the higher of the benchmark rate established by the BCR in line with the cost of certificates of deposit, adjusted for reserve requirements, or the real cost of the resources plus intermediation costs. Added to the latter rate will be a factor to take into account the long-term nature of the resources; (ii) The IFIs will freely determine their intermediation margins according to the risks of each operation. The interest rate spread should be reported to the subborrower and cannot be increased during the life of the subloan; (iii) The maximum cumulative balance of the loans made with resources of the program and other resources to an individual or body corporate or groups of individuals or bodies corporate which are related parties may not exceed 25% of the capital of BMI; (iv) The maximum amount of BMI operations with a single IFI may not exceed twice the value of the capital of the IFI in question; (v) The IFIs may not grant financing with program resources to members of their board of directors and/or managerial body; (vi) The projects to be financed under the program must comply with the requirements of Salvadorian legislation regarding protection of the environment. Adhering to the procedures devised under technical cooperation operation ATN/ST-3600-ES, the IFIs must: (i) ensure that all permits and licenses required under Salvadorian law have been obtained for projects to be financed; (ii) assign the projects

an environmental classification; (iii) ensure that environmental impact studies have been performed; and (iv) record the measures to be taken by subborrowers to prevent or mitigate adverse environmental effects of their projects. Once each year BMI will conduct an audit to make sure that environmental procedures are being implemented. If these audits show that the IFIs are not complying with said procedures, BMI will proceed to impose the penalties set forth in Article 20 of the Credit Regulations. If it is found that the subborrowers are not complying with the environmental protection commitments assumed under the program, BMI will: (i) report this fact to the IFIs; (ii) report this fact to the competent authorities; and (iii) exclude the subborrower from any future disbursements under the program.

IMPACT ON LOW-INCOME GROUPS: This program was designed to finance private investment projects. The program does not comply with the criteria of the Eighth Replenishment which would enable it to be classified as poverty-targeted (paragraph 5.11).

I. FRAME OF REFERENCE

A. Macroeconomic situation

1.1 Since mid-1989, the Government of El Salvador has been successfully applying a strategy of reform to attain stable, sustainable economic growth, with social development. The main accomplishments of this strategy include: (i) recovery of economic activity; (ii) reduction of the inflation rate; (iii) strengthening of the balance of payments; and (iv) reduction of the financial imbalances in the public sector.

1.2 The main objective of the government's new economic plan is to accelerate economic and social growth by inserting the national economy into international markets. To that end, the main areas of action include: (i) encouraging the progressive dollarization of the economy; (ii) gradually reducing tariffs so as to enhance the competitiveness of local industry through a real reduction in private sector production costs; and (iii) attaining greater efficiency in government through a far-reaching public sector modernization program.

1.3 The implementation of market policies has increasingly boosted the Salvadorian economy. During 1993 and 1994 real GDP grew at a rate of 7.4% and 6.0% respectively. During 1994 that growth resulted from the boom in industry (7.9%), construction (10.1%), trade (8.7%), and the financial sector (6.0%). In spite of appreciable economic growth, average annual inflation dropped to 11.0% during 1994, from 18.6% in 1993 and 11.2% in 1992, thanks to a disciplined fiscal policy and prudent handling of monetary policy.

1.4 Since 1993 the Government of El Salvador has made efforts to reduce the high level of tax evasion in the country. These measures along with the increase in imports and economic activity in general made for an increase in tax collection, up from 8.5% of GDP in 1992 to 10.3% in 1993, and 10.8% in 1994. Additionally, the central government's expenditures have been kept under control particularly by limiting capital expenditures, which primarily reveals delays in implementing the National Reconstruction Program. The success of efforts to curb government spending are reflected in the fiscal figures: in 1993 the public sector deficit was 2% of GDP, while projections had been 3.8%; in 1994 this indicator dropped down to 0.6% of GDP, while initial estimates had been 2.2%.

1.5 Total exports increased by 17.9% in 1994, from US$1.035 billion in 1993 to US$1.22 billion. Nontraditional exports grew by 11% to equal 38% of total exports by the end of 1994. The most dynamic component of exports continued to be the *maquila* [in-bond assembly] industry, with annual growth of 49% for the period. Imports have grown rapidly from US$1.767 billion in 1993 to US$2.038 billion in 1994. The trade deficit has continued to grow, reaching US$818 million in 1994, or

10.4% of GDP. However, unilateral transfers, particularly remittances from Salvadorians abroad, increased from US$823 million to US$1.001 billion in 1994, which has made it possible to keep the current account balanced. International reserves increased to US$788 million at the end of 1994, equivalent to four months of imports. The total external debt reached US$2.245 billion at the end of 1994, equivalent to 28% of GDP, and the external servicing of that debt is 25% of total exports of nonfactor goods and services.

1.6 The growth trend in the economy is expected to continue in 1995, even with a slight upward turn. The economic policy objectives for 1995 include: (i) a growth rate of real GDP between 6% and 7%; (ii) an annual inflation rate of 7%; (iii) a fiscal gap of 0.6% of GDP; and (iv) a balanced current account. The Salvadorian government's economic program is expected to receive support from the International Monetary Fund. The World Bank is expected to support the Government of El Salvador, particularly through a private sector development program and a program on modernization of the State.

B. The Salvadorian financial system

1. Composition of the financial system

1.7 The Salvadorian financial system is currently comprised of: (i) the Banco Central de Reserva (BCR); (ii) ten commercial banks that include a branch of a foreign bank (Citibank), three new banks (Unibanco, Banfidex, and Bancasa), and a commercial bank in the process of being privatized (Banco Hipotecario) 1/; (iii) seven *financieras* [finance corporations] – previously called savings and loan associations – three of which were recently part of the informal system; (iv) three official credit institutions: Banco de Fomento Agropecuario (BFA), Federación de Cajas de Crédito (FEDECREDITO), and Fondo de Garantía para la Pequeña Empresa (FIGAPE); and (v) other credit institutions (commercial leasing companies, general bonded warehouses, surety companies, and a factoring company).

1.8 Commercial banking, with a network of 71 branches throughout the country, is the main component of the financial system and is responsible for most private-sector deposit and lending operations. As of December 31, 1994, commercial banks held 85% of total deposits in the financial system, finance corporations held 13%, and Banco de Fomento Agropecuario (BFA) held 2%. At year's end, the banking system held deposits totaling US$3.458 billion, while the total portfolio of the banks and finance corporations reached a new record of US$2.613 billion.

1/ A new bank (Brinsa) is being formed as well as a new finance corporation (Calpin), which will work solely with microenterprises and will receive an equity investment from the MIF.

1.9 The Government of El Salvador has continued its policy of allowing interest rates to be determined by supply and demand. This has enabled positive real yields to once again be established, thus correcting the distortions of the past. Price stability during 1993 made it possible to reduce inflationary expectations to moderate rates, and to reestablish positive real yields in bank financial instruments. During 1994 the average of active nominal interest rates for less than one year reached 19%, and the rate on 90-day certificates of deposit reached 13.2% per annum. When these variables are related to annual inflation, real values of 9.2% and 3.9%, respectively, are obtained.

Year	Average rate 90-day deposits (%)	Average rate < 1 year loans (%)	Apparent spread (%)	Inflation (%)
1992	11.5	16.4	4.9	19.9
1993	14.4	19.4	5.0	12.0
1994	13.2	19.0	5.8	9.0

Source: BCR

1.10 Until now the BCR has discouraged the dollarization of the economy by penalizing dollar deposits with reserve requirements of up to 50%. However, recently, and as a result of the discussions on the country's exchange policy, the BCR put the reserve requirements for local currency and foreign currency on an equal footing and allowed local banks to remunerate demand deposits in foreign currency. These measures are intended as the first steps towards a gradually dollarized economy. The Government of El Salvador hopes that these measures will reduce interest rates, enhance national and foreign investor confidence, and increase the competitiveness of the financial sector.

2. The banking system

1.11 The banks and finance corporations were nationalized in March of 1980. In the mid-1980s the uncollectible portfolio exceeded 40% of the total amount of loans granted, which meant the banking system was technically bankrupt. 2/ To correct this serious problem, the Government of El Salvador began a program to reform and clean up the financial system, which included two basic components. The first component, financial policy, established a new role for the

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2/ Quite different from the current situation in which arrearage in the banking system is only 2.8% of the total portfolio.

BCR and redefined the monetary, credit, and exchange policies. The second component, modernization of the financial system (which is fully under way), seeks to promote soundness, efficiency, and competitiveness within the system, including: (i) readjustment of the legal and institutional framework; (ii) clean-up, strengthening, and privatization of institutions still in government hands; (iii) establishment of incentives for the development of the capital market; and (iv) strengthening of the Superintendencia del Sistema Financiero [Office of Financial System Oversight] (SSF).

1.12 The process of reforming the financial sector was supported by various international agencies, but particularly by the IDB. In 1990 multisector credit program I was approved, whose objectives were to: (i) support the development of economic activities by providing financing for the installation, expansion, modernization, and diversification of private Salvadorian companies; (ii) reduce the segmentation of credit by allocating resources to the most profitable projects in the private sector; (iii) support the BCR in its aim of reorganizing the banking system; and (iv) contribute to setting up an effective SSF.

1.13 Disbursements under this program, which met its objectives, were completed at the end of 1993. Before the first disbursement, the new SSF Act was approved and progress was made in privatizing the financial institutions that had been nationalized. The SSF began to function with the support of the United States Agency for International Development (AID), which allowed it to strengthen the Superintendency of Banks. Another major accomplishment of the multisector program was that it helped eliminate the distortions in the interest rate system by requiring that operations carry positive real rates, thus making them an important signal for the market. It also allowed banking and the productive sector to have fresh resources during a key period of the reform process.

1.14 In 1992 the sector investment program (PSI) was signed with a strong component for reform of the financial sector. This program had the following objectives: (i) successful completion of the privatization program; (ii) continuation of appropriate monetary policies; (iii) solvency and long-term viability of the State-owned development banks; (iv) strengthening of the long-term credit markets; (v) strengthening of regulation and supervision of the financial sector; (vi) strengthening of the contractual savings sector; and (vii) modifications to the commercial code to facilitate the creation of new financial instruments. In many ways the sector investment program became the cornerstone of the government's development program. Thus far, two of the three tranches of the loan have been disbursed. The third disbursement is expected to be released at the end of the year. Substantial progress has been made on compliance with conditions for the sector program. While it may yet become necessary to extend the term for fulfillment of requirements (given the complexity of the issues involved), it is evident that the government is making a concerted effort to

satisfy all conditions within the time frames established. The conditions pertaining directly to the project described herein have either been fulfilled or are well on their way to completion. No major impediments for the present operation are anticipated in this connection.

1.15 The operations to clean up and recapitalize the banks and finance corporations have required the equivalent of US$350 million. During the process three banks were liquidated and four finance corporations merged. Also, the capital of five banks was strengthened (Banco Agrícola Comercial, Banco de Comercio, Banco Cuscatlán, Banco de Desarrollo e Inversión, and Banco Salvadoreño), as was that of four finance corporations (AHORROMET, CASA, CREDISA, and ATLACATL), 3/ as well as their solvency ratios and competitiveness. Both the Banco Hipotecario, which is in the process of being privatized, and BFA had their capital strengthened. 4/

1.16 In 1993 a global credit program for microenterprise was approved with the objective of increasing the flow of formal credit to microentrepreneurs. The strategy of the Bank to strengthen the Salvadorian financial system has been coupled with several small-scale operations, with an equally large impact. The MIF program for US$1.8 million for the strengthening of the SSF approved at the end of 1994 is aimed at strengthening the least developed areas of that entity, such as the Insurance Superintendency and the Securities Superintendency. Financiera Calpia, in which the MIF has an equity investment, was created to meet the financial needs of microenterprise and small savings account holders. The program for the institutional strengthening of BMI is in the process of approval at the IDB.

1.17 The banking system has regained its solvency and the equity status of its institutions is currently solid. Total capitalization of the system reached US$382.2 million at the end of 1994, compared with the negative net worth of US$317 million in 1989 for the State-owned banking system. The profit ratio of the institutions in the system is generally high. On the average, the commercial banks in the system (excluding BFA) obtained a real rate of return of 21%, while for the finance corporations that figure was 26%. This has inspired new players to move into the market, such as three finance corporations and one bank in 1994, and one bank so far in 1995.

3/ The CASA investment bank became BANCASA bank on December 31, 1994.

4/ BFA currently has a solid capital structure (capital to total assets of 52.6%). However, it still will need to lower its excessive administrative costs of 12.9% of portfolio which have kept it from posting an actual profit. Its capital in actual terms continues to erode because its true return is negative (-6.1% annual).

1.18 In spite of the small size of the financial institutions, on the average the system has managed to remain efficient. Measured by the operating costs/assets indicator, the efficiency of the sector during the last three years has maintained levels of close to 3%, which compares favorably with the level attained in countries more developed than El Salvador.

1.19 However, there is a high degree of concentration in the system. The three largest banks (Agrícola Comercial, Cuscatlán, and Salvadoreño) control 57% of the assets of private banking. Additionally, there are clear signs that most financial activity is concentrated in the capital city. This situation is not expected to change in the short term. In order to reduce the risks emanating from the concentration of the system, the Government of El Salvador is planning to introduce even stricter rules on related-party lending, reducing the maximum amount of this kind of loan from 25% to 15% of capital accounts. In addition, this situation has not led to high intermediation margins which compare very favorably with those found in other countries in the region.

1.20 Other important features of the Salvadorian banking system are the following: (i) highly dispersed ownership, since the legal limit on ownership in a bank is 5% per shareholder and at the end of 1993 there were 21,000 shareholders in banks; (ii) complete freedom for banks and finance corporations to enter and leave the system (since July of 1993); (iii) interest rates freely set by the market; and (iv) full observance of basic international concepts on the standards of banking solvency as recommended by the Basle Committee.

3. Financial regulation

1.21 At the beginning of the decade the Government of El Salvador began a far-reaching process of reform of the legal framework for the financial system, incorporating new legal and institutional provisions which have allowed for the institutional strengthening and development of the system. During this process four important new laws have been enacted: (i) the Central Reserve Bank (BCR) Act; (ii) the Banks and Finance Corporations Act; (iii) the Act governing the Superintendencia del Sistema Financiero [Office of Financial System Oversight] (SSF); and (iv) the Stock Market Act. Progress has also been made on bills regarding insurance and sureties, investment funds, and the deposit insurance fund.

1.22 In order to bolster the solvency of the financial system, the Government of El Salvador plans to submit to the Legislative Assembly a proposal to gradually implement, over three years at most, a stricter capital requirement for banks and finance corporations, i.e., the ratio between capital and risk assets would be raised gradually from the current 8% to 10%.

1.23 The Government of El Salvador has also been evaluating various alternatives for revamping the pension system. Substantial

progress has been made in defining the plan of action to follow and some decisions remain to be made on strategy and policy in order to proceed with the drafting of laws. It is hoped that the ensuing bill will be sent to the Legislative Assembly for approval before the end of the year.

1.24 The BCR Act eliminated the authority of the central bank to grant loans to the State. In the case of the private sector, the law only allows it to grant liquidity loans to banks and finance corporations. The role of providing fixed-asset loans to the private sector was transferred to Banco Multisectorial de Inversiones (BMI), recently created by Legislative Assembly Decree 856 of 1994, to act as a second-tier bank. This transfer will allow the financing of private investment projects with medium- and long-term resources from multilateral banks to be handled smoothly, without interfering with the monetary policy of the central bank. Lastly, with regard to exchange and financial policy, the BCR Act gives its board of directors sufficient authority to establish the necessary policies to ensure that exchange and interest rates are freely established based on market forces. 5/

1.25 The Banks and Finance Corporations Act was passed at the end of April 1991, and has been amended several times, the latest in January 1994. In general, the Banks Act covers all aspects that are necessary in modern legislation. In many ways it resembles laws in force in developed countries and it generally establishes appropriate rules which: (i) satisfactorily protect the solvency and stability of financial institutions; (ii) establish the proper legal framework to encourage efficiency in the system through competition; (iii) grant adequate guarantees of transparency regarding the information available to users; (iv) establish parameters to reduce the concentration of credit among related individuals and groups; (v) establish rules for adequate prudential oversight; and (vi) allow the operation of foreign financial institutions in the country in order to generate greater competition in the services of the financial system.

1.26 Generally speaking, international principles of prudential regulation, bank solvency, and limits on the concentration of risk have been adopted. A bill is currently being debated to change and strengthen some aspects, particularly those related to the minimum capital requirements and the minimum ratio of capital to weighted assets, which would go up from 8% to 10%. In addition, it would not be permissible to record profits for the period in the net

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5/ The government has a policy of interest rate decontrol and has virtually eliminated new programs that include preferential interest rates, with the exception of loan programs for low-income students and reforestation programs. Interest and exchange rates can be set by the BCR only in exceptional cases and for periods of no more than 180 days.

worth accounts. This last factor could create pressures on the growth of the sector and motivate the financial institutions to use shorter accounting periods to capitalize profits.

1.27 The SSF Act dates back to 1991 and generally grants the SSF all the authority necessary to do its job completely. The quality of banking supervision has improved substantially in recent years thanks to an AID assistance program that facilitated the institutional and technical strengthening of the SSF, particularly the Superintendency of Banks. However, although an acceptable level has been reached, the degree of sophistication that ensures high quality supervision has not yet been attained. The Government of El Salvador is considering the possibility of creating a new superintendency that would take over the areas of insurance and securities, in order to lighten the burden on the SSF and simplify the administrative management of the superintendencies. The Bank maintains a program of support for the institutional and operative capacity of the SSF which is financed with MIF resources. 6/

4. Monetary policy

1.28 In light of the flow of foreign exchange into the country, in 1993 and 1994 the BCR took restrictive measures to regulate the liquidity in the economy, combining greater legal reserve requirements and placements of securities, Certificados de Estabilización Monetaria [Monetary Stabilization Certificates] (CEM). The reserve requirement for different deposits increased in 1993 by 5%, to 30% and 20% for demand deposits and term savings accounts, respectively. The reserve requirement for deposits in dollars was set at 50%. Reserves are compensated at a substantially lower rate than the basic deposit rate. In 1994, this reserve policy was maintained in order to keep the monetary situation under control, and increases in credit to the nonfinancial public sector continued to be limited. In 1995, in order to spur the progressive dollarization of the economy, the BCR plans to reduce reserve requirements on deposits in dollars, and put them on a par with reserve requirements of deposits in local currency.

1.29 At the same time that direct mechanisms are being promoted, the BCR has proceeded to create the conditions to implement monetary regulation through open market operations. These have included: (i) change in the system of placing CEMs; (ii) diversification of the terms of these securities in multiples of 30 days; (iii) encouragement of investments in CEMs for terms longer than 90 days; (iv) the establishment of a rate of return on CEMs based on the average interest rates of the financial system less a differential

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6/ In January 1994, the MIF approved a program for the institutional strengthening of the SSF (TC-93-08067) for US$1,832,000, which is now fully under way.

of up to 1.5%; and (v) measures to allow more private investors to acquire CEMs by using stock market mechanisms.

1.30 During 1994 the need to maintain monetary control led the BCR to substantially increase open market operations. Operations with CEMs increased by more than 25% to 2.5 billion colones (US$285 million) by the end of the year. Recently, however, the BCR has decided to limit its CEM operations, since the associated costs have begun to generate quasi-fiscal pressures. To somewhat alleviate the pressure on the BCR, short-term treasury bonds, LETES, were introduced at the end of the year to finance the treasury deficits of the Government of El Salvador. In spite of the growing influx of foreign exchange emanating, among other things, from the high price of coffee, the country will face difficult challenges in the upcoming months regarding monetary policy.

II. THE PROGRAM

A. Objectives

2.1 The basic objectives of multisector global credit program II are to: (i) provide medium- and long-term funds to support profitable investment projects in the private sector; (ii) promote the financing of projects through duly qualified financial institutions; and (iii) contribute to the institutional strengthening of Banco Multisectorial de Inversiones (BMI), the executing agency.

B. Description of the program

2.2 The resources of the financing will be used to meet medium- and long-term credit needs for profitable investment projects in the private sector in: (i) the acquisition of fixed assets, including the permanent working capital associated with the project; and (ii) the hiring of technical and managerial services to support the investment. These services are intended to improve and develop technical and managerial capacity, through the hiring of consultants to modernize and streamline the activity of the company and improve the quality and timeliness of production and service delivery. The operations to be financed will meet all the environmental regulations in force in El Salvador and the requirements of the program's Credit Regulations.

2.3 BMI will discount the operations presented by credit institutions that have been qualified and declared eligible. The credit institutions will assume the full risk emanating from the loans made under the program, and may freely negotiate with their clients on the financing terms and conditions. In no case will BMI assume the exchange risks of the operations. The multisector nature of the operation along with the fact that the funds will be loaned to the subborrowers at market rates will make the efficient allocation of program resources possible.

2.4 In addition to this program, a program of institutional support for BMI is being implemented with US$340,000 from the Japan Special Fund (JSF). This component will be supplemented by a local counterpart of US$50,000 with the intent of strengthening BMI's capacity as a second-tier institution. Among other activities, the technical-cooperation project will include advisory services to define the strategic planning functions, introduce internal control rules and procedures, adopt appropriate policies for human resources development, and implement a modern management information system.

C. Scale of the program

1. Demand for loans

2.5 The demand for medium- and long-term resources to be met through the program has been estimated in light of: (i) economic policy during execution of the program and economic growth projections; (ii) the expected level of private sector investments; (iii) expectations for investment in the productive sector by the financial sector; and (iv) the banking sector's medium- and long-term resource intermediation capacity.

2.6 The Government of El Salvador has successfully continued its economic reform process begun in mid-1989, which has resulted in high rates of economic growth. At the same time it has maintained the equilibrium of the other economic variables. The economic plan of the current administration is aimed at taking the reforms further and quickly inserting El Salvador into the world economy. GDP growth for 1995 and 1996 is expected to be around 7% annually, similar to what El Salvador has achieved in the last three years.

2.7 These high rates of growth have been associated with a sustained recovery of private sector gross investment, which has grown satisfactorily at rates of 16% in real terms, a level equal to 18.8% of GDP in 1994. Gross capital formation by the private sector that year reached 10,503,400,000 colones (US$1,200,300,000). It is hoped that this trend will continue in upcoming years, to ensure accelerated rates of economic growth.

2.8 In addition, assets in the banking system have been growing at real rates of between 15% and 16% in the past two years, which means an annual expansion of approximately US$700 million. If this rate of growth continues, the program's funds will not exceed 9% of this amount if disbursements are carried out as expected over the next two years. Under these conditions the aggregate amount of the disbursements under the program would not exceed 2.4% of the assets in the system.

2.9 The growing demand for medium- and long-term resources is reflected in the maturity transformation effected by the banks and finance corporations. Loans granted by the banks and finance corporations for more than one-year terms accounted for 70% of the portfolio by the end of 1994, which portion was essentially financed with short-term deposits or BCR resources (and now from BMI, which from its opening in August 1994 to February 1995 approved operations totaling close to US$93.8 million) as the main sources of long-term funding. The Office of Financial System Oversight (SSF) is devising measures to control maturity mismatching in financial intermediaries. The operation proposed herein should also help lower their risk of mismatched borrowing and lending terms.

2.10 Based on the figures in their financial statements of December 31, 1994, 12 financial institutions would qualify to participate in this program, compared with only five banks under the previous program. These are believed to have sufficient intermediation capacity to place program resources for the periods set forth in the dollar window terms and conditions. 7/ The demand for medium and long-term credit can be expected to keep rising considering the boom in economic activity, the security offered by the peace process, and the private sector's confidence in the economic model.

2. Domestic mobilization of medium- and long-term resources

2.11 In order to promote the development of the capital market, BMI will present to the IDB, within 12 months of the signature of the loan contract, a pilot project for the mobilization of medium- and long-term domestic resources, using securities and stock market transactions. The effect of this pilot program would be significant, primarily because of the important demonstration effect which would induce the IFIs to redouble their efforts to develop the capital market.

3. Credit to the private sector and multisector global credit program I

2.12 One of the main sources of financing for the medium- and long-term private sector investment projects has been the BCR's Fondo de Crédito para Inversiones [Investment Credit Fund] (FCI). It has used funds from multisector global credit program I, financed with the resources of loans 850/SF-ES (US$20 million) and 612/OC-ES (US$40 million), such loans accounting for 34% of the total FCI portfolio.

2.13 Due to the prevailing conditions during the final stage of the armed conflict, which coincided with the beginning of the first stage of the multisector global credit program, the lending of resources was concentrated in the San Salvador metropolitan area. Once the conflict ended and in response to efforts by the national authorities to reactivate the economy, and in keeping with the National Reconstruction Program (PRN), there has been a boost in lending in the areas of the conflict, especially the eastern departments of San Miguel, San Vicente, La Paz, and Usulután. The placement of loans during 1991 and 1992 in the San Salvador metropolitan area accounted for around 71% of the total. However, more recently a substantial proportion (around 50%) of the total

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7/ The IFIs that would participate are: Comercio, Agrícola Comercial, Cuscatlán, Desarrollo e Inversión, Citibank, Banfidex, Unibanco, and Salvadoreño (banks) and Credisa, Corfinsa, Ahorromet, and FICSA (finance corporations).

funds have been placed in the private sector outside the San Salvador metropolitan area.

2.14 The following table shows that subloans averaged around the equivalent of US$207,000, with 10 subloans averaging in excess of the equivalent of US$2 million. In addition, the cumulative amount of operations with the four largest recipients of funds accounted for around 24% of program resources, which implies a high degree of concentration.

SUBLOANS GRANTED WITH RESOURCES OF MULTISECTOR GLOBAL CREDIT PROGRAM I (By amount of loan)

Range	Number of loans	Amount millions US$	%	Average Loan US$ thousands
0 115,000	225	8.1	11	36.1
115,001 ... 400,000	101	22.0	28	217.5
400,000 ... 1,000,000	42	27.8	39	662.1
more than ... 1,000,001	10	20.3	22	2,027.6
	378	78.2	100	206.8

Source: BCR

2.15 Out of the amount contracted, approximately 8% went to finance permanent working capital, 19% to construct different types of buildings except housing and commercial sites, and the remaining 69% went to finance equipment. The smallest amount lent was US$2,200 and the largest amount lent to a single company was for the purchase of publishing equipment in the amount of US$8 million. Most of the resources (77%) were applied to loans to the industrial sector and 13% went to the service sector, including the areas of health, education, and technical advisory services.

2.16 Overall, the contract conditions of the program have been satisfactorily met. However, some factors should be considered for the present operation. It will be necessary to avoid the levels of concentration of operations in the hands of a few users, without imposing too many conditions on the efficient allocation of resources. BMI should improve its information mechanisms in order to conduct better follow-up on the accrual of loans with one subborrower and related individuals and companies, and should properly keep track of the local counterpart funds. Also, the interest rate charged to the IFIs should, insofar as possible, reflect market conditions and include a premium for long-term risk.

D. Cost and financing

2.17 It is estimated that the total cost of the program will be the equivalent of US$125 million, out of which US$100 million (80%)

would be financed by the IDB and the equivalent of US$25 million would be local counterpart funds.

COST OF THE PROGRAM BY SOURCE OF FINANCING
(in thousands US$)

	IDB	Local contribution	TOTAL
Credit component	99,000	25,000	124,000
Inspection/supervision	1,000		1,000
TOTAL	100,000	25,000	125,000
Percentage	80%	20%	100%

1. <u>IDB financing</u>

2.18 The percentage participation of the Bank is compatible with current policy, 8/ which specifies 80% as the maximum percentage of the total costs to be financed in foreign exchange in Group D countries, in which El Salvador is included. The Bank financing would be granted with ordinary capital resources in the context of the dollar window program (document FN-483-3 of May 10, 1994). This modality provides for an amortization period of 10 years, including a five-year grace period. Disbursements may be made in U.S. dollars for two years starting with approval of the program by the Board of Executive Directors, as long as disbursements of not less than 30% of the loan are made during the first year following said approval. After two years, the unused balance may be disbursed using the ordinary capital resources of the currency pool. The maximum term for disbursement under this modality is four years from the signature of the loan contract. The credit fee on nondisbursed funds is 0.75% and the inspection and supervision fee is 1% of the amount of the loan.

2.19 In light of the automatic discount and the conditions deriving from the dollar window, it will be necessary for the executing agency (BMI) to have sufficient funds to ensure that it can discount the loans presented by the IFIs in a timely fashion. Consequently, advances of up to 30% of the resources provided by the IDB will be made.

2.20 Primarily to enable BMI's operations to continue during its phase of organizational consolidation, outlays using program funds for operations that satisfy all the requirements in the loan contract

8/ See document AB-1378.

and that were duly approved after November 10, 1994, will be recognized, in an amount not exceeding 30% of the program resources.

2. Local counterpart funding

2.21 The counterpart resources will total the equivalent of US$25 million. Said funds will include resources contributed by BMI and the participating IFIs that meet the conditions established in the loan contract and the Credit Regulations. Likewise, the funds contributed by the end borrowers to their respective projects can be considered as local counterpart resources for up to 15% of the total cost of the program. According to IDB policy, contributions from the subborrowers cannot be considered a legal counterpart if they are: (i) recurrent labor expenses; (ii) working capital; (iii) imputed values of investments already made; or (iv) contributions in kind. Expenses incurred in the preparation of environmental impact studies may be considered in tallying the local counterpart. Contributions by the local IFIs may be used to cover the working capital needs of the projects.

3. Conditions precedent to the first disbursement

2.22 A condition precedent to the first disbursement is that BMI provide evidence to the satisfaction of the Bank that: (i) it has put into effect the Credit Regulations of the program, the draft of which was agreed upon with the Bank; (ii) at least four IFIs have signed an agreement to participate in the program, and they have sufficient operating capacity to allow disbursement of at least 30% of the loan resources during the first year of execution, according to the dollar window conditions; (iii) a timetable for placement of the resources has been agreed upon by the IDB and BMI, has been incorporated into BMI's lending program for the first year of execution, and has the approval of the BCR; (iv) BMI has undertaken to apply the same eligibility criteria for the IFIs set forth in the Credit Regulations of this program in all the operations it conducts once the loan contract for multisector credit program II is signed, except in instances of commitments assumed before the contract date. Likewise, BMI will submit evidence that it has placed a ceiling on the total of operations with entities that do not qualify under the eligibility criteria contained in the attached Credit Regulations, as a percentage of its capital, and will submit a program for the reduction of said operations in real terms; (v) it has in place a mechanism acceptable to the Bank to coordinate with the SSF to obtain information needed to readily ascertain the aggregate cumulative amount of loans granted to related individuals and companies, and to keep this amount below the limits required by the program; and (vi) the BCR has signed an agreement with BMI under which resources are transferred to BMI under the same terms and conditions established for the loan from the IDB to the BCR.

III. EXECUTION OF THE PROGRAM

3.1 The borrower for the program will be the BCR, and its executing agency will be BMI. Article 53 (transitory) of Decree 856, the Banco Multisectorial de Inversiones (BMI) Act, allows the BCR to continue granting loans and guarantees to BMI for a period of three years starting with its entry into force. Therefore, the Bank's financing will be granted to the BCR, which in turn will transfer these resources to BMI under the same conditions as the loan from the IDB, charging a fee of 0.1% for this service. The loan will be documented by: (i) a loan contract to be signed by the IDB and the BCR; and (ii) an agreement for the transfer of resources, to be signed by the BCR and BMI. The resources will be channeled to the end borrowers through the IFIs operating in El Salvador that qualify to participate in the program. The IFIs will allocate the resources to their customers and will assume the full credit risk.

A. Necessary conditions for the success of the program

3.2 The recovery of private investment in medium- and long-term projects not only depends on the supply of credit, but also on the existence of favorable macroeconomic conditions. It is therefore necessary, for the success of the program, that the government's economic policy be aimed at maintaining a stable macroeconomic environment favorable to the development of the financial sector and capital markets. These objectives are reflected in the Salvadorian government's plans and are consistent with commitments undertaken with the International Monetary Fund and program 714/OC-ES.

B. Credit Regulations

3.3 The Credit Regulations, which are described below, are compatible with the rules and policies of the Bank and with Salvadorian legislation and the banking and finance practices of the country. The Credit Regulations governing execution of the program are included in Annex I.

1. Allocation of resources

3.4 Resources will be allocated through an automatic discount of loans granted by the participating IFIs. BMI will make the disbursement, subject to the borrowing limits established in the Regulations, by no later than the working day following receipt of the request for disbursement, which will contain basic information on the project financed. In order to allow efficient management of BMI's funds, the IFI should report in writing one week in advance the aggregate amount of disbursements under the program it expects to obtain during the following week.

3.5 Requests for disbursement of loans that exceed the delegation of authority extended by the board of directors to BMI's management (currently 10 million colones) should, as established in the BMI Act, be approved by said board. To this end, such requests should be accompanied by a short description of the project and a summary of the analysis conducted by the IFI to support the viability of the project. Based on this documentation, the board of directors of BMI must decide on the matter within no more than 10 working days. Since the IFIs are responsible for the technical, financial, and economic evaluation of the projects, the board of directors only needs to verify that the requests submitted for rediscounting or approval comply with the Credit Regulations. Once the request is approved, BMI will credit the account of the IFI.

2. Qualified borrowers

3.6 Individuals or companies domiciled in Salvadorian territory are eligible to obtain loans from the resources of this program. Individuals or companies that have obtained credit within the financial system of El Salvador cannot have access to program loans if at the time they submit their request, they are classified in category "D" or "E" of the portfolio of any IFI, according to information in the SSF's Loan Grading Information Register, pursuant to prudential regulations in force.

3. Loan amounts

3.7 Program resources may be used to finance investment projects for up to a maximum amount equal to 80% of the total investment. In the case of small companies, the maximum amount to be financed will be the equivalent of 90% of the total investment. The maximum amount of the cumulative balance of loans granted by BMI through the IFIs to a single individual or body corporate or groups of individuals or bodies corporate which are related parties cannot exceed 25% of BMI's capital.

4. Loan currency

3.8 The subloans to the IFIs will be denominated in U.S. dollars.

5. Program interest rates

3.9 BMI interest rates: Regarding interest rates, it is required that:

a. BMI cover its costs and maintain its financial soundness;

b. The rates offered by BMI to the IFIs not distort the national financial market and thereby obstruct the development of the capital market. Therefore, it will be necessary for BMI to establish an upward yield curve in relation to the maturity of the resources involved;

c. Interest rates be variable and truly reflect market costs;

d. The loans carry a rate that will be the higher of: (i) the benchmark established by the BCR – in line with market costs adjusted for reserve requirements and according to the formula established to that end in the Credit Regulations – so as to avoid causing distortions in the national financial market; or (ii) the real cost of resources for BMI (including the cost of interest, fees, and charges) plus an annual percentage point to cover BMI's administrative costs. In addition, to reflect the cost of long-term money, a percentage equal to 0.1% multiplied by the number of years between the first disbursement and the scheduled date for final repayment of the loan will be added to the resulting rate. The resulting rate would be set quarterly, on specific dates to be determined by the board of directors of BMI.

6. Financial intermediaries

a. Eligibility criteria

3.10 The IFIs that may participate in the program will be those legally established institutions in the financial system that: (i) observe the national banking laws and regulations; (ii) are subject to the inspection and supervision of the Office of Financial System Oversight (SSF); and (iii) meet the following requirements, based on the latest six-month report in the statistical bulletin of the SSF:

a. Post capital of no less than 8% of their total risk assets. Total risk assets will be determined as stipulated in article 40 of the Bank and Finance Corporations Act, as amended by the Legislative Assembly on January 12, 1994 (Decree 779).

b. Post a ratio of annual operating costs to total assets of 5% or less. The operating costs will be equal to total annual costs less interest payable and finance fees.

c. Post a percentage of portfolio in arrears over net loan portfolio of 5% or less. Portfolio in arrears is understood to be the total balance of the portfolio over 90 days in arrears net of reserves, rated – according to the "Instructions for the Determination of Doubtful Risk Assets and the Establishment of Clean-up Reserves" – in categories "C", "D", and "E". Net loan portfolio is understood to be the total of the loan portfolio, net of the reserves for categories "C", "D", and "E".

d. Have earned in the previous calendar year annual net profits in relation to the initial capital for the period equal to or greater than the annual inflation index for the period in question.

3.11 In order to limit BMI's risk with a single IFI, under this program rules will be established to limit a single IFI's access to an amount equal to twice its capital funds. This limit constitutes an acceptable risk since the portfolio financed with BMI resources guarantees the obligations the IFI has with BMI. 9/

b. Participation requirements

3.12 In order to participate in the program, the IFIs must sign a participation agreement with BMI which specifically authorizes the BCR to automatically debit their legal reserve accounts in order to service the IFI's debts with BMI. In addition, the participation agreement should include the following commitments undertaken by the IFI to:

a. contribute supplementary loan resources for execution of the project, if necessary, including current working capital needs;

b. ensure the environmental viability of the projects to be financed;

c. provide that information which is reasonably requested by BMI and the IDB regarding the projects financed by the program;

d. allow the auditors of the program to have access to the necessary records and information for audit and review;

e. have a financial information system for the program that makes it possible to identify the amount of the subloans, sources of financing of the project, sectors and goods financed, recovery and status of the portfolio, and other information as reasonably requested by BMI to facilitate identification and follow-up of the subloans;

f. submit a report containing annual financial statements audited by a firm of independent auditors satisfactory to the SSF;

g. conduct the necessary supervision to monitor the investment of resources under all the subloans; and

h. comply with the conditions established in the Credit Regulations of this program.

9/ Loans granted by the eligible institutions with BMI resources especially guarantee the IFI's obligations to BMI, with all the benefits a secured creditor has on the collateral.

7. Use of the resources

3.13 Program resources may be used to finance investments in fixed assets, permanent working capital associated with the investment project, and technical advisory services to support the investment.

8. Restrictions on the use of program resources

3.14 Program resources cannot be used to finance: (i) payment of debts, refinancing of credit in general or under the program, dividends or capital recovery; (ii) purchase of shares, bonds, or other bearer securities; (iii) general or administrative expenses of the subborrowers; (iv) projects that do not comply with the criteria contained in the environmental regulations established by the competent official agencies; (v) vehicles or other goods for personal use; (vi) taxes; and (vii) current working capital in any form. Permanent working capital is understood to be that which is associated with the investment project and corresponds to a net increase in inventory and accounts receivable throughout the life of the requested loan.

3.15 The resources of the IDB cannot be used to finance: (i) the acquisition of real property; or (ii) the acquisition of goods and services from countries that are not members of the IDB.

9. Terms and conditions of the subloans

a. Currency: The subloans will be denominated in dollars of the United States of America (U.S. dollars).

b. Terms: The terms for amortization of the loans will be a minimum of one (1) year and a maximum of ten (10) years. The amortization and grace periods granted by BMI to the IFIs should always be the same as those of the respective subloan.

10. Formalization of the subloans

3.16 The document formalizing the subloans between the IFIs and the subborrowers will include the following provisions: (a) a commitment by the subborrower that the goods and services financed with the subloan will be used exclusively for execution of the respective project; (b) the right of BMI, the IDB and the corresponding IFI to examine the goods, services, sites, and work of the project financed; (c) the obligation of the subborrower to provide all the information that BMI and the IDB may request of it with regard to the project and its financial status; (d) the right of BMI and the IFIs to suspend disbursement of the subloan if the subborrower does not comply with the obligations undertaken; and (e) the right to demand immediate payment of the subloan if the resources are used in any way other than that reflected in the project investment plan.

11. Responsibility for analysis and approval of the subloans

3.17 The IFIs will assume the risks of financing projects with the resources of this program, no matter the amount. BMI will simply need to verify that the requests submitted for rediscounting or approval comply with the Regulations. Likewise, the IFIs will be authorized to approve loan applications which in their view are eligible for financing charged to program resources, as long as the amount requested does not exceed the equivalent in U.S. dollars of 10 million colones, or any increase over this amount that the board of directors of BMI may subsequently establish. Loans for amounts above this figure or free limit must be approved by the board of directors of BMI.

C. Conservation of natural resources and environmental protection

3.18 The projects to be financed under the program should comply with the provisions of Salvadorian legislation regarding preservation of the environment.

3.19 Adhering to the procedures devised under technical-cooperation operation ATN/ST-3600-ES, the IFIs must:

(i) make certain that all permits and operating licenses required pursuant to Salvadorian environmental laws have been obtained for projects to be financed under the program;

(ii) assign each project an environmental classification, based on information supplied by subborrowers;

(iii) ensure that environmental impact studies have been performed for projects classified as III or IV; and

(iv) record the measures to be taken by subborrowers to prevent or mitigate adverse environmental effects of their projects.

3.20 Using funds from the technical-cooperation program mentioned above, BMI will engage a specialized consultant to advise the IFIs on instituting environmental procedures.

3.21 Once each year BMI will conduct an audit to make sure that the environmental procedures are being followed. If these audits show that the IFIs are not complying with said procedures, BMI will proceed to impose the sanctions set forth in Article 20 of the Credit Regulations. If it is found that the subborrowers are not complying with the environmental protection commitments assumed under the program, BMI will: (i) report this fact to the IFIs; (ii) report this fact to the competent authorities; and (iii) exclude the subborrower from any future disbursement under the program.

D. Supervision of the program and review of execution

3.22 The IDB's Country Office in El Salvador will be responsible for supervising the program, with the support of the project team. Annual meetings will be held with the IDB to evaluate the progress of the program. For these meetings, which will take place within 90 days of the end of each calendar year, BMI will prepare a report containing:

a. A report certified to by BMI's external auditors of the accounts of the project, including:

   (i) Flow and balances of the loan, cumulative and for the previous period;

   (ii) A list of the participating entities with evidence of compliance with the eligibility requirements, cumulative balance of operations with each IFI with program resources, and cumulative balance with other resources with each IFI. Evidence of compliance with the limits contained in the Credit Regulations regarding the cumulative balance of operations. List of operations with each IFI specifying the amount and interest rate applied;

   (iii) A list of the subloans broken down by IFI, including the name and basic characteristics of the subborrower, interest rate applied, destination of the resources and cumulative amount of the subloans with each subborrower;

   (iv) Evidence of compliance with the limits set in the Credit Regulations regarding the cumulative amount of operations with each subborrower and with groups of related subborrowers; and

   (v) Evidence that BMI has not granted subsidies or financed operations that incur losses, either with program resources or with other resources, including its own, except in those cases permitted by law. However, the cumulative amount of the loans granted at lower than market interest rates cannot exceed 3% of BMI's assets.

b. The environmental rating of the projects.

c. A copy of the latest environmental audit report available.

d. The audited financial statements of BMI.

e. For the meeting covering the first year of the program's operation, an evaluation of the environmental procedures will be conducted.

When deemed appropriate, the IDB may conduct inspections to ensure that the program is proceeding correctly.

E. Use of recoveries

3.23 The funds from amortization of the loans granted to the IFIs with program resources will be used to grant new loans only in keeping with the rules established in the loan contract and the Credit Regulations.

F. Inspection of the program

3.24 The Bank will apply all the inspection procedures it deems necessary to guarantee satisfactory execution of the program. The borrower and the executing agency will provide full cooperation for this endeavor. The equivalent of US$1 million of the resources of the loan will be paid to the Bank for inspection.

1. Ex post evaluation

3.25 In keeping with the Bank's new policy, ex post evaluation was agreed upon with the borrower, which has indicated its wish that such an evaluation be performed. According to that agreement, within 12 months after signature of the contract, the borrower will submit to the Bank a methodology for conducting an ex post evaluation of the program. Within two years of the date of the final disbursement of the loan resources, the borrower will come to an agreement with the Bank on preparation of an ex post evaluation report according to the methodology agreed upon with the Bank. The report will include, among other things: (a) analysis of the institutional efficiency of the IFIs that participated in the credit component; this efficiency will be determined by applying the parameters established as eligibility criteria; (b) analysis of the characteristics of the subborrowers: size of the enterprise, sector, characteristics of the entrepreneur, access to credit; (c) analysis of the effectiveness of the environmental control mechanisms; and (d) analysis of the level of concentration of resources among groups of related subborrowers.

IV. PARTICIPATING INSTITUTIONS

4.1 The following institutions will participate in the execution of multisector global credit program II: the BCR as the borrower, Banco Multisectorial de Inversiones (BMI) as executing agency vis-à-vis the IDB, and intermediary financial institutions (IFIs) that are part of the formal sector subject to the supervision of the Superintendencia del Sistema Financiero [Office of Financial System Oversight] (SSF) and meet the eligibility requirements agreed upon by the IDB and the borrower (see chapter II and Annex I to this proposal).

A. Banco Multisectorial de Inversiones (BMI)

1. Functions

4.2 On April 21, 1994, the Legislative Assembly of El Salvador passed Decree 856 containing the BMI Act. This law establishes BMI as a public credit institution with its own legal capacity and capital. The law also establishes the following functions to be carried out by BMI: (i) promote the growth and development of all productive sectors; (ii) promote the development and competitiveness of companies; (iii) encourage the development of microenterprises and small businesses; (iv) generate productive employment; and (v) improve education and health services.

4.3 In pursuit of its objectives, BMI will grant medium- and long-term loans under market conditions through financial institutions eligible to finance investment projects in the private sector. BMI may also invest in securities issued by the central bank and by banks and finance corporations, as long as the resources attracted this way are used for the purposes set forth in the BMI Act. BMI may also maintain deposits in local currency or foreign exchange at those same institutions or in leading foreign banks.

4.4 BMI may not directly or indirectly finance or underwrite the government or any autonomous State institutions or enterprises. Nor may it accept demand deposits or grant loans of any kind to entities not classified as eligible according to the current rules of BMI, or invest in capital stock.

4.5 BMI must submit its financial statements and annual financial plan to the board of directors of the BCR for approval. The financial plan includes, among other things, the credit plan and plan for attracting resources, which must be consistent with the monetary program of the central bank. The BMI Act limits total administrative expenses to a maximum of 0.6% of the value of assets at the end of the previous year, and in no case may they grow at a rate higher than the inflation rate projected for the following year, starting in 1996.

2. Organizational structure

a. Structure

4.6 BMI is governed by a board of directors, comprised of five full members and four alternates. The chairman of BMI will be appointed for three years by the board of directors of the BCR. The four full directors and four alternates will also be appointed for three years by the board of directors of the BCR. They will respectively be nominated by: (i) the Ministry of Planning; (ii) the Ministry of the Treasury; (iii) the banks and finance corporations; and (iv) associations representing the agricultural and industrial sectors. The vice chairman of BMI will be elected by the full directors.

4.7 The board of directors of BMI is in charge of approving the financial statements and annual credit plan and the organizational structure of BMI, hiring and dismissing permanent staff as proposed by the chairman, and hiring temporary professional and technical staff to perform studies or specific jobs, also as proposed by the chairman. The board is additionally responsible for approving borrowing and lending operations, a job that may be delegated to other BMI officers; approving the system of interest rates; rule on eligibility of applicant institutions; and issuing credit rules and policies. Currently the board must approve all loans for more than 10 million colones (US$1,207,000).

4.8 The chairman of the board of directors is a full-time officer of BMI. His main responsibilities are as follows: (i) act as legal representative; (ii) ensure attainment of the goals established in the annual financial program and compliance with the objectives and functions of BMI; and (iii) supervise the general operation of BMI.

4.9 Management of BMI is in the hands of a general manager who coordinates and supervises the operation of the three management divisions: the credit division, the development and analysis division, and the finance division.

4.10 The total staff of BMI consists of 54 people, exclusive of the chairman and board of directors. Most of these employees came from the former credit department of the central bank, which has facilitated the continuity of operations and put previously acquired experience to good use.

4.11 During its first few months of existence BMI has been functioning adequately. While BMI has staff trained in the various basic functions of a bank, in order to avoid hindering the normal operations of the institution and allow it to attain the efficiency required in a competitive system, the technical capacity of the staff must be strengthened. This is particularly true of areas that traditionally have not been part of banking activities in El Salvador, such as risk management through terms or interest

rates. Therefore, in tandem with this loan, a program for institutional strengthening is being proposed, financed with resources from the Japan Special Fund in the amount of US$340,000.

3. Financial situation

4.12 BMI began operations in mid-1994 with initial capital of 300 million colones (US$35.9 million), provided completely by the BCR in cash and through a portfolio transfer. Since then BMI has taken on all the functions of a second-tier bank that the BCR had been performing. By the end of the year, the entire portfolio for credit operations had been handed over to BMI. Both the portfolio and long-term loans, which the BCR granted to BMI to finance the transfer, are in colones. The foreign exchange risk, which originated in the financing granted by multilateral banks, was fully assumed by the BCR.

4.13 BMI is the main, if not the only, source of long-term resources in El Salvador. The assets on the books of BMI originated in operations primarily financed with IDB resources (multisector program I) and the Central American Bank for Economic Integration (CABEI), although a significant amount of the operations were financed with the BCR's own resources. All of these loans from the BCR have terms longer than those of the loans granted by BMI, which places the latter in a comfortable position to handle its liquidity. Most of the operations have market interest rates. Just 5% of the portfolio has subsidized interest rates, and these operations are primarily old BCR lines of credit that are being phased out.

4.14 The ratio of risk-weighted assets to capital at the end of 1994 was 8:1, which is below the level permitted by the BMI Act (12.5:1). BMI therefore enjoys ample room for growth, enough at any rate to assume the loans resulting from this operation.

4.15 BMI has established its intermediation margin at 1% over all funds received from the BCR. This margin is sufficient to cover its operating costs, which cannot exceed 0.6% of assets, and to generate increases in the capital base necessary to allow for the expected growth in operations.

4.16 At the close of 1994 the entire portfolio of BMI was current, which is partially a reflection of the fact that the private banks and finance corporations have not had serious portfolio problems. Additionally, BMI is protected through security on the subloans which act as a counterpart to the loans granted to the IFIs, and can also debit the accounts of the IFIs when the obligations mature.

V. FEASIBILITY

A. Feasibility

5.1 The Government of El Salvador's economic program for the upcoming years is aimed at maintaining the macroeconomic balance and laying the foundations for sustained economic growth in the medium term, along with greater social impact. It is hoped that economic policy during the execution of the program proposed here will promote efficiency in the allocation of resources and stimulate international competitiveness in the economy. Execution of the National Reconstruction Program (PRN) will in turn give a boost to the economy and facilitate the assimilation into the economy of those segments of the population affected by the recent armed conflict, which will enhance confidence in the country and improve the climate for private investment.

5.2 It would be appropriate to carry out this program with the features proposed because it would help finance private investment projects with suitable profit ratios. The program would also enhance the consolidation of BMI as a second-tier bank.

5.3 The proposed operation will also encourage the domestic mobilization of medium- and long-term resources in line with the levels of the free market and competitiveness. Therefore, the program is considered to be temporary, for the period in which the national financial markets are forming and consolidating, and while appropriate incentives are developed to mobilize national savings and the respective institutional structure is created. The role that BMI is intending to play is not limited to providing lines of credit. BMI will also be actively involved, through the national stock market, in developing the capital market.

5.4 The general principles of the program have been established in a way that guarantees its financial viability. The interest rate BMI charges the IFIs will make it possible to cover the costs of the IDB's financing and other liabilities of the institution, including administrative costs. Likewise, the BMI Act establishes the requirement that the IFIs, in order to be eligible, obtain acceptable returns. In order to avoid ambiguities, under this program this means that the IFIs will have to obtain a rate of return that is positive in real terms. This provision reinforces the principle of maintaining the financial soundness of the program. In addition, the IFIs must demonstrate that their solvency, liquidity, and operational efficiency are in line with the program's eligibility criteria. The IFIs will conduct the feasibility analyses of the projects, will assume the credit risk of the operation, and will set the conditions of the subloans. The program delegates to the IFIs the task of identifying the viability

of the projects and allows them to set their own intermediation margin, thus enabling the credit decisions to be made taking free market criteria into consideration.

5.5 The institutional viability of BMI, as executing agency, will be strengthened through a technical-cooperation project to be financed with funds from the Japanese government, which will be processed concurrently with this operation. Additionally, the experience acquired by the former Private Credit Department of the BCR (which now makes up much of the BMI staff) will supplement the new entity's capacity, ensuring proper execution of the program. Likewise, before this proposal is sent to the Board of Executive Directors, the BCR and BMI will have agreed on the following regarding BMI: (i) the 1994 to 1997 credit plan; (ii) liquidity management policy; and (iii) adoption of criteria for solvency, profitability, liquidity, and uniform management to be incorporated into the eligibility criteria for the IFIs participating in all of BMI's operations.

B. Benefits

5.6 The Government of El Salvador's economic program is aimed at positioning the country's economy in international markets. This program will be an important tool in the industrial retrofitting process by providing the country with stable long-term financial resources to complement the available domestic sources of financing. The program thus seeks to promote the modernization and diversification of the productive base, with ensuing benefits in terms of the competitiveness of companies, the production of goods and services, and the creation of jobs.

C. Risks

1. Macroeconomic stability

5.7 The proposed program requires a stable macroeconomic environment, in which monetary policy and interest rates make for appropriate development of the credit supply and demand. The current economic policy, the structural reforms, and deregulation of the financial system are fundamental factors to establish the necessary climate for the program to meet its objectives. As long as the current economic policy continues to be applied, the viability of the proposed operation is ensured. However, one must consider that some of the aspects of the Salvadorian government's new economic policy, particularly the dollarization of the economy, are not free of risks that could hinder execution of the program. Although this measure will probably result in lower inflation and interest rates, monetary policy will lose its effectiveness as an instrument of economic policy, leaving the economy more vulnerable to external shocks. In addition, the BCR's capacity to intervene to correct reductions in the system's liquidity would be substantially decreased. However, the dollarization of the economy is envisaged

as a gradual process in which the necessary adjustments could be made along the way. Furthermore, the Government of El Salvador has requested support from the International Monetary Fund for implementation of the plan.

2. The operation of BMI

5.8 Startup of BMI's administrative and operational systems may be delayed, which could negatively affect execution of the program. However, the likelihood of this would be significantly reduced by the Bank's technical-cooperation project for institutional strengthening in the areas of management, finance, and monitoring.

3. Concentration of credit

5.9 Concentration of the system's assets in a few intermediaries could limit broad access to program resources. To reduce this risk, the cumulative amount of loans that BMI can grant through the IFIs to one company or economic group has been limited.

4. Intermediation capacity of the financial system

5.10 In spite of the progress made in recent years, the Salvadorian banking system is still relatively small. The rapid growth of the banks has led them to maintain a level of borrowing very close to the legal limit. Projections were done to evaluate the intermediation capacity of the system. Even considering adequate growth in deposits in real terms, the intermediation capacity necessary to place program resources within the periods required by the dollar window conditions was found to exist. In addition, the high profit ratio of the financial institutions is encouraging new companies to enter the market and existing ones to be capitalized.

D. Impact on low-income groups

5.11 This program was designed to finance private investment projects. The program does not comply with the criteria of the Eighth Replenishment such as would enable it to be classified as a poverty-targeted operation.

E. Natural disasters

5.12 The program is neutral with regard to natural disasters.

F. Women's participation in the program benefits

5.13 The program is neutral with regard to women's participation in its benefits.

G. Project file

5.14 The project file contains detailed documentation on the various aspects of the program dealt with in this loan proposal.

H. Additionality of the program

5.15 At its present state of development, the Salvadorian financial system is not yet in the position to offer a supply of medium- and long-term credit. The Government of El Salvador is committed to furthering the financial sector reforms and stimulating the development of long-term savings systems. To this end, it is working on a plan to restructure the social insurance system as part of the commitments undertaken under the sector investment program. However, during the period necessary for these reforms to yield the desired results, the resources obtained by BMI from multilateral banks will continue to be the main source of medium- and long-term resources.

MULTISECTOR GLOBAL CREDIT PROGRAM II

CREDIT REGULATIONS

These Regulations establish the terms and conditions that will govern multisector global credit program II, which will be financed by the Inter-American Development Bank (IDB) and Banco Multisectorial de Inversiones (BMI). The program will be executed by BMI using the eligible intermediary financial institutions (IFIs), according to the provisions of these Regulations.

Article 1. Definitions

For the purposes of these Regulations, the following definitions are established:

BCR:	Central Reserve Bank of El Salvador
BMI:	Banco Multisectorial de Inversiones
Cancellation:	Written communication from the IFI reporting its decision not to use part or all of the funds of a project previously included in a Disbursement Notice.
Certification of Eligibility:	Certification issued by an IFI declaring the eligibility of a project to be financed with resources of the Program under the terms of these Regulations.
Disbursement Notice:	Message sent by an IFI to BMI to notify its intent to use a certain amount of Program resources on a specific date.
Free Limit:	Amount set by the board of directors of BMI to determine the loans that will require its approval before being disbursed. This amount has been set at 10 million colones and may be increased by the board of directors.
IDB:	Inter-American Development Bank
Loan:	Financial resources granted by BMI at the request and in favor of an IFI for the financing of a Project under the Program.
Participation Agreement:	Legal document through which an IFI assumes obligations to BMI to intermediate Program resources.

Program:	Multisector global credit program II
Project:	The investment plan of a potential subborrower which requires Program financing through an IFI.
Subborrower:	Individual or corporation legally established in El Salvador that may potentially receive a Subloan granted by an IFI with resources of the Program.
Subloan:	A credit operation conducted by an IFI with Program resources to a Subborrower to partially finance the cost of the investment Project of the Subborrower.

Article 2. Program objective

The main objective of multisector global credit program II, hereinafter "the Program," is to support the modernization and economic reactivation of El Salvador through medium- and long-term financing of investment Projects carried out by the private sector in the country.

Article 3. Amount of the Program

Program resources will be comprised of IDB loan funds in the amount of US$100 million and local counterpart funds for the equivalent of US$25 million. The local counterpart is considered to be those resources contributed by BMI and the participating IFIs. Furthermore, the contributions of the Subborrowers to their respective Projects for up to 15% of the Program amount may be considered part of the local counterpart, as long as they are not: (i) recurrent labor costs; (ii) working capital; (iii) imputed values of investments already made; or (iv) contributions in kind.

Resources emanating directly or indirectly from any other IDB loans may not be used to finance the local counterpart of the Program.

Article 4. Use of Program resources

Program resources may be used to finance: (i) investments in fixed assets, including permanent working capital (permanent working capital is understood to be that which is associated with the investment Project and corresponds to a net increase in inventory and accounts receivable, throughout the life of the requested loan); and (ii) technical assistance services to support the investment Projects.

Article 5. Restrictions on the use of Program resources

Program resources may not be used to finance:

a. Payment of debts, refinancing of credit in general or under the Program, dividends or capital recovery;

b. Purchase of stocks, bonds, shares in companies, or other bearer securities;

c. General or administrative expenses of the Subborrowers;

d. Projects that do not comply with the criteria contained in the environmental regulations established by the competent official agencies;

e. Vehicles or other goods for personal use;

f. Taxes; or

g. Current working capital in any form.

In addition to the restrictions listed above, resources from the IDB may not be used for:

a. Acquisition of real property; or

b. Acquisition of goods and services from countries which are not members of the IDB.

It is the exclusive responsibility of the IFI to ascertain the eligibility of the Subborrowers.

Article 6. Eligibility criteria for the IFIs

The IFIs that may participate in the Program are all those legally established institutions in the financial system that, according to the latest available information: (i) abide by the national banking laws and regulations; (ii) are not under any system of sanctions, special supervision, or a financial clean-up plan ordered by the Office of Financial System Oversight (SSF); (iii) are subject to the inspection and supervision of the SSF; (iv) comply with the reserve requirements established by the competent authority; and (v) meet the following requirements, based on the latest six-month report in the SSF's Statistical Bulletin:

a. Post capital of no less than 8% of total risk assets. Total risk assets will be determined based on the provisions of Article 40 of the Bank and Finance Corporation Act, as amended by Legislative

Decree 779 published in the Diario Oficial [Official Journal] on January 27, 1994; 1/

b. Post a ratio of annual operating costs to total assets of 5% or less. Operating costs will be equal to the sum of personnel expenses, general expenses, depreciation and amortization, according to the chart of accounts issued by the SSF.

c. Post a percentage of portfolio in arrears over net loan portfolio of 5% or less. Portfolio in arrears is understood to be the total balance of the portfolio over 90 days in arrears net of reserves, rated – according to the "Instructions for the Determination of Doubtful Risk Assets and the Establishment of Clean-up Reserves" – in categories "C", "D" and "E". Net loan portfolio is understood to be the total loan portfolio, net of the reserves for categories "C", "D" and "E".

d. Earn net annual profits for the rating period (in relation to initial capital) equal to or greater than the annual inflation index for said period.

Article 7. Participation requirements for IFIs

In order for an IFI to participate in the program, it must sign a Participation Agreement with BMI which gives the BCR explicit authorization to automatically debit the accounts of the IFI to service its debts with BMI. In addition, the Participation Agreement must include the following commitments by the IFI to:

a. contribute supplementary loan resources for execution of the Project, if necessary, including current working capital needs;

b. ensure the environmental viability of the Projects to be financed;

c. provide that information which is reasonably requested by BMI and the IDB regarding the Projects financed by the Program;

d. allow the auditors of the Program to gain access to the necessary records and information for purposes of audit and review;

e. have a financial information system for the program that makes it possible to identify the amount of the Subloans, sources of financing of the Project, sectors and goods financed, recovery and status of the portfolio, and other information that may be reasonably requested by BMI to facilitate identification and follow-up of the Subloans;

1/ This ratio will increase when the prudential regulations in force in El Salvador so determine.

f. submit a report containing annual financial statements audited by an independent firm of auditors acceptable to the SSF;

g. conduct the necessary supervision to monitor the investment of the resources under all of the Subloans; and

h. comply with the conditions established in these Regulations.

Article 8. Terms

The terms for amortization of the Loans under this Program will be a minimum of one (1) year and a maximum of ten (10) years. The amortization and grace periods granted by BMI to the IFI must always be the same as those of the respective Subloan.

Article 9. Interest

The Loans will bear an interest rate in line with market costs in order to prevent the creation of distortions in the national financial market, and will be the higher of:

a. The reference (benchmark) rate (RR), which will be established by the BCR using the following formula:

$$RR = \frac{TPDUS}{1-e} - er \times TE$$

RR = reference rate

TPDUS = Average interest rate on 90-day deposits attracted by the banking system and denominated in United States dollars in effect during the 30 days prior to the date on which the BCR establishes the reference rate.

e = Percentage of total legal reserve over deposits that serve as the basis for calculation of the TPDUS.

er = Percentage of compensated reserve taken over the total of deposits that serve as the basis for calculation of the TPDUS.

TE = Annual interest rate that is recognized over compensated legal reserves.

The reference rate will be set monthly on specific dates to be determined by the board of directors of BMI. Given that the percentage of deposits in dollars as part of total deposits in the

system continues to be small, the BCR may determine occasions on which the TPDUS is distorted and therefore not representative of the market. In such cases the BCR may abstain from setting a reference rate and may use the rate defined in clause (b) of this Article.

b. The real cost of resources under this Program to BMI (including the cost of interest, fees, and charges) plus one annual percentage point to cover the administrative costs of BMI.

Plus, to reflect the cost of long-term money, a percentage equal to 0.1% multiplied by the number of years between the first disbursement and the scheduled date for final repayment of the loan will be added to the resulting rate.

Article 10. Responsibility for analysis and approval of the Subloans

The IFIs will assume the risks associated with the financing of Projects with Program resources, regardless of the amount. BMI will simply need to verify that the requests submitted for rediscounting or approval comply with these Regulations. Likewise, the IFIs will be authorized to approve those loan applications which in their judgment are eligible for financing with Program resources, as long as the amount requested does not exceed the equivalent in United States dollars of 10 million colones, or any increase over this amount as may be established later by the board of directors of BMI. Loans for amounts greater than this figure or free limit must be approved by the board of directors of BMI.

Article 11. Disbursements

a. **Loans below the free limit:** As a second-tier bank and executing agency of this Program, BMI will automatically discount the resources of the program for the IFIs eligible to participate in it. BMI will make the disbursement, subject to the borrowing limits established in these Regulations, by no later than the working day following receipt of the Disbursement Notice.

The Disbursement Notice will contain only basic information on the Project financed: (i) place and date of request; (ii) name of the IFI; (iii) total value of the Project, financing requested, and amount of disbursement requested; (iv) term for payment; and (v) certification of eligibility of the Project according to the provisions of these Regulations. Each Disbursement Notice will be signed by the authorized representatives of the IFI in question, previously registered with BMI.

However, in order to allow efficient management of BMI's funds, the IFI should notify in writing one week in advance the aggregate amount of disbursements under the Program it expects to obtain

during the following week. These communications should be received by BMI during the calendar week (no later than Friday) prior to the week in which the IFI wishes to obtain said amount. Disbursements in excess of the amount so notified will be decided upon by BMI. The IFI will pay a 1% per annum fee on the unused portion of the amount of disbursements notified. BMI will charge a fee of 0.1% on the amount of cancellations of operations previously notified by the IFIs. These fees will not be applicable when the disbursements do not take place for reasons attributable to BMI.

b. **Loans above the free limit**: In addition to the documents listed in the previous Article (11.a), Disbursement Notices for loans that exceed the free limit must be accompanied by a short description of the Project and a summary of the analysis conducted by the IFI supporting the viability of the Project. Based on this documentation the board of directors of BMI must make a decision within 10 working days. Given that the IFIs are responsible for the technical, financial, and economic evaluation of the Projects, the board of directors must verify that the applications submitted for rediscounting or approval comply with these Regulations. Once the application is approved, BMI will credit the IFI's accounts.

Article 12. Documentation

For each Subloan financed, within five working days of the disbursement made to the IFI, the IFI must submit the following documents to BMI:

a. copy of the disbursement request;

b. promissory note from the IFI to BMI;

c. copy of the loan contract between the IFI and the Subborrower for the Loan;

d. copy of the credit memorandum issued to the Subborrower;

e. Project financing structure detailing the contribution of the Subborrower and the IFI;

f. copy of the corresponding environmental brief and the environmental impact studies that were conducted, with clear indication of the measures the Subborrower will take to prevent or mitigate the environmental impact of the Project.

g. for those Projects that require several disbursements, the IFI will submit the relevant timetable; and

h. other information that BMI may reasonably request.

Article 13. Operations requiring several disbursements

Submission of a timetable for Projects that require several disbursements does not imply a commitment by BMI to disburse. The IFIs may request a disbursement commitment from BMI on the dates and in the amounts indicated in the timetable. However, the IFI will pay a commitment fee of 0.75% per annum on amounts thus committed but not disbursed. This commitment does not exclude the obligation of the IFI to include these amounts in the Disbursement Notices referred to in Article 11.

Article 14. Disbursements to Subborrowers

Once BMI credits all or part of the loan to the account of the IFI, the latter has up to three working days to disburse to the Subborrower.

Article 15. Maximum amounts

The cumulative amount of all BMI operations with a single IFI (financed with Program resources, its own resources, or other resources) cannot exceed the equivalent of twice the value of the capital of the IFI in question.

Article 16. Subborrowers

Individuals or corporations domiciled in Salvadorian territory are eligible to receive loans from the resources of this program. Those individuals or corporations that have obtained loans from the financial system, who at the time of submitting their application have loans classified in categories "D" or "E" of the portfolio of any IFI, according to the prudential rules in force, may not receive loans under the Program. The IFIs may not grant financing with Program resources to members of their board of directors and/or management. It is the exclusive responsibility of the IFI to ascertain the eligibility of the Subborrower.

Article 17. Formalization of the Subloans

The document formalizing the Subloans between the IFIs and the Subborrowers will include the following binding provisions:

a. a commitment by the subborrower that the goods and services financed with the Subloan are to be used exclusively for execution of the respective Project;

b. the right of BMI, the IDB and the respective IFI to examine the goods, services, sites, and work of the Project financed;

c. the obligation of the Subborrower to provide all information that BMI and the IDB may request on the Project and its financial status;

d. the right of BMI and the IFIs to suspend disbursement of the Subloan if the Subborrower does not comply with the obligations undertaken; and

e. the right to demand immediate payment of the Subloan if the resources are utilized in any way other than that reflected in the Project investment plan.

Article 18. Terms and conditions of the Subloans

a. Currency: The subloans will be denominated in United States dollars (U.S. dollars).

b. Terms: The terms of the Subloans will be agreed upon by the IFIs and the Subborrowers, and will be a minimum of one (1) year and a maximum of ten (10) years.

c. Interest rate spread: The interest rate spread of the IFIs will be freely determined by them according to the risk of each operation. The spread must be reported to the Subborrower and may not be increased during the life of the Subloan.

Article 19. Subloan limits

The resources of the Program may be used to finance investment Projects for up to 80% of the total investment. In the case of small businesses, 2/ the maximum amount to be financed will be up to the equivalent of 90% of the total investment.

The maximum cumulative balance of the loans granted by BMI through the IFIs to any individual or body corporate or group of individuals or bodies corporate which are related parties may not exceed 25% of BMI's capital. The regulations issued by the SSF will be used to determine ties among Subborrowers.

Article 20. Audit and inspection

BMI and the IDB reserve the right to conduct audits and inspections to ascertain that the resources are being invested properly and that the

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2/ "Small businesses" refers here to firms having less than one million colones in assets.

Credit Regulations are being fulfilled, both by the Subborrowers and the IFIs.

If as a result of these audits and inspections or any other means it is determined that:

a. the resources of the loan have been diverted;

b. disbursement to the Subborrower has not been made within the established deadline;

c. there has not been compliance with the environmental procedures; or

d. there has been any other violation or lack of compliance with the requirements for the granting of loans or execution of the Projects,

BMI will take the following measures:

a. Request that the IFI correct the violation or noncompliance.

b. If within 15 calendar days from said request the IFI has not taken measures to the satisfaction of BMI and the IDB to correct the situation, BMI will ask the BCR to debit the current account of the IFI at the BCR in an amount equal to the total balance of the loans financed with Program resources plus the respective interest. The interest will be calculated using the average loan rate applied by the IFI to the loans. The board of directors of BMI may approve a one-time extension of this deadline for not more than five working days, based on a well-founded request by the IFI in question;

c. As long as the violation or noncompliance persists, the IFI responsible may not have access to the resources of the Program.

d. In addition to restoring the resources, BMI will suspend the sanctioned IFI's access to the resources of the Program for six months. If such a situation recurs, the suspension period will be for a longer period, at the discretion of BMI.

Article 21. Temporary exclusion

BMI may temporarily exclude one or more IFIs from the Program if their financial status deteriorates so much that the credit risk deriving from operations with them is not acceptable to BMI. In such a case BMI must report its decision to the IFIs involved and to the IDB.

Article 22. The environment

The Projects to be financed under the Program must comply with the provisions of Salvadorian legislation regarding preservation of the environment.

Adhering to the procedures devised under technical-cooperation operation ATN/ST-3600-ES, the IFIs must:

(i) make certain that all permits and operating licenses required pursuant to Salvadorian environmental laws have been obtained for projects to be financed under the program;

(ii) assign each project an environmental classification, based on information supplied by subborrowers;

(iii) ensure that environmental impact studies have been performed for projects classified as III or IV; and

(iv) record the measures to be taken by subborrowers to prevent or mitigate adverse environmental effects of their projects.

Once each year, BMI will conduct an audit to ascertain compliance with the environmental procedures. If as a result of such audits it is found that the IFIs are not complying with said procedures, BMI will impose the sanctions set forth in Article 20 of these Regulations. If it is found that the Subborrowers are not complying with the environmental protection commitments undertaken in the Program, BMI will: (i) report this fact to the IFIs; (ii) report this fact to the competent authorities; and (iii) exclude the Subborrower from the Program for any future disbursements.

Article 23. Amendment of these Regulations

BMI may suggest amendments to these Regulations to adapt them to new circumstances or conditions arising during the course of Program execution. Any changes to these Regulations will enter into force once the IDB has stated that it has no objections thereto.

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Appendix I

PROPOSED RESOLUTION

EL SALVADOR. LOAN ___/OC-ES TO THE BANCO CENTRAL DE RESERVA DE EL SALVADOR. MULTISECTOR GLOBAL CREDIT PROGRAM II

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with the Banco Central de Reserva de El Salvador, as Borrower, for the purpose of granting it a financing to cooperate in the execution of a Multisector Global Credit Program II. Such financing will be for the amount of up to US$100,000,000, or its equivalent in other currencies, except that of El Salvador, which are part of the Ordinary Capital resources of the Bank, and will be subject to the "Special Contractual Conditions" and the "Terms and Financial Conditions" of the Executive Summary of the Loan Proposal. The loan shall be financed under the modalities indicated in Document FN-483-3, "Proposal for the Establishment of a U.S. Dollar Window", approved by the Board of Executive Directors on May 11, 1994.