GLOBAL MULTISECTOR FINANCING PROGRAM

(BR-0277)

EXECUTIVE SUMMARY

BORROWER:	Banco Nacional de Desenvolvimento Econômico e Social (BNDES)
GUARANTOR:	The Federative Republic of Brazil
EXECUTING AGENCY:	Banco Nacional de Desenvolvimento Econômico e Social (BNDES)

AMOUNT AND SOURCE:

IDB: Ordinary Capital (OC)	
Formalizing and consolidating microenterprise and small-scale businesses component (BR-0289)	US$ 150 million
SME component (BR-0277)	US$ 750 million
Private social services delivery component (BR-0290)	US$ 200 million
Total IDB:	**US$1,100 million**
Borrower:	US$1,100 million
Total:	**US$2,200 million**
Currency:	United States dollars

FINANCIAL TERMS AND CONDITIONS:

Amortization period:	20 years
Disbursement period:	4 years
Interest rate:	variable
Inspection and supervision:	1%
Credit fee:	0.75%

COFINANCING: The Export-Import Bank of Japan (JEXIMBANK) has communicated its interest in cofinancing the operation in an amount of up to US$900 million, in two equal stages, covering exclusively the borrower's contributions for the credit component for SMEs and the component for formalizing and consolidating microenterprises and small-scale businesses. Negotiations are well advanced, and the amount of JEXIMBANK financing is expected to be firmed up during the course of this year.

OBJECTIVES: The general objective of the program is to support: (i) development and modernization of Brazil's productive sector, by expanding medium- and long-term financing on market terms for private investment projects aimed at restructuring, improving and expanding efficient activities of microenterprises, small-scale businesses, and small and medium-scale enterprises; (ii) facilitated formalization and

financial consolidation of microenterprises and small-scale businesses, to give them access to medium- and long-term financing by intermediary financial institutions (IFIs), and help them meet their tax, labor, social security and environmental obligations; (iii) better access to long-term financial resources for private investment projects for increasing the coverage and improving the quality of private services in higher education and health; and (iii) development of the financial market that was initiated under the previous program by providing liquidity for introducing and developing new and more sophisticated products for private investment projects. In line with that previous operation, the program will support Brazilian government efforts to modernize productive sectors and make them more competitive by reducing the so-called "Brazil cost". The proposed operation will continue support for development of the financial market, in accordance with guidelines for the Bank's programs in the financial area.

DESCRIPTION: The proposed program will consist in providing global multisector financing under three components. The first focuses on financial support for formalizing and consolidating microenterprises and small-scale businesses included in the SIMPLES system. The second component emphasizes financing for modernizing and expanding small and medium-sized enterprises (SMEs) to enhance their competitiveness in a more open economy. The third component will help strengthen the private delivery of higher education and health services.

Support for formalized microenterprises and small-scale businesses, in particular, will help to regularize their tax status and bring them into the mainstream economy, enhance their access to financing from the financial system, and contribute to effective operation of the country's programs in support of women and of environmental and health controls. As well, the program will encourage development of new financial products and market facilities for the business segments in question.

The program consists of a loan to be totally executed by means of three rediscount facilities for medium- and long-term financing, through IFIs declared eligible by BNDES. The projects to be financed by way of these operations must meet the technical, financial, economic, legal and environmental requirements of the program. <u>The first window</u> (BR-0289, US$150 million) for formalizing and

consolidating microenterprises and small-scale businesses is intended as a credit facility for: (i) microenterprises (including working capital), up to US$25,000 per transaction, and small-scale businesses (including working capital), up to US$144,000 per transaction. The facility is intended to help these enterprises, in both the producing and service sectors, to gain access to adequate financial services and to help modify the practices of the IFIs with respect to providing credit to microenterprises and small-scale businesses. NGOs that lend to microenterprises may also access these credits, if they are declared eligible by BNDES under Bank-financed technical-cooperation project ATN/SF-1128/BR being executed by BNDES. The second window (BR-0277, US$750 million) is intended as another rediscount facility for providing financing of up to US$3 million per transaction to small and medium-sized enterprises (SMEs) for capital investments in modernizing and expansion projects in nearly all manufacturing and service activities. The third window (BR-0290, US$200 million) would be a further rediscount facility for providing financing of up to US$15 million per transaction for strengthening private providers (other than SMEs) of higher education and health services.

All of the resources under the program will be channeled by BNDES through IFIs declared eligible under criteria established in each of the program's sets of Credit Regulations, which, as in previous operations, are consistent with the operating rules of BNDES. Those IFIs will use these resources in turn to grant credits to finance the purchase, installation and start-up of capital goods in areas covered by the three components described above.

RATIONALE FOR THE OPERATION:

There are currently a number of serious constraints on the availability of medium- and long-term financial resources to meet the needs of microenterprises, small-scale businesses and SMEs, in both financial institutions, which avoid medium- and long-term exposure with short-term deposits and the capital market, which, from a practical viewpoint, is generally restricted to large corporations. A similar situation is facing private providers of services in the higher education and health areas. The only significant source of this type of financing for microenterprises, small-scale businesses and SMEs are the credit programs offered by BNDES.

The selection of BNDES as the executing agency offers access to that institution's Brazil-wide network of

IFIs, the only one in the country that has the coverage to ensure that the program's resources will filter to a large number of end-borrowers thoughout the country. Moreover, it has the procedures, standards and institutional capacity for evaluation and supervision that are needed for sound operational management of a program of the size proposed here.

In the framework of the special relationship between the IDB and BNDES, new products will be developed, such as leasing, which BNDES has already launched, guarantee funds, credit insurance for microenterprises and small-scale businesses, etc.

ENVIRONMENTAL AND SOCIAL REVIEW: The design of the proposed program is consistent with the environmental requirements already established in the previous operation, which have been proven satisfactory. Those requirements include a comprehensive mechanism for monitoring the environmental quality of subprojects based on the environmental standards of the National Environment Commission (CONAMA). That mechanism, which is now applied in all BNDES loans, has worked well in the previous SME operation, in which there were very few subloans that had an environmental impact, and effective control measures were taken in every instance. The present program will therefore maintain the mechanism without major changes, while incorporating the recommendations that came out of the evaluation conducted by BNDES. The IFIs will not onlend for activities classified as having a negative impact unless their design includes a timetable for mitigation measures to give effect to the environmental undertakings of the subborrowers.

POVERTY TARGETING: Window BR-0289, for formalizing and consolidating microenterprises and small-scale businesses, automatically qualifies as a poverty-targeted project. The SME window (BR-0277) and that for private social service providers (BR-0290) are not, by their nature, considered to be targeted on poverty.

EXCEPTIONS TO BANK POLICIES: None

PROCUREMENT: Not applicable

BENEFITS: The growing competition coming from within MERCOSUR and from the globalization of markets demands financial intermediation and, in particular, the availability of medium- and long-term financing to increase the competitiveness of Brazil's

microenterprises and small-scale businesses and its SMEs, which together represent an important part of the country's industrial plant, and have the potential to restructure and modernize for exports. To this end, the component for financing SMEs will promote: (i) extending the coverage of medium- and long-term finance to all efficient private sector activities, including social-sector operations; and (ii) the development of medium- and long-term financing mechanisms and instruments, for small and medium-sized enterprises.

Similarly, the component for formalizing and consolidating microenterprises and small-scale businesses will enhance (i) the efficiency and competitiveness of this group of businesses, and (ii) expand and consolidate its access to credit for the purchase of capital goods and for working capital.

With respect to the component for credit to private higher education and health service providers, the principal direct benefits will derive from expanding the supply of services and extending their coverage, especially for low-income groups. In higher education, the benefits will depend on the extent to which private providers respond to the educational needs of students with a more diversified income profile than do the public-sector institutions. In health, benefits will consist in increasing access for people of few means to effective, high-quality services.

Given the nature of the operation to provide financing for all efficient, private-sector activities in all sectors, it is impossible to produce an ex ante measurement of the specific outputs, either at the macroeconomic level (GDP, exports) or in terms of the number and amounts of the subloans and the size of the subborrowing enterprises. However, previous experience with BNDES operations supports achievement of the proposed objectives, the arrangement selected, and BNDES's capacity to implement the operation.

RISKS:

Successful implementation of the proposed program will depend on maintaining a macroeconomic and financial framework that is conducive to the growth of private investment. In this respect, the government has already achieved noteworthy results in terms of economic reforms and stabilization under the *Plano Real*, and has reinforced these with the package of measures announced in late 1997 and early 1998, which reduce the risk of speculative runs on the *real*

and will help to consolidate progress under the *Plano Real*. Under these circumstances, the macroeconomic risk is considerably reduced. In addition, the experience that BNDES has gained in programs of this kind, operating under much more difficult macroeconomic conditions, gives assurance of its capacity to manage the macroeconomic risks.

The risk of disruptions in the financial system is low, given the restructuring that has occurred since the introduction of the *Plano Real*, which has entailed consolidation of the financial system, the strengthening of regulatory and supervisory mechanisms, and the reorganization and/or privatization of part of the State banking system, all of which provides grounds to expect that the resources of the proposed program will be channeled to good use. In addition, it should be noted that the proposed program will help to mitigate this risk by acting as a catalyst for sound practices, by insisting on more rigorous application of selection mechanisms and portfolio monitoring by the IFIs, and in the surveillance that BNDES will exercise over the IFIs' lines of credit. As well, by placing long-term funds at the disposal of the IFIs, the proposed program will facilitate more balanced growth of their lending portfolios.

The past experience of BNDES and its proven effectiveness in funneling credit to a large number and variety of SMEs will significantly reduce the risk that the program may not fully reach its target groups, or that the operation will not achieve the anticipated results.

Finally, with reference to the component for private social-services providers, and more specifically the health subcomponent, there is a risk that technology costs will translate into social costs, in situations where private providers fail to rationalize their service costs. This risk can be reduced at the time BNDES conducts its technical and financial review of loan applications submitted by accredited IFIs.

ROLE OF THE PROJECT IN THE BANK'S COUNTRY AND SECTOR STRATEGY:

The proposed program is consistent with the Bank's financing strategy for Brazil, which addresses the challenges identified in the county paper. It accords with the policy guidelines and principal goals of the government and the priorities established by the Brazilian authorities in response to the request from BNDES to the Ministry of Planning (SEAIN) of March 19, 1997. That request was included in the Bank's programming pipeline as one of the

priority projects for 1998. The Bank's strategy for 1996-1998 calls for three basic areas of action: (i) reform and modernization of the State; (ii) modernization of production and reduction of the "Brazil cost"; and (iii) addressing social inequities and poverty. The proposed operation addresses item (ii), in the sub-area of the financial sector, and item (iii) in the sub-areas of reducing social inequities and urban poverty, and the education and health sectors.

The program will also be used for technical exchanges between the IDB and BNDES to develop new financial products, disseminate BNDES's second-tier methodology, and devise new market pricing methods.

SPECIAL CONTRACTUAL CONDITIONS:

Prior to the first disbursement of resources allocated to each component of the program, the borrower will submit evidence that the Credit Regulations for the component are in force and that they include: (i) eligibility conditions and parameters for IFIs and their subborrowers, as well as their contractual relationship with BNDES; (ii) the financing charges for the IFIs, which will be calculated on the basis of the "long-term interest rate" (TJLP), adjusted quarterly, plus an onlending fee of 2.5% for SMEs and 1.0% for microenterprises and small-scale businesses, and for the social component, in all cases covering the institution's operating costs; (iii) the provision that IFIs will be free to set their interest rates, fees and other charges on their subloans under each component; and (iv) mechanisms for monitoring the IFIs and their transactions under each component of the program, by BNDES.

I. FRAME OF REFERENCE

A. The macroeconomic setting

1.1 Brazil has since 1990 been immersed in a process of public sector reforms, economic integration and opening of its economy, and has achieved encouraging results to date. The administration that took office on January 1, 1995, has placed great emphasis on continuing with the *Plano Real* to eradicate chronic inflation and its adverse effects on investment, capital markets, and income distribution. It has also stressed de-indexation of the economy; reform and modernization of the public sector; privatizing public enterprises; opening the economy to international competition and the attendant modernizing of the country's productive sectors; and increasing employment and reducing poverty.

1.2 The *Plano Real* has achieved significant progress: (i) inflation has fallen from monthly rates of 50% to an annual rate of 6.5% for 1997; the GDP growth rate was positive over the three-year period 1994-1996; and the public finances (federal government, central bank, states, municipalities and State enterprises) show a downward trend in their borrowing requirements. Despite this progress, the notable deterioration in the trade balance poses a major obstacle to success of the *Plano Real*.

1.3 In late 1997, the *Plano Real* had to contend with a speculative run on the *real* that was driven by spillover effects from the deteriorating financial situation and falling exchange rates in a number of Asian countries. The attack on the *real* helped the government to win the support of Congress to undertake: (i) administrative reform, which among other things would remove job security guarantees for public servants; (ii) social security reform; and (iii) a package of measures to raise taxes and reduce public sector expenditure. The package introduced in late 1997 also included a sharp, temporary increase in interest rates and other monetary control measures, and a 3% increase in the common external tariff of MERCOSUR. With these steps, the country's exchange reserves were swiftly restored and its financial markets returned to normal. Trends in Brazil's main macroeconomic variables are examined below.

1.4 GDP, according to preliminary estimates, grew at a rate of 3.3% in 1997, higher than the 2.9% recorded in 1996, while inflation ran at 5.6% in 1997, a significant improvement over the 1996 rate of 9.5%. Under the impact of the package of fiscal, monetary and balance-of-payments measures introduced in late 1997, the current year will see a significant reduction in the growth rate of GDP; in fact, real GDP fell back 1.1% in the first quarter of the year. At the beginning of 1998, unemployment had already risen to 8.9% of the economically active population, again as a result of the adjustments brought in to stop the run on the *real*. In contrast,

inflation fell to 0.13% for April, and the annual inflation rate for 1998 is expected to stand between 2.5% and 3%.

1.5 The fiscal situation is a key element affecting economic policy in Brazil. The fiscal deficit for 1997 amounted to 5.9% of GDP, compared to 6.1% in 1996. As noted, the Executive Branch responded to the run on the *real* in late 1997 with a package of measures to reinforce stability in the economy. The Congress, for its part, has moved swiftly to raise taxes and approve the civil service reform, which will contribute to improving the public finances over the medium term. The proposed social security reform did not receive the required ratification, and the government will have to submit it once again to Congress. The primary deficit still persists, as a result of rising public expenditures on salaries and social security.

1.6 Monetary policy is tight in an effort to control credit and monetary aggregates. Interest rates in dollar terms are high, although until recently they had declined since mid-1995 to a range of 10%-15%. In October/November 1997, they were increased to shore up the *real*, in the face of the speculative attack that was driven, as mentioned above, by events in global capital markets. The interest rate (TBC) rose temporarily from 22% to 42% per annum. Subsequently, interest rates have dropped noticeably, and in May the rediscount rate stood at 23.5%.

1.7 The balance-of-payments deficit on current account rose from US$24.4 billion in 1996 to US$33.4 billion, or 4.2% of GDP, in 1997. Of this figure, the shortfall on the trade balance accounts for US$9.2 billion, well above the US$5.5 billion recorded in 1996. Exports rose 10.6% in 1997 to a level of US$52.8 billion, while imports grew by 16.3% to a total of US$62.0 billion.

1.8 The rising level of imports is a cause of concern. It stems in part from overvaluation of the *real*, as well as from the surge in economic activity. As of March 1998, however, the trade deficit had declined from US$2.5 billion to US$1.5 billion in comparison with the same period in 1997.

1.9 Apart from rising imports, the higher current account deficit on the balance of payments also reflects the growing deficit in the services account, occasioned in particular by greater outlays for profits and interest, international travel and transport. This situation results from the rising volumes of external debt and foreign investment, as well as the appreciating exchange rate which encourages tourist spending abroad and more imports, which in turn lead to higher expenditures on transport.

B. The macro-financial framework

1. The financial system

1.10 In the mid-1980s and thereafter, in a situation of high inflation and the impossibility of securing funds on deposit at long term, commercial banks extended few loans, and all of them were at very short terms. The banking system all but abandoned its traditional intermediation function, in the face of much more attractive and less risky options for placing banks' available funds. Bank financing to the private sector virtually dried up.

1.11 Meanwhile, major investment and subsidized credit programs served to strengthen the State financial sector, which by 1994 held close to 50% of the total assets of the financial system, 60% of its outstanding loans, and 45% of its deposits. The consequence was a portfolio with a high rate of non-performing loans, and the State banks found themselves in a position where they could no longer continue to finance municipal and state projects. Attempts to rehabilitate the State banking sector have been successful with respect to the two largest of the State-owned institutions: BANESPA and BANERJ, the latter bank having been privatized.

1.12 With the reduction of inflation and "remonetization" of the economy following introduction of the *Plano Real*, the banks have been forced to undertake adjustments. The basic question for the non-State-owned banks was to manage the move from a banking system focused on arbitrage with government securities through management of their daily float, to one that would provide commercial and investment credit with revenues deriving primarily from the margin of intermediation between deposits and loans. As well, the banks enhanced their efficiency and reduced their operating costs, by taking steps to automate services and reduce their payrolls.

1.13 There has been a wide-ranging pattern of mergers and acquisitions in the Brazilian financial system. The number of banks declined from 243 in 1995 to 211 in 1997, and this trend is expected to continue, with the disappearance of the smaller institutions, until perhaps 120 banks remain. The system is becoming highly concentrated: the 10 largest banks control 78% of assets and deposits. In tandem with the restructuring process, foreign banks have increased their presence considerably. The following have recently entered the Brazilian market: Hong Kong and Shanghai Bank (HSBC), Banco Santander, Banco Inter-Atlántico, Banco de Bilbao Vizcaya, Caixa Geral de Depósitos (Portugal), Nations Bank, Swiss Bank Corporation (SBC) and American Express Bank. The growing interest of foreign banks in acquiring Brazilian financial entities is an indicator of the country's market potential.

2. The regulatory system

1.14 The regulatory structure for the Brazilian financial system is headed by the National Monetary Board (CMN), consisting of ministers, directors of the Central Bank and the Chairman of the National Securities Commission (CVM). The Central Bank regulates the banking system and exercises supervision by conducting on-site inspections (some 600 inspectors make visits to banks, with priority to those in difficulty), and monitoring information submitted by the banks. The system's performance standards are based on a set of criteria known as the CAMEL system (capital, asset quality, management, earnings and liability structure), under which institutions are rated in terms of the quality of their operations and their financial condition. The CVM regulates and supervises the securities market; the Superintendency of Private Insurance (SUSEP) and the Brazilian Reinsurance Institute (IRB) regulate and supervise insurance companies; and the Ministry of Planning and Budget performs similar functions with respect to the mortgage market.

3. Restructuring of the financial system

1.15 With the introduction of the *Plano Real*, the Brazilian financial system has had to adapt itself to new market conditions, a process that was foreseen in the study conducted in connection with consideration of loan 907/OC-BR. 1/ As can be appreciated from the preceding paragraphs and from the regulatory standards in force (available in the technical files), the system has been strengthened considerably. In particular: (i) commercial banks have been reorganized, through a process of mergers, acquisitions and restructuring that has embraced approximately one third of the banks existing at the time the *Plano Real* was launched; (ii) the regulatory system has been reinforced, in accordance with the recommendations of the Basle Committee, as have oversight mechanisms and IFI accounting systems; and (iii) some major state banks have been restructured and/or sold (for example, Banco de Rio de Janeiro and Banco de São Paulo). 2/

1.16 The progress that has been made in the Brazilian financial system's adjustment was an important factor in avoiding a repetition of what occurred in Asia in late 1997. Thanks in part to the positive effects of the financial system adjustments introduced under the *Plano Real* in 1994-1997, Brazil was able to move swiftly, as described earlier, to avoid having its markets contaminated by developments in Asia.

1/ IDB, Brazil: Analysis of the Financial System: Banking Sector and Capital Market, November 1996.

2/ J.R. Mendoça de Barros, G.J. Laboissiere Loyola, and J. Bogdanski. Restructuring of the Financial Sector, February 1998.

4. Profitability

1.17 With the sharp drop in inflation and "float" business, the financial system has developed new products and moved into new market segments. Under the *Plano Real*, the banks have significantly expanded their portfolio of personal loans to finance consumption and the acquisition of durable goods, and this has greatly enhanced the earnings position of financial institutions. Similarly, it is apparent that rising lending and deposit rates and the temporary drop in the demand for credit after November 1997, occasioned by the slowdown in economic activity, have forced the banks to move more quickly to enhance their efficiency as the main means of sustaining adequate levels of profitability and solvency.

5. Arrearages

1.18 The average arrears rate of the commercial banks overall (22.2%) is higher than that for the larger private institutions (8.4%), which in turn is lower than that of the small commercial banks (13.9%). The IFIs' experience with BNDES resources shows lower rates of arrears than do the private and public IFIs.

TABLE I.1
ARREARS RATES IN THE FINANCIAL SYSTEM (%)

FINANCIAL AGENTS	OVERALL	WITH BNDES RESOURCES
Overall average	13.0	9.0
a. Average public	22.2	16.6
b. Average private	8.4	6.7
(i) with debts to BNDES exceeding R$16 million		3.9
(ii) with debts to BNDES less than R$16 million		8.8

6. Credit supply and demand

1.19 Despite progress under the *Plano Real*, which served to reactivate, in some measure, the supply of credit to the private sector, that credit continues to have a short-term profile, given the persistent uncertainties about the behavior of the macro-financial setting, and in particular because there has been little success to date in attracting longer-term deposits. IFIs raise their loanable funds through short-term instruments, such as fixed-term and interbank deposits, and demand deposits that pay no interest (current accounts). Since the term of these savings instruments is generally less than three months, IFIs continue to make their loans for maturities of less of one year, in order to avoid maturity

mismatching that could impinge on their liquidity and solvency. The lack of medium- and long-term credit to meet a growing demand from SMEs for financing their modernization and expansion forces them to depend on self-financing or on short-term credit, which increases the risk that they may be unable to continue to obtain funding. In contrast, large companies are able to meet their funding needs through the issuance of shares and debentures on local securities markets, by borrowing at lower rates abroad (in the case of the big multinationals), through the reinvestment of earnings, or by arranging short-term revolving credit. Large companies in the private nonfinancial sector had total external borrowings of US$13.0 billion in 1997, compared to US$8.2 billion in 1996; average maturities rose from 8.1 years in 1996 to 9.5 years in 1997.

1.20 For these reasons, and in particular because of the short maturities of savings instruments, there is not expected to be a significant increase in the near future in the availability of medium- to long-term credit from the financial system, as will be needed to meet the demands for increased productive capacity and/or better utilization of existing capacity of micro and small businesses. In fact, the only significant source of such financing available at this time for microenterprises and SMEs is the funds that are intermediated by the IFIs of the BNDES system, and which the IFIs onlend at market interest rates. In 1996, funds intermediated by BNDES represented 4% of gross fixed capital formation in the country. This situation reflects not any attempt at monopoly by BNDES, but simply what is happening de facto.

C. Social problems and the microenterprise sector

a. Income distribution

1.21 Social problems and income distribution continue to be a serious concern in Brazil, although the *Plano Real* has succeeded in raising the income share of the two poorest deciles of the population. Attesting to the magnitude of this phenomenon is the continued spread of *favelas* or shantytowns in the major cities. These communities generate intense local economic activity in commerce, production and the provision of services, which means that efforts to strengthen microenterprises and small-scale businesses, especially by providing them with financing, will have a positive impact on reducing poverty. 3/

b. Microenterprises

1.22 The microenterprise sector, according to data from the Brazilian Institute of Geography and Statistics (IBGE), encompassed in 1993

3/ BNDES, DEPEC, A. Villela, As Micro, Pequenas e Medias Empresas, 1993.

about five million registered microbusinesses. These statistics take into account only formal operations. According to more recent studies carried out for the IBGE by the Brazilian Service of Support for Micro and Small Enterprises (SEBRAE) and IBASE, microenterprises account for as much as 40% of the country's gross domestic product, and employ between 40% and 60% of the country's economically active population of about 60 million workers. The distribution of microenterprises by sector is as follows: commerce (60%), services (25%) and manufacturing (15%). Most of these are family-run businesses with one or two employees.

1.23 The microenterprise sector has grown for two major reasons. (i) The restructuring of State enterprises and the public service has brought about privatizations, voluntary departure programs and the end of tenure for the civil service. (ii) Private companies have been shedding staff in an effort to enhance their competitiveness in the face of the opening of the economy. Some of the newly unemployed in both these sectors have used their separation settlements and allowances to establish their own microbusinesses. Self-employment or flexible employment in the microenterprise sector, which is for the most part informal, represents a logical option, especially for unskilled or manual workers. According to a study entitled "Informality and Income", produced by SEBRAE and IBASE in 1997, 50% of the microenterprises recently created in the Rio de Janeiro region were set up mainly for that reason.

1.24 A number of constraints are impeding this sector from consolidating itself and growing. The informal nature of microenterprises, together with a banking regulatory regime that discourages the extending of credit to informal businesses, makes it exceedingly hard for them to obtain loans from the mainstream financial system. In fact, the lack of access to credit constitutes the greatest obstacle to the development of microenterprises. Most of them must resort to loans from: (i) friends and relatives, who are the largest source of funding (50%); (ii) credit from suppliers and profiteering moneylenders (40%); and (iii) financial institutions (10%) such as cooperatives, finance companies and NGOs. Informal providers of finance offer unfavorable conditions: loans from friends and family are small and short-term; credits from suppliers and loan sharks are also short-term — generally for two weeks to three months — but at extremely high interest rates.

1.25 In January 1997, the SIMPLES program was introduced (the Tax and Contributions Payment System for Microenterprises and Small-Scale Businesses), which consolidates tax obligations into a single monthly sum, at a rate ranging from 3% to 7% of gross monthly revenues. The SIMPLES system treats businesses as microenterprises if their annual revenues are R$120,000 or less, and as small-scale businesses if their revenues fall between that figure and R$720,000. SIMPLES is a very positive step forward in mainstreaming vast sectors of the informal economy, where corporate

taxes go unpaid, employers fail to make their social security contributions, and workers' wages commonly go unrecorded. Regularizing this tax situation will help to reduce the public sector deficit and ensure the success of the *Plano Real*, thereby creating an enabling environment for investment, both local and foreign. By encouraging the formalization of microenterprises, the scheme will help them to become eligible for credit from the formal financial system, 4/ which is a further important advantage for them. The informality of these businesses, in fact, constitutes one of the major reasons for their lack of access to credit, and hence represents a serious obstacle to their growth, as well as frustrating the enforcement of tax, labor, social security and environmental legislation. The lack of regularized taxation status leaves informal microenterprises at the mercy of microcredit systems and/or moneylenders, with highly negative consequences for the development and growth of their business, given the high cost and volatility of such financing.

1.26 At the same time, BNDES is also providing direct support to microenterprises through its Social Progress Division, by granting loans to NGOs that specialize in microcredit and to low-income individuals who want to set up a microenterprise. The Social Progress Program has two facilities: the Solidarity Fund [*Solidariedade BNDES*] and the Workers' Fund [*Trabalhador BNDES*]. The IDB is supporting the development of both these facilities through ATN/1128-BR, granted to BNDES in 1997 to help NGOs engaged in microcredit lending to develop new products and strengthen themselves institutionally.

D. Small and medium-sized enterprises (SMEs)

1.27 The market imperfections that are evident in the scarcity of medium- and long-term funding in the financial system have a serious impact on SMEs, businesses with annual sales volumes of between US$720,000 and US$15,000,000 that for the most part have no access to capital markets. Market globalization requires that attention be paid to the plight of the SMEs, since they have a key role to play in the strategy for industrial modernization, and account for a huge share of the country's industrial apparatus. Moreover, the Brazilian government considers an outsourcing approach to be critical to national development, and the SMEs are the key to this strategy. For this reason, the government has given the highest priority to supporting their productive restructuring through adequate supplies of medium- and long-term financing.

4/ Regulated financial institutions are prevented by law from making loans to firms that are not in compliance with tax registration obligations.

E. The private delivery of higher education and health services

1.28 Private providers of higher education and health services also face limitations on their access to medium- and long-term financing. This can retard the growth of such services, not only in terms of their coverage but also of their quality.

a. Higher education

1.29 The private sector has become a fundamental player in the provision of higher education services in Brazil. 5/ Since the 1960s, the Brazilian government's efforts to improve access to higher education have been based on an implicit policy of creating a system of public universities that would offer a free education to the best students, while encouraging private facilities to accommodate the remainder of the student body. Over the last 30 years, enrolment in higher education rose from under 100,000 students in 1960 to more than 1.6 million in 1994, and 51% of the students are enrolled in private higher education establishments. Today, of a total of 851 institutions of higher learning in Brazil, about three quarters (74%) are private.

1.30 Despite this growth, only 11.4% of young people between the ages of 19 and 24 are enrolled in higher education, a rate that compares poorly with other countries of the region, where the average is over 20% (for example, the enrolment rate in Argentina is 39%, in Uruguay 30%, and in Chile 27%). But, even with this low level of enrollment, supply is insufficient to meet the demand. The Ministry of Education and Recreation estimates that there are 1.8 candidates today for every space available in the system as a whole.

1.31 Yet federal funds available for attending to this need are increasingly tight, despite the fact that higher education receives, each year, 62% of the entire federal education budget of R$9.6 billion. Moreover, in light of the Brazilian government's stated priority of promoting primary education, it is not politically feasible at this time to increase public funding for the higher levels.

1.32 Given these financial limitations, and the rapidly growing ranks of graduates from the country's secondary schools, recent efforts to enhance quality and coverage at the higher education level mean that the private sector will continue to play an important role in

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5/ The formal education system consists of four sub-systems managed by different authorities: pre-school and basic education (municipalities); middle/high school (states); and post-secondary or higher education (the federal government, via the Ministry of Education). It is at this last level that the private sector role is growing, and now accounts for more than half of enrollment.

meeting the demand for university level instruction, as explained below.

1.33 With the exception of a few cases where foreign banks have agreed to participate, private providers have no access to financing for the up-front investments needed to open new programs or expand coverage. Moreover, in many cases these private institutes are in no position to buy expensive equipment and supplies, since their students have limited access to funding to pay their tuition fees. This lack of funding results in meager investment in higher education, especially in fields that place heavy demands in terms of capital and personnel such as the sciences and engineering, and those where the social return is greater than the private return, such as basic research and public health. Therefore, it will be essential to mobilize financing for private institutions if Brazil is to raise its enrollment rates in higher education.

1.34 Greater private involvement in the delivery of higher education would not only mean financial benefits but efficiency gains as well. Public institutions of higher learning in Brazil are subject to restrictive regulations and are highly inefficient, with excessive unit costs and poor administration. Private institutions in Brazil are generally run with greater internal efficiency than most of the public ones.

1.35 Besides bringing greater internal efficiency to higher education, private delivery contributes to reducing inequities in the access to those services. In fact, private institutions are the ones offering most of the less expensive programs (e.g. administration, accounting, pedagogy, social sciences and data processing), where students for the most part come from families of fewer means. According to data from the National Review of Academic Programs of 1997, students in private higher education tend to come from lower-income households than do those who attend public universities. At the same time, those students tend to hold full-time jobs while pursuing their studies, to a far greater extent than do students at federal and state universities. 6/ To accommodate such working schedules, private institutions offer night courses. Expanding the offerings of private providers thus represents one of the most effective ways of beginning to reduce the inequities in the Brazilian higher education system. In the absence of such private facilities, those students who are unable now to attend the public universities would have no way to pursue further education.

6/ Inter-American Development Bank. Claudio de Moura Castro and Juan Carlos Navarro, "Will the Invisible Hand Fix Private Higher Education?", Mimeograph, 1998, Washington D.C.
World Bank.

b. Health

1.36 The structure of the delivery and financing of health services in Brazil encompasses, on one hand, a private system, and on the other the publicly-funded Single Health System (SUS). Their joint expenditures amounted to 4.5% of GDP (US$23.2 billion) in 1994. The private system is comprised of companies offering pre-paid health plans and health insurance, self-managing systems and medical cooperatives, and covers approximately 30% of the country's population (about 50 million people). The SUS, which is funded with resources from the three levels of government, reimburses services contracted with public and private providers, through a fee-for-service approach. It serves the other 70% of the population, or some 110 million people who are not covered under private health plans. Within this group are an estimated 30 million low-income people who depend exclusively on the SUS.

1.37 This method of contracting for services reflects a process whereby the public sector is moving away from its traditional involvement in the direct delivery of health services, towards a function of financing and regulating such services. Yet although this process (which was initiated in 1988 with the new Constitution) is moving in the right direction, the SUS is currently in an institutional crisis stemming from its financial and management structure, and its mandate to provide universal free coverage. One consequence has been an accommodation of preference of service providers for medical procedures that "pay best", and not necessarily those that are of the greatest benefit from a health viewpoint. This situation not only restricts the expansion of the system's coverage, but also affects its quality, and tends to channel large subsidies to the wealthier segments of the population.

1.38 The Ministry of Health has undertaken to adopt reforms that will address these problems and will encourage private providers of health services to take a larger and appropriate role. The core policy goals now under consideration within the Ministry for promoting this participation are: (i) to have adequate medium- and long-term financing available to the sector; (ii) to bring reimbursements paid to providers into line with their real costs, with preference given to the most cost-effective types of interventions; (iii) to improve the quality of service; and (iv) to strengthen the regulation and supervision of public and private providers alike.

1.39 This policy framework is consistent with the advantage that private providers offer over public providers in Brazil: (i) they spend a smaller proportion of their resources on personnel (lower unit costs); (ii) they offer greater consistency in the level and makeup of their spending (they are not subject to non-economic factors that do influence the budget allocations of public providers); and

(iii) they offer economies of scale in their hospital charges, given their unit costs. 7/

1.40 At present the main obstacle to making better use of the advantage offered by private service providers in the health system is the lack of medium- and long-term funding in the amounts needed to meet the growing health-care needs of the majority of the population. In fact, the current pressures on the supply of health services have led to a proliferation of private health insurance plans without any matching increase in the pace of investments that would ensure an adequate supply of services to their subscribers. In the last five years, there has been a decline of 3% in the number of private hospitals. On the public side, between 1993 and 1997, the 8% decline in private beds available under agreements with the SUS has meant a 21% drop in beds accessible to low-income people.

1.41 Consequently, in these circumstances, if effective use could be made of the advantages offered by private providers of health services, the public sector could step back from managing the delivery system, with the problems that entails, and concentrate on providing care for low-income groups. That would also help generate healthy competition for financial resources, both public and private, and could induce major improvements in the quality of services provided in the public and private sectors alike.

F. The Bank's strategy and rationale for its participation

1.42 The proposed program fits with the Bank's financing strategy for Brazil, with the policy guidelines and principal goals of the government, and with the priorities established by the authorities in response to the request submitted by BNDES to the Ministry of Planning on March 19, 1997. That request was included among the priority projects for 1998 in the Bank's operations pipeline.

1.43 The basic elements of the Bank's strategy place an emphasis on: (i) reforming and modernizing the federal and subnational levels of government; (ii) the process of opening the economy through the modernization of its productive sectors and the reduction of the "Brazil cost"; and (iii) the problems of social inequity and poverty. Microenterprises, small-scale businesses and SMEs, because of the high proportion of economic activity that they account for, and their importance in generating employment among low-income groups, represent an ideal vehicle for achieving the strategy objectives of the country and the Bank.

1.44 The focus chosen for the three components of the proposed program, besides addressing the process of opening the economy and reducing

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7/ World Bank. Report No. 12655-BR. Musgrove, Philip. Brazil. Organization, Delivery and Financing of Health Services in Brazil: An Agenda for the 1990s. Washington DC, 1995.

inequities and poverty, represents an effort to provide support to small and medium-sized enterprises, consistent with the proposal made by the Bank for promoting such businesses under the Plan of Action of the Summit of the Americas. First, the three components are aimed at removing the obstacles that now impede access by microenterprises, small-scale businesses, SMEs and private service providers to finance sources, and especially to medium- and long-term financing. Secondly, one of the program components will help to consolidate and formalize microenterprises and small-scale businesses with respect to taxation, social security, labor and environmental matters. Third, another of the program components will help expand the coverage of education and health services.

G. Higher education and health strategy

1.45 This component is consistent with the Bank's strategy for Brazil, and the sector strategies for higher education and health, as well as with the mandate from the Eighth Replenishment for improving social services.

1.46 The Bank's higher education strategy establishes three overall goals that would justify the use of Bank resources in this sector, in order to: (i) enhance governance, efficiency and quality; (ii) support programs that are expected to produce public goods, such as training intellectual leaders, fostering good citizenship, research, and technology development; and (iii) stimulate greater equity.

1.47 The Bank's health strategy, as proposed in the country paper (in preparation) stresses the following priorities: (i) a focus on lower-income groups; (ii) designing incentives for delivering public and private (both for-profit and philanthropic) services more cost-effectively, with an emphasis on primary care through family health teams/community health workers, and substantial increases in PAB allocations; (iii) the principle of cost recovery for people covered by private insurance; (iv) decentralization of financing to the municipal level, encouraging the convergence of public, private and community institutions in joint action to meet the health needs of small and medium-sized municipalities; and (v) public health initiatives targeted at specific problems (e.g. malaria, cardiovascular disease, etc.).

H. Experience of the Bank with global multisector credit operations

1.48 Global multisector credit programs I and II, targeted at SMEs, have enjoyed great success. Loan 602/OC-BR for US$250 million was used to finance medium- and long-term credit for a broad range of expansion and modernization activities in eligible sectors, with a high proportion of SME participation. The total program amount was US$750 million, including cofinancing by JEXIMBANK of US$250 million. Loan 907/OC-BR for US$300 million, devoted exclusively to assisting SMEs in restructuring and expanding their

activities, also had JEXIMBANK cofinancing (US$300 million). Both operations have been disbursed. Paragraph 3.12 presents the results of program II. 8/

I. Experience of the Bank in the education and health sectors

1.49 The Bank has a long history in financing education projects in Brazil. Since 1964, it has provided a total of US$290 million for higher education (MEC-IDB programs I, II and III), equivalent to half of all funding to education. With the present program, the Bank would be returning to this subsector after an interval of 11 years, which means that there are no recent evaluations available. The ex post evaluation of higher education projects that was prepared by the Bank in 1985 (GN-1543) contains some lessons that could usefully be applied, including the importance of conducting demand studies, ensuring cost recovery, and collecting data on internal and external efficiency.

1.50 The Bank's experience in the health sector in Brazil is much shorter, and relates primarily to the project for expanding and consolidating the Mother and Child Services Institute of Pernambuco (ATN/SF-4008-BR), which was executed successfully. The other recent experience is the Health Sector Reform Program (REFORSUS, 951/OC-BR), approved in 1996, initial execution of which has been slow, as a result of the executing agency's lack of experience in managing external funds, and recent institutional changes in the senior ranks of the Health Ministry.

8/ For greater detail, see Annex 7 (Results of operation 907/OC-BR) in the project technical files.

II. THE PROGRAM

A. Objectives and strategy

2.1 The general objective of the program is to support: (i) development and modernization of Brazil's productive sector, by providing financing at market terms and conditions for private investment projects aimed at restructuring, improving and expanding efficient activities of micro, small and medium-sized enterprises; and (ii) development of the financial market that was initiated under the previous program. In line with that previous operation, the program will support the government's efforts to modernize the producing sectors and make them more competitive by reducing the "Brazil cost". The proposed operation will continue support for development of the financial market, in accordance with guidelines for the Bank's programs in the financial area. At the same time, the program will seek to improve access to long-term financing for private investment projects aimed at increasing the coverage and quality of privately provided higher education and health services.

2.2 The specific objectives of the program are: (i) to facilitate the formalization and financial consolidation of microenterprises and small-scale businesses, improving their access to medium- and long-term financing by IFIs, and helping them to comply with their taxation, labor, social security and environmental obligations; (ii) to expand medium- and long-term financing for microenterprises and SMEs through the formal financial system; (iii) to promote and strengthen financial markets, by providing liquidity for introducing and developing new and more sophisticated products for private investment projects, in nearly all productive sectors and the service industries, aimed at restructuring, improving and expanding efficient activities under market conditions; and (iv) to support private social-service delivery. In particular, the program's support for formalized microenterprises participating in the SIMPLES system will help to regularize their tax situation and bring them into the formal economy, improve their access to financing through the financial system, and assist in implementing programs introduced by the country in support of women and of environmental and health controls.

B. Description of the program

2.3 The proposed program will consist in providing global multisector financing under three components. The first focuses on financial support for formalizing and consolidating microenterprises and small-scale businesses that have joined the SIMPLES system. The second component emphasizes financing for modernizing and expanding small and medium-scale enterprises (SMEs) to enhance their competitiveness in an opening economy. The third component is for

strengthening the private delivery of education and health services.

2.4 Support for formalizing microenterprises and small-scale businesses, in particular, will help to regularize their tax status and bring them into the formal economy, enhance their access to financing from the financial system, and contribute to effective operation of the country's programs in support of women and of environmental and health controls. As well, the program will encourage development of new financial products and market facilities for the business segments in question.

2.5 The program consists of a loan to be totally executed by means of three discounting facilities for medium- and long-term financing, through intermediary financial institutions (IFIs) declared eligible by BNDES. The projects to be financed thereby must meet the technical, financial, economic, legal and environmental requirements of the program. <u>The first window</u> (BR-0289) for formalizing and consolidating microenterprises and small-scale businesses is intended as a credit facility: (i) for micro-enterprises (including working capital) up to US$25,000 per operation and (ii) for small-scale businesses (including working capital) up to US$144,000 per operation. The facility is intended to help these enterprises, in both the production and service sectors, to gain access to suitable financial services and to help adjust the practices of the IFIs with respect to lending to microenterprises and small-scale businesses. NGOs that lend to microenterprises and have the potential to become formal financial vehicles may also access these credits, if they are declared eligible by BNDES. In this regard, the Bank approved technical cooperation ATN/SF-1128/BR to be executed by BNDES for use in transferring microfinance technology and establishing performance indicators for institutional strengthening of NGOs that transform themselves into financial intermediaries. <u>The second window</u> (BR-0277) is intended as another rediscount facility for providing financing of up to US$3 million per operation to private SMEs for capital investments in modernizing and expansion projects in nearly all producing and service activities, including those providing education and health services. <u>The third window</u> (BR-0290) is intended as a further rediscount facility for providing financing of up to US$15 million per operation for strengthening private higher education and health service delivery.

2.6 All of the resources under the program will be channeled by BNDES through intermediary financial institutions (IFIs) declared eligible under criteria established in each of the program's sets of Credit Regulations, which, as in previous operations, are consistent with the operating rules of BNDES. The IFIs will use these resources in turn to grant credits to finance the purchase, installation and start-up of capital goods in areas covered by the three components described above.

2.7 Specifically, the funds will be used to meet the modernization and expansion needs, and the growing requirements for equipment and training of private entities that, thanks to recent reforms, are now operating in increasing numbers and scale throughout Brazil. Microenterprises may also draw upon the program to finance their working capital needs.

C. Scale of the program

2.8 The program will consist of three discount facilities totalling US$2.2 billion for financial intermediary institutions. The proposed loan will consist of a total of US$1.1 billion from the IDB dollar window. JEXIMBANK has shown an interest in cofinancing the operation for an amount of up to US$900 million, exclusively to cover local counterpart funding for the components for support to SMEs and to microenterprises and small-scale businesses.

2.9 The size of the program components for microenterprises and small-scale businesses and for SMEs is based primarily on BNDES' experience with the financing of microenterprises and SMEs over the period 1994-1997. In light of that experience, as the following table shows, the proposed program size is fully justified, both in terms of demand and the institution's operational capacity to implement it (see Table II-1).

TABLE II-1
FINANCING BY THE BNDES SYSTEM TO COMPANIES ELIGIBLE FOR THE PROGRAM
(in millions of dollars)

Size of firm	1994	1995	1996	1997	TOTAL
Micro and small	1,616	1,561	1,128	1,817	6,122
Medium	846	1,540	1,300	1,378	5,064
TOTAL	2,462	3,101	2,428	3,195	11,186

Source: BNDES

2.10 This amount, in light of experience with past programs, has been increased by US$200 million for private providers of higher education and health services. As an indicative sample for sizing this area of the component, an inventory was made of 39 projects that were submitted to BNDES by private institutions and which fit the MEC protocol, for a total of US$384 million. As well, a broader inventory was taken of prospective projects. From these inventories the average cost per project classed as fitting the protocol or identified emerges at between US$10 million and US$15 million.

2.11 The indicative sample for scaling the **education** subcomponent was based on an inventory of 39 projects submitted to BNDES by private institutions, and which have already been classed as fitting the MEC protocol and/or are under analysis by that institution as direct operations (with no IFI participation), for a total amount of US$200 million. Analysis of this sample was supplemented with data on projects that have been identified and that may eventually be included. On that basis, an average cost per project of US$15 million to US$20 million was calculated.

2.12 The indicative sample for sizing the **health** subcomponent was based on an inventory of nine projects submitted to BNDES by private institutions, and which already fit the protocol and/or are under analysis by that institution as direct transactions (with no IFI participation), for a total amount of US$200 million. Analysis of this sample was supplemented with data on projects that have been identified and that may eventually be included. On that basis, an average cost per project of US$15 million to US$20 million was calculated.

D. Justification of the multisector credit approach

2.13 The selection of multisectoral credit as the instrument for addressing the dearth of medium- and long-term financing in the Brazilian financial system is based on the following grounds. First, channeling funds from the proposed program through the IFIs of the BNDES system will provide continued support to the development of a banking system that is closely involved in analyzing and supplying financial and other support to the producing and service sectors. This factor becomes even more significant, both in terms of the program's catalytic approach to the development of medium- and long-term credit and the effort to promote sound portfolio management practices, now that it is being recognized that the commercial banking system needs these operations strengthened as it makes the "macrofinancial" transition from a market that was focused on float management to one that places the priority on lending.

2.14 Secondly, other approaches for encouraging the supply of medium- and long-term credit have substantial shortcomings as a prompt and effective response: (i) the effectiveness of guarantees (back-up facility) 9/ could be seriously compromised in the short term, given the scarcity of resources and the lack of medium- and long-term outlets in the Brazilian capital market, although this should not preclude their development in the future; and (ii) loan

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9/ A stand-by facility in support of the sale of medium- and long-term paper in the capital market, whether effected by IFIs, which will then place the proceeds, or directly by companies seeking project financing.

guarantee funds would not resolve the up-front problem (and would merely supplement the proposed operation): they would not by themselves remedy the immediate shortage of medium- and long-term funds that led to the Brazilian government's request for the proposed operation.

2.15 At the same time, the selection of BNDES as the executing agency takes into account a number of important elements: (i) there is a considerable demand for credit on the part of microenterprises, SMEs and private providers of social services; (ii) all of the financing can be channeled, consistent with the Bank's strategy, through the IFIs within the BNDES system, which will allow coverage of nearly the entire spectrum of demand through eligible IFIs, with loans kept under a relatively low ceiling, and so will ensure distribution of the resources far and wide throughout the commercial banking system; (iii) the commercial banking system will be encouraged to engage in medium- and long-term credit intermediation to the private sector; (iv) the program's target groups will be assured the chance to participate in use of the resources provided; (v) the mechanism makes it possible to ensure that the resources are allocated transparently and according to market and profitability criteria without subsidies or pre-earmarking, and to ensure that they are properly administered and supervised, 10/ as the Bank's policy requires in operations of this kind; 11/ (vi) the success of the previous operations (602/OC-BR and 907/OC-BR) has demonstrated the capacity of BNDES to execute programs of this kind for SMEs, small-scale businesses and microenterprises; and (vii) during its execution of those operations, BNDES took a number of measures to bolster its institutional workings, such as setting up a single credit

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10/ The assurance that this aspect will indeed be respected under the proposed program lies in the mechanisms that were worked out during the analysis for determining IFI eligibility, ensuring portfolio evaluation and monitoring, and setting interest rates that will avoid distortions and ensure that the funding costs of the participating financial institutions are covered.

11/ The Bank's policy was amended in response to joint IDB/World Bank experience with government intervention in the allocation of credit to institutions and businesses, the capping of interest rates, and other examples of what has been called "financial repression". The World Bank's experience was recounted in the *Report of the Task Force on Financial Sector Operations* (F. Levy and M. Hinds, World Bank, R 89-163, August 1, 1989). According to that report, loans granted by institutions supported with IBRD resources should be the result of business decisions, and returns, rather than social considerations, should be the principal yardstick for a financial institution's financial and development performance. Social factors, the report suggests, should be considerations only in the fiscal accounts of government entities.

committee, adopting a rating system for businesses, 12/ analyzing the long-range corporate strategies of its major clients, carrying out sector studies, and developing indicators of competitiveness with the view to establishing a comprehensive credit policy that assesses the credit risk both in terms of the company and of the sector in which it operates.

E. Component for formalizing and consolidating microenterprises and small-scale businesses (BR-0289, US$150 million)

2.16 The US$150 million component for **formalization and consolidation of microenterprises and small-scale businesses** is intended to establish a rediscount facility, with total resources of US$300 million, for loans (including working-capital loans) of up to US$144,000 per operation to help microenterprises in nearly all producing and service sectors to gain access to adequate financial services and to encourage changes in IFI practices with respect to microlending. NGOs that lend to microenterprises and have the potential to become formal financing vehicles may also access these credits, if they are declared eligible by BNDES. At the same time, under the program IFIs could be eligible to obtain compensatory financing for technical assistance to strengthen their credit management structures, including training for loan officers in the management and recovery of loans to microenterprises and setting up appropriate accounting systems for microcredits that are compatible with the accounting and management systems already established in the IFIs. In this regard, the Bank has adopted a strategy for supporting institutional strengthening of intermediary institutions providing credit to microenterprises. Under this strategy, it approved technical cooperation ATN/SF-1128/BR to BNDES to help transfer microcredit technology and establish performance indicators for institutional strengthening of NGOs that become financial intermediaries for microenterprise credit. The technical cooperation subsidizes these entities in upgrading their technology and developing the administrative capacities needed for efficient intermediation of credit to microenterprises. Another form of subsidy to entities providing credit to microenterprises, that allows them to absorb the greater transaction costs involved in such dealings, was to set the onlending spread for BNDES funds at 1% as compared to the 2.5% rate applicable to transactions with SMEs. Beneficiaries will have access to the BNDES "Solidarity Fund" program.

2.17 The **rediscount facility for microenterprises and small-scale businesses** will work with the following ceilings: (i) up to US$25,000 per operation for microenterprises with annual sales of up to US$120,000; and (ii) up to US$144,000 per operation for

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12/ The concept of "businesses" takes in both financial institutions (IFIs) and nonfinancial enterprises.

enterprises with annual sales of between US$120,000 and US$720,000. An average of US$50,000 per operation is expected. Subloans under this component are expected to be an average of US$50,000, and 20% of the amount is to be allocated to microenterprises.

2.18 This operation offers the Bank, for the first time, the chance to help strengthen microenterprises and small-scale businesses by way of institutional credit, as opposed to the financing typically available to small firms in the informal sector that operate at the margins of environmental controls, systems and other legal requirements. When informal micro- and small enterprises evade taxes they also block the good things they stand to gain from expanding, enhancing their efficiency and making an even greater contribution to the national economy. Such advantages carry with them the duty to pay taxes and comply with other regulations. This concern has been highlighted in a recent consultant's report. 13/

F. Component for modernizing and expanding SMEs (BR-0289, US$750 million)

2.19 The **SME loan component** of US$750 million is intended to constitute a rediscount facility with total resources of US$1.5 billion to extend loans of up to US$3 million each. It will support private small and medium-sized enterprises (SMEs) for capital investments in modernization and expansion projects in nearly all producing and service activities, and will include financing for education and health service providers. The program will also encourage the development of new products and market facilities.

2.20 The **SME rediscount window** will provide subloans up to its ceiling (US$3 million) 14/ to meet the financing needs of expansion and restructuring projects for enterprises of this type, including private technological undertakings in social areas that have had difficulty accessing long-term financing, such as those pursued by private investors in health and education areas. The IFIs provide credit almost exclusively to micro, small and medium-sized enterprises (which represent close to 90% of their customer base).

13/ McKinsey Global Institute, *The Key to an Accelerated Development Path for Brazil*, the principal conclusions of which were reproduced by S. Fidler, *Sticking with Reforms with Double Living Standards*, The Financial Times, March 13, 1998.

14/ The definition of SME used by BNDES applies to firms with annual sales volumes between R$720,000 and R$15 million. A financial analysis of the debt service capacity of SMEs in Brazil suggests that loans of more than US$3 million should be granted to such firms only on an exceptional basis.

2.21 Channeling resources through the IFIs pursues the twofold purpose of (i) promoting the development of intermediated medium- and long-term credit for the private sector via the commercial banking system, and (ii) ensuring that SMEs and microenterprises have a real chance to participate in use of the program's resources.

2.22 The proposed operation, besides broadening the previous program's coverage of eligible activities, is intended to contribute through all its components to developing a series of financial products, such as lease facilities (finance and operating), securitization, etc. 15/ This will be undertaken gradually, with due regard to trends in financial market conditions. It is planned that the lease finance feature will be in operation before the first disbursement, since BNDES is setting up a facility for such transactions (FINAME Leasing), for which the program will provide support.

G. Component for strengthening the private delivery of higher education and health services (BR-0290, US$200 million)

2.23 This US$200 million component is intended to constitute a rediscount facility with total resources of US$400 million to meet the credit needs of private providers of higher education and health services, to help them improve and expand their operations and ensure that these services respond to national priorities for these sectors in terms of coverage and quality.

a. Higher education (US$100 million)

2.24 A total of up to US$200 million will be channeled through the IFIs to finance the rehabilitation or expansion of installed capacity of private providers of higher education. Specifically, it will finance civil works, equipment and teaching materials, as well as training for teachers. Eligibility criteria for subloans will be established as follows: (i) applicants must be private institutions of higher education accredited by the MEC pursuant to the protocol that the Bank signed with the MEC in May 1997, entitled "Program for Rehabilitation and Expansion of the Physical Facilities of Higher Education Institutions", and (ii) the maximum amount of a subloan is to be US$15 million.

2.25 The financial terms and conditions will be same as those applied by BNDES to higher education projects: (i) a financial cost equal to

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15/ While the program, in principle, will provide only simple bank credit for the purchase and start-up of new investments, it is planned subsequently to introduce new mechanisms. The timing and features of these new products will be determined by the Bank and BNDES in the context of the Technical Exchange Committee that will be created, and will pay particular attention to prevailing market conditions.

the long-term interest rate (TJLP) + the BNDES basic spread of 1% + the IFI risk premium; and (ii) an amortization term of up to 10 years and a grace period of up to 24 months.

b. Health (US$100 million)

2.26 A total of up to US$200 million will be channeled through the IFIs to finance the rehabilitation or expansion of installed capacity of private providers of health services. Specifically, it will finance: (i) civil works and facilities necessary for the expansion of services; (ii) replacement and/or upgrading of equipment; and (ii) modernization of management capacity. Eligibility criteria for subloans will be established as follows: (i) applicants must be private institutions that have executed an agreement with the SUS under Protocol 01/98 on Joint Action signed with the Ministry of Health in March 1998; and (ii) the maximum amount of a subloan is to be US$15 million.

2.27 The financial terms and conditions will be the same as those applied by BNDES to health projects: (i) a financial cost equal to the TJLP + the BNDES basic spread of 1% + the IFI risk premium; and (ii) an amortization term of up to 8 years, and a grace period of up to 24 months.

H. Cost and financing of the program

2.28 The total cost of the proposed program is estimated at the equivalent of US$2.2 billion, distributed as follows:

TABLE II-2 PROGRAM COST BY FINANCING SOURCE (US$ million)			
Investment component	**IDB**	**Local counterpart**	**Total**
Micro and small-scale enterprises			
Credits	148.5	150.0	298.5
Inspection and supervision	1.5	-	1.5
Subtotal	150.0	150.0	300.0
SMEs			
Credits	742.5	750.0	1,492.5
Inspection and supervision	7.5	-	7.5
Subtotal	750.0	750.0	1,500.0
Private social services providers			
Credits	198.0	200.0	398.0
Inspection and supervision	2.0	-	2.0
Subtotal	200.0	200.0	400.0
Total loan			
Credits	1,089.0	1,100.0	2,189.0
Inspection and supervision	11.0	-	11.0
Grand total	1,100.0	1,100.0	2,200.0
Percentage	50%	50%	100%

2.29 The sources of finance for the program will be: (i) the IDB loan proposed herein, with its three components totaling US$1.1 billion; and (ii) local counterpart funds in the amount of US$1.1 billion. The Export-Import Bank of Japan has expressed interest in cofinancing this latter amount, exclusively for the SME and micro and small-scale business components, in an amount that could cover up to the total local counterpart requirement for these two components, in two equal stages, totaling up to US$900 million. JEXIMBANK has indicated its interest in this respect to BNDES. Despite the magnitude of these operations, which could see additional disbursements of some US$500 million to US$600 million per year over the next four years, there is still a large gap between the supply and the demand for medium- and long-term financing to meet the needs of the productive sector (see paragraphs 1.14 and 1.15). It should also be noted that financing from the BNDES system covers approximately 55% of a project's investment requirements, which means that the program could provide

financing for investments with an aggregate value of up to about US$4 billion.

I. IDB financing

2.30 The IDB loan will be provided entirely in foreign currency from the ordinary capital resources, and as can be seen in the preceding table, would be for a total amount of US$1.1 billion, which would represent 50% of the total cost of the program, in keeping with IDB policy for programs in Group A countries.

2.31 The Bank's loan would come from the dollar window. It would carry a variable interest rate and would have an amortization term of 20 years with four years' grace, and it would be subject to the normal terms and conditions with respect to credit fee and inspection and supervision charge.

J. Local counterpart funds

2.32 BNDES has undertaken to provide the local counterpart contribution, and is also in negotiations to obtain funding from JEXIMBANK for the program components intended to provide credit to microenterprises, small-scale businesses and SMEs, which, if arranged, could be used to cover local counterpart requirements. It should be noted, however, that, if this financing is not obtained, BNDES has other sources of funds that are sufficient to meet the local counterpart requirements for those loans under the program. Finally, it has been agreed, consistent with the Bank's policies, that the proceeds of repayments under previous IDB loans may not be used toward the local counterpart contribution.

K. Disbursement schedule

2.33 The terms for commitment of the program proceeds will be three years, and the disbursement period, four years. The yearly disbursement schedule is shown in Table II-3.

TABLE II-3
PROGRAM DISBURSEMENTS
(US$ million)

Loan	Year 1	Year 2	Year 3	Year 4	TOTAL
IDB	300	250	250	300	1,100
BNDES	300	250	250	300	1,100
TOTAL	600	500	500	600	2,200

L. Determination of interest rates

2.34 BNDES will onlend the resources of the three components – microenterprises and small-scale businesses, SMEs, and private social services – to the IFIs at a variable interest rate, adjustable semiannually on the basis of the long-term interest rate (TJLP). 16/ The interest rate applicable to subloans will be equal to the sum of: (i) the TJLP; (ii) the basic BNDES spread to cover its operating costs, the IFI risk and a return on capital for BNDES; and (iii) the IFI spread, which will be freely negotiated between the IFI and the final borrower. Security requirements will be at the discretion of the IFI. The basic BNDES spread will be 1% for the component for financing microenterprises and small-scale businesses; 2.5% for the component for financing SMEs; and 1% for financing for private education and health providers, pursuant to the BNDES-MEC and BNDES-MS protocols. This mechanism for setting interest rates is the one now in effect for BNDES operations of a similar nature to those of the proposed program. BNDES is in a position, at no additional cost to the program and in the framework of its joint operations, to assume the exchange risk in respect of the program funds.

2.35 The Central Bank introduced the TJLP as a benchmark rate of interest for medium- and long-term credit transactions, in the absence of a market-based yield curve. The supply of credit is inelastic beyond a certain term, i.e. the curve becomes almost vertical for maturities of more than one year, which makes it impossible to plot a medium- and long-term yield curve. In addition, the need to match lending against funding sources, which are at short term, places severe limits, for prudential reasons, on the capacity of the IFIs for maturity transformations of the length needed for the type of financing contemplated under this program.

2.36 The TJLP is a proxy for the cost of long-term funds based on parameters of yield and maturities for domestic and external government debt. That rate is variable and is calculated as a weighted arithmetic mean of the average yields on marketable long-term External Public Debt Instruments (TDE) and on marketable long-term Internal Federal Public Debt instruments (TDI), weighted at 75% and 25% respectively. The TDE yield is the average internal rate of return on external instruments that are "obligations of the federal government", with average maturities of more than two years. The value of the TDE is linked to the behavior of the London Interbank Offered Rate (LIBOR). The cost of TDIs takes as a benchmark the weighted yield of type D Treasury Bills adjusted for the exchange rate (US$).

16/ Annex 1 "Long-term interest rate: TJLP" in the technical files on the project explains the method of calculating the TJLP.

2.37 The information available on the behavior of the TJLP shows that it has remained positive in real terms, even though it plunged from 24.75% in August 1995 to 15.44% in August 1996, and to 9.89% in December 1997, as a result of the falling inflation rate. Recently, the TJLP has reflected the temporary increase in short-term interest rates brought in to counter the effects of the Asian crisis. In April 1998 it rose to 11.77%. Including the BNDES spread, the nominal annualized rate charged for funds onlent from the BNDES system to IFIs for use in investment credits for SMEs was 14.27%, and 12.77% for microenterprises, small-scale businesses and private providers of higher education and health services. 17/ Effective rates to the IFIs and to end-borrowers are higher, however, because the excess of the TJLP above 6% is capitalized, thus increasing the amount of principal on which interest is charged in each subsequent period (i.e. the TJLP plus the spreads charged by BNDES to the IFIs and by the latter to the end-borrower). 18/

2.38 In April of this year, the effect referred to above pushed up effective annual onlending rates to the IFIs to about 18.9% and 17.3%, respectively. And, given the average spread that the IFIs add to the onlending rate of BNDES, the effective annual rates to end-borrowers in April were approximately 21.5% for SMEs and 20% for microenterprises, small-scale businesses and private providers of higher education and health services. Those rates were similar to the average rates charged by the IFIs on 120-day working capital credits funded with their own resources, which in April were approximately 20.8% p.a. (16% plus a reference rate of 4.78% p.a.). The average effective annual rates paid by end-borrowers were fully consistent during this period with the Bank's policy in this regard, since: (i) they covered the costs of intermediation, (ii) they were positive in real terms, and (iii) they were higher than prevailing deposit rates during the period. 19/ Periodic adjustments of interest rates will be made during execution of the program, pursuant to a covenant in the agreement, which will ensure that this situation continues and that there is no distortion to the cost of funds under the different components that might hinder attainment of the program's objectives in this regard.

2.39 Given the realities of the Brazilian market, there is little likelihood that the onlending of program funds to the IFIs and the end-borrowers will generate excessive profits. In its operating policies, BNDES has recently been adopting the approach of a modern commercial bank by setting prices based on the overall relationship

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17/ Source: *Gazeta Mercantil*.

18/ Annex II-A, available in the project's technical files, contains a detailed description of how the TJLP is structured and applied.

19/ During the month of April 1998, the average rates paid on savings accounts and on 120-day bank certificates of deposit (CDB) were approximately 11.7% and 17.7% per annum, respectively.

with the client ("relationship risk pricing"). This stands in contrast to the system whereby the leading banks set market prices on an individual basis for each transaction or banking service provided ("deal pricing"), which, given the weight of those banks in the market, will determine the prices that the smaller banks can charge for each product. This practice can give rise to excess profits in markets where there is no competition. On the other hand, in the relationship risk pricing system, banks take into account the overall cost structure of the products they offer each client, so as to optimize the return to the bank from the total client relationship, rather than from an individual transaction.

2.40 In the foregoing context, the generation of excess profits could only arise from attempts by some Brazilian banks to engage in "skimming pricing" with their clients. Experience shows, however, that the advantages gained in this way would be of short duration: banks that behave in this fashion would find their business dwindle as clients go over to the competition.

III. PROGRAM EXECUTION

A. Borrower, executing agency, and guarantor

3.1 The borrower and executing agency of the program would be the National Bank for Economic and Social Development (BNDES), created by Law 1628 of 1952, and governed by the provisions of Law 5,662 of 1971. The operation would be guaranteed by the Federative Republic of Brazil.

3.2 Within BNDES, the primary responsibility for executing the program will lie with the office of the Manager of Operations with International Agencies, located in the Funding Department (DECAP), a unit that falls under the international and finance area, and with the Lending Department (DCRED), the Department for Processing of Joint Operations with IFIs (DEPOC) and the office of the Manager of Social Operations II (GEPOS) and that of the Manager of Social Policies (GEPSO), in the regional and social development area.

1. Origin and objectives

3.3 BNDES is a public enterprise constituted with a legal personality under private law and with its own capital. Its principal purpose is to promote the economic and social development of the country. The institution has two wholly-owned subsidiaries, BNDES Participações S.A. (BNDESPAR) and the Special Industrial Financing Agency (FINAME) which together with the bank make up the BNDES system. BNDES is authorized to raise funds domestically and abroad for conducting its operations, and is subject to the standards and rules set by the National Monetary Board.

3.4 BNDES is the primary instrument for executing federal policies for promoting private investment, and it is administratively connected to the Ministry of Planning and Budget. In this context, BNDES has selected five priority areas of action: (i) modernization, adaptation and expansion of economic infrastructure, (ii) support for external trade, (ii) restructuring and modernization of industry and other productive sectors, (iv) environmental protection and (v) privatization, with an emphasis on public services. With regard to number (iii), BNDES gives priority to the development of SMEs that supply inputs, parts and components for large companies, with a view to enhancing the systemic competitiveness of the production chain.

3.5 In its operations, BNDES has seen a significant increase in indirect transactions involving microenterprises and SMEs, through the medium of IFIs. Between 1985 and 1990, 32% of approved credits were effected through this channel. Since 1990, with a view to encouraging participation by the commercial banking system in the market for medium- and long-term domestic credit, and ensuring more

equitable access to its resources for a greater number of businesses, especially SMEs, an effort has been made to extend this method to all regions of the country, through creation of a network of IFIs.

3.6 BNDES' continuing commitment to lend to micro and small businesses can be appreciated from the overall pattern of lending for the period 1994-1997 (see Table III-1).

TABLE III-1
Loans (1994-1997)

Size of business financed	Financing (in US$000)	Number of loans	Average amount (in US$00)
Micro and small	6,122,000	161,577	38
Medium-sized	5,064,000	41,763	121
TOTAL	11,186,000	203,340	55

Source: BNDES

3.7 The eligibility criteria applied by BNDES to IFIs are based on these parameters: (i) maximum allowable level of indebtedness; (ii) minimum levels of liquidity and profitability; and (iii) financial ratios for establishing the soundness of its portfolio, its administrative capacity, and the previous experience of BNDES with each IFI. It should also be noted that, in order to ensure that financing is granted at terms and conditions that will adequately cover the institution's operating and funding costs and will yield positive real interest rates, BNDES applies adjustments to the principal of its loans: for those denominated in local currency, on the basis of the TJLP interest capitalization method, and for those denominated in foreign currency, on the basis of BNDES' currency pool. 20/

2. Financial and operating performance

3.8 The total assets of BNDES were equivalent to US$44.2 billion at December 30, 1996. They were funded primarily from the "Workers' Protection Fund" (FAT), 21/ which provides 40% of the bank's

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20/ In both cases, the financing costs are positive in real terms, and are greater than the cost of the Bank's OC funds.

21/ The FAT belongs to the workers and is administered by BNDES with worker participation. It was created by the 1988 Constitutional reform, and replaced the PIS-PASEP, the accrued funds of which continue to be administered by BNDES. A minimum of 40% of contributions to the FAT is deposited in BNDES. The FAT represents the largest source of funding for BNDES.

resources. Next in importance comes the PIS-PASEP Participation Fund (the Program for Social Integration and the Government Employees' Pension Fund) with approximately 27%, and the institution's own capital, at 22%. External borrowings accounted for only 9% of resources, and the remaining 2% consisted of various miscellaneous obligations. BNDES also manages the Administered Funds (the Merchant Marine Fund, the National Development Fund, and the Social Participation Fund), which represent a further US$5.6 billion of off-balance-sheet resources.

3.9 At December 1996, the BNDES loan portfolio amounted to US$32.4 billion, or 73% of the institution's total assets of US$44.2 billion. BNDES' capital stood at US$9.7 billion, which is considered an adequate level of capitalization (22%) as a proportion of its total assets. Annex III-1 (Selected portions of BNDES financial statements) describes the most significant aspects of the financial structure of BNDES and its performance in recent years, based on its audited financial statements.

3. Previous IDB loans to BNDES

3.10 The IDB has made 15 direct loans to BNDES, for a total amount equivalent to US$1,012.7 million. Seven of these loans have been repaid; seven have been fully disbursed and are being amortized; and the last one is totally disbursed (907/OC-BR).

3.11 Multisector Global Credit Programs I (602/OC-BR) and II (907/OC-BR), for providing medium- and long-term financing to SMEs, have proceeded very successfully.

3.12 Multisector Global Credit Program II (907/OC-BR) provided 1,036 subloans, of which 58% (totaling US$185 million) were for operations of less than US$500,000. Subloans under the SME program and JEXIMBANK counterpart funding were distributed as follows: 18% to agriculture; 33% to industry; 24% to commerce; 4% to energy, telecommunications and transport; 9% to education services; 5% to health services and 7% to other services.

TABLE II-5 Distribution of subloans by size			
Size/Range	**Number of subloans**	**Total amount (US$ million)**	**Average amount (US$ thousand)**
IDB-JEXIMBANK PROGRAM SUBLOANS			
Up to 500,000	601	185	307.8
501,000 -1 million	272	182	669.1
1 million -2 million	135	171	1,226.7
2 million-3 million	28	62	2,214.3
Total program	1,036	600	579.2
TOTAL BNDES SUBLOANS			
Micro and small enterprises	41,009	1,817	44.3
Medium-sized enterprises	8,392	1,378	164.2
TOTAL BNDES	49,401	3,195	64.7
Ratio Program/Total BNDES	2.1%	18.8%	11.1%

Source: BNDES

B. Program executing units

3.13 The administration and control of components I and II of the program will be the responsibility, on one hand, of the office of the Manager of Operations with International Agencies (GEPIN) and the Funding Department (DECAP), which is in charge of the entity's external financing and coordinates and executes activities relating to international loans, and on the other hand, the Department of Financial Agent Evaluation (DEPAF), which evaluates IFIs and their credit line limits. The Department for Joint Operations with IFIs (DEPOC) is responsible for executing operations and their subsequent supervision. The execution of the higher education and health projects will be the responsibility of the office of the Manager of Social Policies in the Departments of Labor Policies (DTRAB) and of Social Policies (DEPOS), respectively, both of which are under the Regional and Social Development Office.

C. Implementation of program components

3.14 The procedures planned for executing the components in support of micro and small-scale enterprises and SMEs are essentially those used in the previous SME financing operation, which are considered appropriate to the needs of these components. The operating regulations applicable to each of these components can be found in the respective Credit Regulations, available in the technical files of the Division.

3.15 Resources of the program components will be 100% allocated through the IFIs to subloans no greater than: (i) US$25,000 per operation for microenterprises having annual sales of up to US$120,000; (ii) US$144,000 per operation for small-scale businesses with annual sales up to US$720,000; (iii) US$3 million for SMEs with annual sales of less than US$15 million; and (iv) US$15 million for higher education and health undertakings with revenues not exceeding US$75 million.

D. Operating arrangements common to all the program components

1. Environmental controls in the proposed program

3.16 The Committee on Environment and Social Impact reviewed the operation on March 6, 1997, and found the current institutional mechanisms of BNDES to be satisfactory. The programs under consideration will therefore continue using the current mechanisms and procedures for environmental control of subprojects financed by the IFIs. The Committee recommended that, insofar as was possible, BNDES should explore avenues for supporting initiatives to strengthen the operational capacity of local environmental authorities.

2. Program supervision

3.17 BNDES will supervise the proposed program through its technical units. The IDB will conduct its supervision and monitoring of the program through the Country Office. The BNDES/IDB Joint Technical Committee will examine progress under the program and discuss issues of mutual interest relating to the credit programs and the development of new products.

3. Audit of the program and the executing agency

3.18 BNDES and the IFIs will keep records showing the amounts of the subloans made with IDB funds, and funds provided by BNDES, the end-borrowers and other sources. BNDES must also keep certified accounts of interest accrued and paid on the funds used and subloans granted, and on the constitution and use of provisions for bad debts, etc. The data must be sufficient for the preparation of annual financial statements and other reports on the program.

3.19 The Federal Audit Office will be responsible for auditing the financial statements of the program. Auditing of BNDES will be performed by an independent firm of auditors of recognized professional capability, acceptable to the IDB.

4. Transfers between principal investment categories

3.20 As stipulated in section III B.4 of policy OA-420 relating to changes in the annexes to a loan contract, the Representative may authorize a transfer of up to 40% between principal categories of

investment financed with the Bank's contribution, provided that this does not affect the project objectives, subject to approval by the Manager in the case of larger changes.

5. Revolving fund

3.21 The program may establish a revolving fund of up to 5% of the Bank's loan. Use of its resources will be subject to Bank rules.

6. Regular program evaluations

3.22 During execution of the program, the borrower and the executing agency, on one hand, and the Bank, on the other, will regularly review the interest rates charged on subloans, in accordance with Bank policies. The borrower and the executing agency, if necessary, will take appropriate steps, consistent with the country's economic policies, to bring interest rates on subloans into line with the policy objective pursued by the Bank.

3.23 Within 12 months after the date of the first disbursement of the loan, or when 50% of the loan has been committed, whichever occurs first, the borrower and the Bank will conduct a review of compliance with the program's objectives, and of the results achieved. If it is found that the program has not substantially achieved its objectives, steps must be agreed for resolving the problems identified before any further funds can be committed.

3.24 In the case of higher education and health projects, the regular program reviews will include an operational review of the respective protocols (see paragraphs 2.24 and 2.26). Amendments to them may be recommended if it is found that their application is impeding the mobilization of resources under the program.

7. Ex post evaluation

3.25 By decision of the executing agency, following consultation of the borrower and that agency in accordance with Bank policy there will not be an ex post evaluation as part of the program's activities. BNDES justifies this decision on the grounds that the regular evaluations performed during execution of the program will provide sufficient information on its progress and results. However, it should be noted that an ex post evaluation could be readily undertaken in due course, since the pertinent information will be available.

E. Sharing of experiences

3.26 The program will provide a springboard for a program to exchange technical information on the development of niche products for microenterprises, small-scale businesses and SMEs. To this end, the two banks will set up a group to exchange know-how, under IDB Region 1, for the development of new products.

3.27 It is planned to hold at least two consultation meetings a year, to be coordinated by COF/CBR and RE1/FI1, on the IDB side, and by DECAP, on the BNDES side. Those meetings will discuss not only the progress of the program itself, but also: (i) experiences of mutual interest in the area of credit programs and the development of financial products for microenterprises, small-scale businesses, SMEs and private providers of social services; and (ii) the state of the Brazilian financial market, the advisability of introducing new products through the program, and the features and timing of mechanisms for ushering them in.

3.28 In discussions with BNDES, the following areas for launching the exchange were identified:

a. The possibility of disseminating the "second tier" methodology used by BNDES to other Latin American countries. That methodology covers, among other things: (i) evaluation of liquidity, solvency and return levels on the basis of a weighting of 14 indicators; (ii) regular submittal of financial statements for off-site inspection and regular in situ inspections, using the "CAMEL" rating system; and (iii) monitoring and control of operations with BNDES, including verifying environmental controls, consistent with the need for information on operations and the status of the portfolio. The methodology will first be disseminated to other entities within Brazil (e.g. FINEP), and then to other countries of the region (e.g. Uruguay, Bolivia).

b. A joint BNDES/IDB study on alternative techniques for developing new pricing methods that will avoid excess profits for IFIs or end-borrowers in loans extended by BNDES with resources of the program, including a study of the applicability of auction methods.

c. Development of mechanisms to ensure adherence to free market rules, refraining from subsidies, and maintaining equal access to credit for all sectors, such as will ensure that social considerations are left to the fiscal accounts. This aspect would be pursued in accordance with the policies relating to: the promotion of long-term savings and the development of new instruments for financing private investment; maximizing user access to financial services, in particular for micro-enterprises and SMEs; encouraging competition among the providers of financial services; and strengthening compliance with regulatory standards.

d. Development and evaluation of new financial products and lengthening finance terms on various markets: leasing, guarantee funds, and the possibility of developing a credit insurance program for microenterprises and small-scale businesses. BNDES recently released details of a leasing facility that covers: eligibility, financing terms, automatic

clearance or prior project clearance required, operating modalities, forms of payment, etc. As well, it has instituted a guarantee fund for promoting competitiveness, aimed primarily at microenterprises and small-scale exporters. This would be a first step toward developing new market activities within the proposed program.

3.29 BNDES is prepared to use its own technical teams in developing new financial products and in joint activities. Those teams have demonstrated their effectiveness in activities in the government sphere (municipal tax administration reform, privatization, etc.) and in specific economic activities such as manufacturing, software and higher education. Nevertheless, the bank, to fulfill its commitments under the program, will use a combination of staff and external consultants, and will pay for them from its own budget.

IV. VIABILITY AND RISKS

A. Economic and institutional viability

4.1 The progress that has been achieved under the *Plano Real*, in a non-inflationary and open economy, and recent experience with the imbalances that have arisen in Asian countries, offer convincing evidence that macroeconomic conditions over the medium and longer term should remain favorable to the success of the proposed program. The institutional framework of the program, as well, is promising, with: (i) demonstrated capacity for sound lending under adequate conditions and at competitive cost; and (ii) competitive markets free of "financial repression" and other distorting practices that might divert resources to privileged sectors or unprofitable entities, i.e. profitability is the main indicator of a financial institution's financial performance. Moreover, the relatively modest size of the program, given the size of Brazil's economy and its credit needs, suggests no significant risk, even if there should be a recession.

4.2 With respect to the financial context, the *Plano Real* has imposed a broad process of restructuring, in which only the more efficient and financially sound IFIs have survived, and this, in combination with the strict application of IFI selection criteria by BNDES, augurs well for the success of the program.

4.3 The analysis conducted shows that BNDES is fulfilling its functions responsibly and competently. It also has the experience, the administrative and operational capacity, and the qualified personnel to execute the proposed program. BNDES has the only IFI network in the country with the quality and breadth sufficient to ensure that onlent funds will indeed be spread to many target businesses throughout the country. IFIs are selected by BNDES on the basis of strict classification criteria, as demonstrated by experience with the previous SME operation, and those IFIs have procedures, standards and capacities for evaluation and supervision that are appropriate for ensuring satisfactory operational management of a program of this scope.

4.4 Finally, Brazil's banking legislation, supplementary regulations, and the oversight standards and procedures of the Central Bank and BNDES constitute an adequate regulatory framework for monitoring financial agencies' performance and safeguarding their solvency, stability and liquidity.

B. Financial viability

4.5 The program's financial viability will depend on interest rates, maintenance of sustained value of the loans, and the timely availability of local counterpart funds. Subloans with program

funds will be granted in local currency. The financial charges in respect of the program subloans will be enough for BNDES and the IFIs to cover the finance costs and administrative expenses, earn a reasonable profit, and cover the credit risk. The executing agency will bear the exchange risk arising from the Bank's financing operation, and will reposition its loan portfolio accordingly, so as to maintain its currency balance and not alter its overall corporate risk.

4.6 The local counterpart will consist of contributions from BNDES, from the beneficiaries, and from other sources, such as the possible JEXIMBANK financing. BNDES will have no difficulty in making its contribution under any of these formulas. In short, it is expected that the local counterpart funds will be available in a timely manner for execution of the program.

C. Benefits

1. Enhancing market competitiveness

4.7 The growing pressure of competition coming from within MERCOSUR and from the globalization of markets demands a deeper financial system and more efficient financial services, and in particular requires that medium- and long-term finance be made available for restructuring and modernizing Brazil's microenterprises and small-scale businesses and its SMEs, which together represent an important part of the country's productive capacity in goods and services. To this end, the program will promote: (i) extending the coverage of medium- and long-term financial resources to all efficient private-sector activities conducted by microenterprises, small-scale businesses and SMEs, including the for-profit delivery of social services by SMEs, especially in the education and health areas; and (ii) development of deeper long-term finance markets, in particular those for small and medium-sized enterprises. In this way the program will help to consolidate the country's economic base and expand the domestic market, and will enhance the efficiency and competitiveness of microenterprises and small-scale businesses by improving their access to the credit they need to purchase capital goods and obtain working capital.

4.8 The component for supporting microenterprises and small-scale businesses will have a positive effect on: (i) raising productivity and output; (ii) enhancing their access to formal credit; (iii) broadening the spectrum of eligible institutions; (iv) promoting the participation of women microentrepreneurs; and (v) sensitizing microentrepreneurs and small-scale businesses to the importance of environmental protection.

4.9 The expansion of leasing operations will also provide important benefits for businesses, in particular micro and small enterprises, by providing access to capital goods under more flexible arrangements consistent with their capacity.

4.10 With respect to the component for credit to private providers of higher education and health services, in addition to the positive externalities that their services can generate (e.g. upgrading human capital and improving standards of living), the principal direct benefits will derive from extending their coverage, and hence from greater equity in access to them. In the case of higher education, equity will be served to the extent that private providers respond to the educational needs of students with a more diversified income profile than do the public-sector institutions. In the case of health, equity will consist in increasing access for people of fewer means to cost-effective and high-quality services. In this way, both aspects will help make it possible for the public sector to focus more of its attention on meeting the needs of the lowest-income segments of the population.

2. Poverty targeting

4.11 The microenterprise and small-scale business component qualifies automatically as a poverty-targeted operation.

D. Risks

4.12 Successful implementation of the proposed program will depend on maintaining an enabling macroeconomic and financial framework for the growth of private investment. Important results have already been achieved under the *Plano Real*, and the package of measures undertaken or announced to date is expected to carry this record further. Under these circumstances, the macroeconomic risk is considerably reduced.

4.13 The risk of disruptions in the financial system is low, given the restructuring that has occurred under the *Plano Real*, which has entailed consolidation of the financial system, the strengthening of regulatory and supervisory mechanisms, and the reorganization and/or privatization of a major part of the State bank system – all of which took place before the onslaught of the Asian financial crisis. The current situation of the Brazilian financial system provides grounds to expect that the resources of the proposed program will be channeled to good use.

4.14 The risk that the program may not fully reach its target groups, or that the operation might not have the expected results, is very low as far as the SME component is concerned. In the microenterprise and small-scale business component, this risk could be somewhat more significant but, in any case, it is expected to be low, given past experience with BNDES and that institution's demonstrated effectiveness in funneling credit to many low-income borrowers spread throughout the country.

4.15 In the specific case of the health subcomponent, there is a risk that technology costs could translate into social costs, in situations where private providers elect not to rationalize their

pricing. This risk can be reduced at the time BNDES conducts its technical and financial review of loan applications submitted by accredited IFIs.

I. SELECTED PORTIONS OF BNDES FINANCIAL STATEMENTS

1.1 This annex discusses the most significant aspects of BNDES's financial structure, based on its audited financial statements. 1/

1. Assets

1.2 Over the past three years, BNDES's total assets have posted an average annual cumulative increase of 7.4%, 2/ from the equivalent of US$41,625 million in 1994 to US$53,335 million in June 1997. The category with the largest share is the loan portfolio, which has remained at approximately 65% of total assets throughout the period in question, followed by fixed investments, at approximately 20%. The balance consists of other assets, mainly liquid loans. BNDES maintains a strict balance between its assets and liabilities in foreign exchange and between the interest rates paid on deposits and charged on lending and borrowings, and therefore has no exposure to exchange or interest-rate risk.

2. Loan portfolio

1.3 The loan portfolio increased by 31% during the period under review. Noteworthy in this growth was the decrease in the public-sector share of BNDES lending activities as a whole, which dropped from 57% of disbursements in 1985 to only 17% on average during the three-year period from 1994 to 1996. 3/ These figures reflect the effective redesign of BNDES credit policies in recent years, in line with government policies designed to reduce the direct role of the State in productive activities and to support the development of private investment as a means of ensuring the competitiveness of domestic private enterprise as the Brazilian economy opens up to international trade.

1.4 The total delinquent portfolio, including amounts past due as of June 30, 1997, was approximately 5.6% of the total. This is substantially lower than the figure at year-end 1994, when loans due and payable at the close of the fiscal year reached 7.4% of the

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1/ A comparative table of past performance, based on the main categories in the financial statements, is included at the end of this annex.

2/ This increase is even greater than the 7.25% growth achieved between 1991 and 1994, demonstrating that BNDES is growing on a sustained and stable basis.

3/ The percentage had dropped to just 10% in 1995 but rose again to 15% in 1996 and 13% in June 1997, due to the bridge loans BNDES has been granting to states participating in the privatization program.

portfolio, indicating improved credit management on the part of BNDES. In addition, it should be noted that (i) of that amount, arrearages only amounted to 0.9% of the portfolio and exclusively concerned BNDES's direct portfolio; and (ii) in May 1997, BNDES established loan loss provisions in the amount of 100% of the total delinquent portfolio, including arrearages, 4/ and that BNDES generally requires collateral in amounts of at least 130% of the loans granted.

1.5 In order to avoid portfolio concentration, which had been significant in the past (with 10 clients accounting for 26% of the portfolio in 1994), BNDES established and implemented a strict lending policy. Under the policy, the public sector may not account for more than: (i) one third of BNDES assets; (ii) 10% of its net worth; or (iii) 3% of its risk assets. Furthermore, BNDES exposure for any individual borrower may not exceed 20% of its net worth or 30% of its total assets.

1.6 BNDES's largest individual debtor is the National Treasury, with a debt equivalent to approximately 2% of total BNDES assets. This level has remained the same for the past three fiscal years, after having gradually decreased since the early 1990s (see paragraph 1.2 above). Loans granted to government enterprises and regional or state banks are guaranteed by the respective governments. The state and regional banks transfer funds onlend the funds they receive from BNDES to the private sector. At year-end 1996, lending to the public sector was divided among approximately 100 enterprises and direct lending to the private sector among some 1,300 businesses. About 79 IFIs channel BNDES system funds to some 7,000 individual clients.

1.7 It should also be noted that BNDES is making a clear, ongoing effort to achieve the capillarization of the resources, thus ensuring equitable, transparent access to the resources for the greatest possible number of enterprises throughout the country, with preference being given to SMEs. Accordingly, BNDES is increasing lending through its network of financial agents and especially through the so-called "automatic" system, through which the network of IFIs using BNDES lines of credit for onlending may transact operations of up to R$7 million without prior authorization by BNDES. Of the total disbursements made in 1991 (US$3.077 billion), 47% were carried out through IFIs, with almost one half under the automatic arrangement, whereas in 1996 indirect lending reached the equivalent of almost US$4.6 billion (49.5%), of which again one half was granted through the automatic system.

4/ As of December 1996, the provisions covered 100% of doubtful loans and 41% of loans in arrears.

1.8 This automatic indirect lending system will be used in the proposed program, since it is considered essential to ensure proper fulfillment of the program objectives.

3. Liabilities

1.9 Central Bank regulations prohibit BNDES from receiving sight or term deposits from the public. Moreover, the situation of Brazilian financial markets during the past decade has prevented BNDES from attracting direct long-term domestic savings deposits in significant amounts. The perceived country risk on international markets has also made it difficult for BNDES to obtain financial resources on terms and at prices suitable for its operational needs.

1.10 Given this situation, BNDES resources have been limited mostly to its own funds and FAT institutional funds, with domestic and external borrowings remaining modest. On average, during the period from 1994 to 1996, BNDES's own funds financed approximately 25% of assets, FAT/PIS-PASEP funds some 64%, and domestic and external borrowings about 8%, and the remaining 3% consisted of miscellaneous liabilities.

1.11 It should be noted, however, that this structure has proven highly stable, not only due to the low equity leverage, but also to the fact that, as shown in the following table, the institutional obligations do not call for any net reimbursements in the near future, which gives BNDES excellent financial coverage of its obligations.

BNDES - PROFILE OF DEBT COVERAGE
as of December 31, 1994
(in millions of Brazilian reais)

CATEGORY	1995	1996	1997	1998	Post 1998	TOTAL
ASSETS						
Cash and other liquid assets	677					677
Securities (net) 1/					2,098	2,098
Loan portfolio	4,001	4,782	4,538	3,978	16,574	33,873
TOTAL	4,678	4,782	4,538	3,978	18,672	36,648
LIABILITIES						
Borrowings						
- domestic	1,594	140	1	95	669	2,499
- external	226	157	140	119	1,463	2,105
Institutional borrowings (PIS/PASEP; FAT; etc.)					30,726	30,726
Other obligations 2/	824					824
TOTAL	2,644	297	141	213	32,855	36,154
Net worth for the year	2,034	4,485	4,397	3,764	-14,186	494
Accumulated net worth	2,034	6,519	10,916	14,630	494	

1/ All assets and securities are assumed to be held for the long-term.
2/ All "other obligations" are assumed to be payable on demand.
3/ The exchange rate as of December 1996 was US$1 = R$1.0449
SOURCE: BNDES audited financial statements

4. Net worth

1.12 The net worth of BNDES as of December 31, 1996 was US$9.604 billion equivalent. Of that amount, US$7,137 billion was capital stock. The debt-to-equity ratio was approximately 3.6, which is considered adequate given the makeup and liquidity profile of the bank's assets and liabilities.

5. Income statement

1.13 The income statement for 1996 (see Table 3) shows net income before and after taxes of US$922 million equivalent, with a return on assets (ROA) of 2.1% and return on equity (ROE) of 9.6%. The

latter figure represents an improvement over the previous two years, in which the ROE was 5% and 3.7%, respectively. 5/

1.14 The improvement in profitability was the result of a combination of factors, including principally better management, which led to increased lending, improved collections, and highly successful implementation of new programs. Under one such program, the national State divestment program, BNDES, acting as agent for the federal government, achieved greater collections in 1996 than in any previous year. The financial spread, understood as the gross income from financial intermediation on average liquid assets (cash and banks plus securities plus loan portfolio) was 2.3%. Administrative and payroll expenses represented 0.60% of average liquid assets and 0.48% of average total assets, levels that have remained much the same since 1995.

6. Audits

1.15 BNDES has an internal audit department that reports directly to the office of the president. Government auditors from the National Treasury and firms of independent outside auditors review its financial statements and the accounting flows for the programs and trust funds it manages. Although BNDES is not subject to review by BACEN's supervision department, inspectors from the national audit office supervise its accounting records.

7. Subsidiaries

1.16 Capital contributions to subsidiary firms as of December 31, 1996 accounted for virtually all of BNDES's fixed investments (95.6%), with 9.9% for FINAME and the remainder for BNDESPAR. FINAME has approximately US$10.32 billion equivalent in assets. Of that amount, 98% is for its IFI loan portfolio, since FINAME does not grant loans directly to enterprises. The level of past due loans is insignificant. BNDES is the sole owner and principle source of funds for FINAME (US$9.271 billion equivalent as of December 31, 1996). FINAME carries out its own programs (automatic credit, special agriculture loans, and FINAMEX) and also operates BNDES programs such as the BNDES automatic credit program.

1.17 BNDESPAR helps finance enterprises through equity investments and operations for subscriptions to debt and stock issues. Its total assets as of December 31, 1996 were US$12.326 billion equivalent, with the resources coming almost entirely from BNDES, either in the

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5/ The profitability in 1995 was seriously affected by the change in valuation of the investments made by BANDESPAR and FINAME, which, when incorporated into the BNDES's balance sheet using the equity participation method, implied a decrease in value of approximately US$4.745 million.

form of loans (38%) or equity (61%). Within the BNDES system, BNDESPAR is the agent for privatization, in which it has gained considerable experience in the past three years.

HISTORY OF BNDES EQUITY STRUCTURE	**In millions of constant reais as of December 1996**		
ASSETS	**1994**	**1995**	**1996**
Cash in hand and in banks	1,865	502	677
Securities	1,182	1,715	2,098
Credit operations (net)	21,667	28,032	33,873
Fixed investments (net)	9,400	7,032	9,110
Fixed assets (net)	114	137	135
Other assets (net)	987	1,324	296
TOTAL ASSETS	35,215	38,742	46,189
LIABILITIES			
Institutional borrowings (FAT-PIS/BASEP, etc.)	20,851	25,097	30,726
Domestic borrowings	754	1,804	2,105
External borrowings	1,269	1,355	2,499
Other liabilities	1,277	1,356	824
TOTAL LIABILITIES	24,151	29,622	36,154
Net worth	11,064	9,120	10,035
TOTAL LIABILITIES AND NET WORTH	**35,215**	**38,742**	**46,189**
Consumer price index (August 1994 = 100)	107.45	123.83	135.23
US$/R$ exchange rate as of December 31	0.846	0.975	1.045
Source: BNDES — audited financial statements			

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PROPOSED RESOLUTION

BRAZIL. LOAN /OC-BR TO THE NATIONAL BANK FOR ECONOMIC AND SOCIAL DEVELOPMENT (BNDES)

GLOBAL MULTISECTORIAL FINANCING PROGRAM

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with the National Bank for Economic and Social Development (BNDES), as Borrower, and the Federative Republic of Brazil as, Guarantor, for the purpose of granting the former a financing to cooperate in the execution of a Global Multisectorial Financing Program. Such financing shall be for the amount of up to US$1.100,000,000, from the Single Currency Facility 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.