

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK  
MULTILATERAL INVESTMENT FUND

**ECUADOR**

**SUPPORTING AN INNOVATIVE MECHANISM FOR PROVIDING  
RURAL CREDIT TO UNDERSERVED COMMUNITIES**

**(EC-M1006)**

**DONORS MEMORANDUM**

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**Monetary unit**

United States dollars (US\$)

**ABBREVIATIONS**

DNC	Dirección Nacional de Cooperativas (National Directory of Cooperatives)
IDB	Inter-American Development Bank
FEPP	Fondo Ecuatoriano Populorum Progressio
MIF	Multilateral Investment Fund
MFI	Microfinance Institution
RFE	Rural Financial Entities
RFR	Red Financiera Rural (Rural Financial Network)
SIB	Superintendencia de Bancos
NGO	Non Governmental Organization

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## LIST OF ANNEXES

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## **Abstract**

The main goal of this project is to provide financial services to isolated rural populations in Ecuador through a two-tier mechanism where Codesarrollo, a regulated savings and loan cooperative, on-lends to rural financial entities (RFEs) that belong to its network. To achieve this goal, in addition to providing financing, the project will assist Codesarrollo in improving its internal capabilities (policies, processes, staff skills, institutional culture) and how it administers this second tier product.

A technical assistance grant will be made to enhance the effectiveness of the second tier product in terms of its credit policies as well as through a comprehensive marketing strategy. In addition, the technical assistance will strengthen Codesarrollo's ability to monitor and administer the loans it makes to the RFEs. Finally, a component of the technical assistance will be devoted to supporting Codesarrollo at the institutional level in developing a strategic and marketing plan as well as in strengthening its overall technical capabilities through training and exchanges with similar institutions in Latin America.

The MIF will also provide a revolving line of credit at market interest rates which will enable Codesarrollo to expand its Credifinanciero product, to lend to at least some 160 RFEs by 2006, with a loan size average of US\$10.250, and to reach 26.000 end clients, members of the RFEs.

Codesarrollo is a regulated savings and loan cooperative that dates back to 1972, when it was first incorporated. The most important feature that makes Codesarrollo unique among its peers is its social mission of working towards the development of the marginalized rural segments of Ecuador's population, through the promotion and strengthening of local financial systems. Codesarrollo's main clients are small agricultural producers and rural microentrepreneurs who have very limited access to rural financial services.

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**UNDERSERVED COMMUNITIES**

Executive Summary

<b>Executing Agency and Borrower</b>	Codesarrollo
<b>Project Number</b>	EC-M1006
<b>Beneficiaries</b>	Codesarrollo, the rural financial entities (RFEs) it serves through its second tier-lending program, and the end clients, rural microenterprises.
<b>Objectives</b>	<p>Overall Objective. The main goal of this project is to provide financial services to isolated rural populations through a two-tier mechanism. In order to achieve this goal, in addition to providing financing, the project will assist Codesarrollo in improving its internal capabilities (policies, processes, staff skills, institutional culture) and how it administers the <i>Credifinanciero</i> product line.</p> <p>Component I. Technical assistance grant of US\$290.000, for strengthening Codesarrollo and the <i>Credifinanciero</i> product line. A technical assistance grant will be made to enhance the effectiveness of the <i>Credifinanciero</i> line of credit in terms of its credit policies and a more systematic marketing strategy. In addition, the technical assistance will strengthen Codesarrollo's ability to monitor and administer the <i>Credifinanciero</i> product. Finally, a component of the technical assistance will be devoted to supporting Codesarrollo at the institutional level in developing a strategic and marketing plan as well as in strengthening its overall technical capabilities through training and exchanges with similar institutions in Latin America.</p> <p>Component II. Revolving Line of Credit. The MIF will provide US\$1.2 mm revolving line of credit at market interest rates. The total availability of the line of credit will be six years. It will enable Codesarrollo to expand its <i>Credifinanciero</i> product, to lend to at least some 160 RFEs by 2006, with a loan size average of US\$10.250, and to reach 26.000 end clients, members of the RFEs.</p>
<b>Borrower</b>	Codesarrollo is a regulated savings and loan cooperative that dates back to 1972, when it was first incorporated. The most important feature that makes Codesarrollo unique among its peers is its social mission of working towards the development of the marginalized rural segments of Ecuador's population, through the promotion and strengthening of local financial systems. Codesarrollo's main clients are small agricultural producers and rural microentrepreneurs who have very limited access to rural financial services.

## Financing

The proposed line of credit will make an amount of up to US\$1.2 million available on a revolving basis. The first loan will be capped at US\$400,000. Thereafter, Codesarrollo will be able to borrow up to US\$800,000 in one or two more tranches, on the condition that all financial and developmental indicators are met. Once each tranche is paid back in full (including principal and interest), Codesarrollo will be able to once again borrow that amount, up to a maximum of US\$1.2 million.

The line of credit will be made available for up to six years. Individual loans may be disbursed for terms of no more than three years. The second tranche will be disbursed no sooner than 12 months and no later than 36 months from the disbursement of the first tranche. The maximum period of time allowed for paying back each loan will be such that the principal and interest of the last loan that Codesarrollo takes out must be paid off by the sixth year after the inception of the program.

Small Enterprise Investment Fund of the Small Enterprise Development Facility.

MIF/IDB	US\$1,200,000
Codesarrollo	US\$1,200,000
Total	US\$2,400,000

Small Enterprise Development Facility.

MIF/IDB	US\$290,000
Codesarrollo	US\$185,000
Total	US\$475,000

## Environmental and Social Review

The Committee on Environment and Social Impact (CESI) approved this project at its meeting of July 30, 2004. The Committee's suggestions have been taken into account in designing this project.

## Risks

**Financial risk:** Codesarrollo's impressive growth in the past three years has been primarily financed through debt, putting its debt to equity ratio at a relatively high level. **Mitigating factors:** There are three factors that help mitigate this risk. (i) Codesarrollo has been in a campaign to enlist a greater number of members. Institutional and private investors have been contacted and from 2002 to 2003, 22 new members have joined the membership of the organization. (ii) Codesarrollo has a well-balanced liability structure with 68% of it in deposits and 28% in loans from

external sources, 99% of which are in US\$. On average, Codesarrollo pays a 4.5% on these liabilities, which is an acceptable interest rate that has allowed it to mitigate the financial exposure and risk. Additionally, Codesarrollo has established an innovative and strong relationship with a group of Italian commercial banks and credit unions. These institutions have provided key support for the growth of the institution and are currently assisting the cooperative to diversify its membership and shareholder base. (iii) Finally, an important mitigating factor to the financial risk, is the fact that 54% of its depositors are large institutional investors close to the organization and committed to the same social mission of Codesarrollo. This commitment from a limited number of depositors who hold a large percentage of the liabilities, limits the organization's exposure to sudden sector or economic fluctuations and allows it to better manage its short term liquid assets.

**Use of proceeds:** Codesarrollo could on-lend MIF resources to some of the other product lines, such as housing or commercial lending.

**Mitigating factor:** Codesarrollo will have a contractual obligation to use resources granted under this program to expand its *Credifinanciero* portfolio. The line of credit may only be renewed if there is evidence of the growth in the number of RFEs who borrow from Codesarrollo and the loan amounts. Codesarrollo is committed to maintaining levels of coverage and achieving goals that are consistent with its mission to serve the rural sector and specifically the development of the RFEs. Codesarrollo is aware that its competitive advantage lies in the services it provides to these rural entities. The line of credit will be made at competitive market rates in order to prevent situations in which Codesarrollo could use resources to substitute liabilities. If this were to occur, the line of credit would be terminated for failure to fulfill the goals agreed on for assisting Ecuadorian rural financial intermediaries.

**Risks of operating as a second tier lending agency:** Codesarrollo is aware of the risks involved in providing first tier and second tier lending to its clients. **Mitigating factor:** Codesarrollo has well-established products primarily for rural micro enterprises and low-income families. It has built a strong reputation in part due to its alliance with the FEPP, a non government organization working in rural credit for the past 30 years. In this regard, the management of the cooperative has prudently entered with the *Credifinanciero* product in a pilot phase and has experienced a good level of success and impact. *Credifinanciero* does not compete with Codesarrollo's other products because the markets they serve are different and geographically distant from each other. While Codesarrollo recognizes that other MFIs and itself may some day tap into these remote rural markets with direct lending operations, it is also aware that this will not happen in the near future. In addition, Codesarrollo sees this rural penetration as an essential first step to educate and prepare rural populations, before more widely financial services become available, in rural areas.

**Management risks:** Codesarrollo has seen significant growth across its three product lines in the past two years. Each one of these lines



has its own set of markets, mechanics, analytical requirements and expertise. The growth in these products and in its deposit taking has come with increased levels of interaction and supervision from the Superintendency of Banks. All these activities have put a great deal of pressure on management at all levels, and may pose a risk in terms of its capacity to sustain this level of growth while maintaining its overall good performance. **This risk will be mitigated** by two key factors. On the one hand, the organization has already started to put in place a series of actions aimed at managing growth, such as hiring key personnel in local branch offices, working on incentive mechanisms that are based on overall performance by product line, and contracting technical expertise in various financial and systems areas. On the other hand, the Technical Cooperation grant of this project, will be directed at strengthening the organizations capacity to manage the growth of not only the Credifinanciero product, but also of the organization as a whole.

**Risk of portfolio deterioration:** Codesarrollo's recent rapid growth increases the risk of portfolio deterioration in the future, which could lead to losses for the institution and an inability to service its debt. **Consideration.** In order to keep its past due portfolio under control Codesarrollo has adopted a number of management tools including a new incentive structure that penalizes loan officers for past due amounts in their portfolios and requires that they prepare a plan for how they will collect past due amounts from each account holder. In addition, the project's financing component will be disbursed in tranches so as to limit the MIF's exposure and to condition the disbursements on the institution's continuing financial health. The MIF will carry out regular supervision activities (site visits) in order to ascertain the institution's financial situation.

**Exceptions to the Bank's Policies**      None

## **I. COUNTRY ELIGIBILITY**

- 1.1 The Donors Committee declared Ecuador eligible for all forms of financing from the Multilateral Investment Fund (MIF) on 20 September 1995.
- 1.2 The MIF Policy and Operations Committee declared the operation eligible to receive MIF financing under the Small Enterprise Investment Fund, underscoring its contribution to increasing the breadth and depth of the microfinance services available in rural areas of the country. This is an innovative operation for the MIF since it will support a unique two-tier model for reaching out to rural populations where a regulated institution will act as second tier lender and on-lend to unregulated rural financial entities to which they are affiliated through a national network.

## **II. BACKGROUND**

### **A. The Ecuadorian financial system and Economy**

- 2.1 The financial system in Ecuador seems to have recovered relatively well from the severe crisis that it faced in 1998-1999. Although only 22 of the 48 banks existing in 1998 still exist today, banking sector liquidity has improved significantly.
- 2.2 The economy has also begun to recover, leading to rising GDP and an easing of inflationary pressures (1.3% inflation rate as of September 2004). In addition, unemployment rates fell to 9% in 2003 and real wages grew by 6.4%. Borrowing costs, while still high because of banks' weariness to lend in the aftermath of the 1998-1999 crisis are also on the decrease<sup>1</sup>.

### **B. The microfinance industry in Ecuador**

- 2.3 Amidst the social and economic pressures that Ecuador faced in the wake of dollarization, the microfinance sector has performed very well. Ecuador's outstanding microfinance portfolio has grown from a total of US\$50 million in 2001, to about US\$254 million in March 2004. The number of clients served by MFIs over the same period went up from 134.000 to reach 330.000. The level of savings deposited in microfinance institutions (MFIs) also increased to US\$70 million from US\$22 million over the same period, although this represented only reported figures primarily from regulated entities. Throughout, microfinance loans performed significantly better than the average in the financial system: they currently face a combined arrears rate of 4.07%, which is less than half of that in the banking sector.

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<sup>1</sup> See the table in Annex XII for a review of current interest rates.

- 2.4 Among the key participants of the Microfinance industry in Ecuador are two banks, a financial company, and a number of savings and loan cooperatives. Banco Solidario, CREDIFE, and Financiera Ecuatorial, together have 52% of the market, while regulated credit unions have 33% and unregulated NGOs specialized in financial services capture the remaining 15%.

<b>MFIs Portfolio in US\$000s</b>	<b>June 2004</b>	<b>% Market</b>
Banco Solidario <sup>2</sup>	67,040	26%
CREDIFE (Banco del Pichincha)	35,772	14%
Sociedad Financiera Ecuatorial <sup>3</sup>	30,973	12%
Savings and Loan Cooperatives (30 Regulated)	84,543*	33%
NGOs	35,500*	15%
<b>Total</b>	<b>253,828</b>	<b>100%</b>

\* March 2004

Source: Superintendency and Red Financiera Rural reports.

- 2.5 There exist 30 regulated savings and loan cooperatives in Ecuador, with a combined portfolio of US\$344 million (of which US\$85 million is in microfinance activity). Although each one is small compared to the main players in the microfinance system, these institutions are very dynamic and are quickly expanding their client base. These cooperatives tend to be located in intermediate cities, offer microfinance at relatively low cost and are principally funded through member deposits.

### **C. The role of local Rural Financial Entities (RFEs)**

- 2.6 In spite of the growth in supply of microfinance, rural credit still only represents a small percentage of the portfolio of regulated microfinance institutions, who predominantly serve urban and peri-urban populations<sup>4</sup>. Within this limited rural microfinance industry, the most important players are small, unregulated credit unions established at the community level. Ecuador has an estimated 300 unregulated rural financial entities (RFEs), which combined, have approximately US\$200 million in deposits and US\$240 million in loans

- 2.7 These RFEs distinguish themselves from other financial entities because of their positioning and presence in rural markets. Their deep knowledge of the region where they operate, their agricultural specialization, and the particular interest they have in the growth of their communities gives them a competitive advantage in

<sup>2</sup> Currently has an outstanding MIF loan of \$1,014,914 (MIF/AT-398).

<sup>3</sup> Currently has an outstanding MIF loan of \$1,500,000 (MIF/AT-449).

<sup>4</sup> For example, only 4% of Banco Solidario's portfolio is made up of rural loans, a percentage which has remained constant for some time.

serving the rural areas over formal MFIs who perceive rural areas as too risky or very costly to serve. In addition, the rigid urban and commercial microfinance methodologies used by MFIs have proven to be too inflexible for rural markets that need tailored savings and credit services. Moreover, while some of these institutions still rely on external sources of funding for their credit operations, the majority of them have demonstrated a strong capacity to mobilize local savings. These RFEs help to generate a financial “culture” among the most marginalized segments of the economy.

- 2.8 These RFEs are not required to submit themselves to regulation and supervision of the Banking authority<sup>5</sup> but they are registered under the Social Welfare ministry and are limited to capturing deposits from their members.
- 2.9 Typically, RFEs lend to members amounts ranging from US\$50 to \$400 for periods of between 6 to 18 months. Terms are flexible, to accommodate to agricultural cycles of production and cash flow. Recent Bank studies suggest that governments and donors looking to strengthen rural financial systems should consider the role that local RFEs can play, given their extensive rural presence that allows them to reach both farm as well as non-farm rural activities and households. According to the study, strengthening and expanding the operations of local RFEs, in addition to other types of MFIs, may work better than trying to lure predominantly urban commercial banks out to rural areas.<sup>6</sup>

#### **D. The Rural Microenterprise Sector**

- 2.10 According to the Employment Survey of the National Statistics and Census Bureau, there are over 1.000.000 micro enterprises in Ecuador that generate close to 2 million jobs. Only 31% of these, however, have obtained loans<sup>7</sup> and scarcely 20% of them have done so through a formal financial institution. Rural populations have the worst access to microfinance services. Although an estimated 40-50% of micro enterprises are located in rural areas, rural financial entities are currently serving no more than 15% of this potential clientele. The rest either rely on their own resources or obtain financial services from informal sources such as shopkeepers, suppliers and local savings and loans groups. These rural microenterprises, while active in the agricultural and trade services, operate in the areas of the country where most of the poverty is concentrated. Close to 80% of Ecuador’s poor are in rural areas, where the per capita income is less than \$1000 a year.

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<sup>5</sup> In order for savings and loan cooperatives to be supervised by the banking authority - the Superintendencia de Bancos (SIB) - they must have at least US\$200.000 in paid in capital and US\$1 million in assets.

<sup>6</sup> Westley, Glenn. Village Banking Joining the Mainstream. Microenterprise Development Review. IDB. July 2004.

<sup>7</sup> Survey by Corporación Financiera Nacional.

- 2.11 Rural microentrepreneurs' demand for credit is characterized for (i) being short term, with periods of repayment ranging from 4 to 18 months; (ii) being flexible in payback options, with either lump sum payments at the end of the term or more frequent payments including weekly; (iii) being used primarily in agricultural or dairy production, housing improvements and short term liquidity requirements; and (iv) little or no collateral provided except that of the peer group pressure from those in their community.

### III. THE PROPOSED PROGRAM

#### A. Project Rationale

- 3.1 While MIF projects in Ecuador have sought to reach rural populations through the traditional channels of large regulated banks and financial companies<sup>8</sup>, the current project supports an alternative path.
- 3.2 The innovation consists in leveraging RFEs as ideal channels to reach out to rural populations. This is achieved by using an indirect, two-tier system, whereby a regulated cooperative, Codesarrollo (the second tier lender), members with RFEs around the country (the first tier lenders) and provides them with both technical support as well as a line of credit for onlending to the RFEs' clients and members (product known as *Credifinanciero*). Codesarrollo is the only large institution in Ecuador that has developed the technical expertise and memberships with RFEs that enable it to perform this role. At present, the only other organizations that can lend to RFEs are a few NGOs but they do not have the capacity to reach out to as large a number of RFEs that *Credifinanciero* has.
- 3.3 Due to the severe lack of financial services in rural areas, the demand from RFEs is far outstripping Codesarrollo's ability to provide this service. In seeking to expand this service, Codesarrollo is facing dual obstacles: on the one hand, a limited supply of resources for lending, and on the other, the pressures on its own institutional capabilities that scaling up such a program would entail.
- 3.4 In the past several years, Codesarrollo has grown extremely quickly and the institution as a whole has faced the challenge of keeping pace with the growing demands on its systems and staff. This project will help Codesarrollo strengthen its internal capabilities at both an institution-wide level and more specifically in those areas that are most relevant to Codesarrollo's role as a second tier institution. In addition, the project includes a line of credit that Codesarrollo will use to onlend to selected RFEs.

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<sup>8</sup> See Annex II for a full list of MIF projects in Ecuador

- 3.5 Those RFEs that obtain Credifinanciero loans benefit from the affiliation with Codesarrollo which provides them with assistance in structuring credit products, improving their operations, implementing effective governance etc. Importantly, Codesarrollo provides them access to a centralized credit bureau, helping to identify loan candidates who have multiple loans from different institutions.
- 3.6 The project will also benefit from a contribution from the Italian Central Institute for Cooperative Credit (ICCREA) which will leverage and complement MIF's technical assistance. By working together with ICCREA on the design of the technical assistance component, the project team was able to structure a more effective technical assistance package. In addition to other smaller interventions, the big impact ICCREA's contribution will have is that it will finance the hiring of a "coach" to guide Codesarrollo over a period of several years through the institutional strengthening process it needs to carry out ICCREA has in the past, both directly and indirectly through its cooperative members, provided lines of credit to Codesarrollo which represent the totality of Codesarrollo's liabilities with Financial institutions. ICCREA has demonstrated a commitment to supporting Codesarrollo through financing as well as through technical assistance projects. Their participation in the technical assistance component of this project will greatly improve the impact that this project will have on the cooperative.

**B. Objectives and components of the proposed program**

- 3.7 The main goal of this project is to provide financial services to isolated rural populations through a two-tier mechanism. In order to achieve this goal, in addition to providing financing, the project will assist Codesarrollo in improving its internal capabilities (policies, processes, staff skills, institutional culture) and how it administers the *Credifinanciero* product line.
- 3.8 Component I. Technical assistance grant for strengthening Codesarrollo and the Credifinanciero product line. A technical assistance grant will be made to enhance the effectiveness of the *Credifinanciero* line of credit in terms of its credit policies and a more systematic marketing strategy. In addition, the technical assistance will strengthen Codesarrollo's ability to monitor and administer the *Credifinanciero* product. Finally, a component of the technical assistance will be devoted to supporting Codesarrollo at the institutional level in developing a strategic and marketing plan as well as in strengthening its overall technical capabilities through training and exchanges with similar institutions in Latin America.
- 3.9 Component II. Revolving Line of Credit. The MIF will provide US\$1.2 mm revolving line of credit at market interest rates. The total availability of the line of credit will be six years. It will enable Codesarrollo to expand its *Credifinanciero* product, to lend to at least some 160 RFEs by 2006, with a loan size average of US\$10,250, and to reach 26,000 end clients, members of the RFEs.

### C. *Credifinanciero* and Eligibility of RFEs

- 3.10 Through the *Credifinanciero* instrument, Codesarrollo is currently providing financing to approximately 60 RFEs that belong to its network, most of which are either savings and loan cooperatives or savings and loan groups<sup>9</sup>. The delinquency rate of *Credifinanciero* is close to 0%. A summary listing of Codesarrollo's top 15 local RFEs can be found in Annex VII.
- 3.11 Typically, these RFEs provide their members loans for productive and commercial activities, limited consumption loans, emergency loans and housing and home improvement loans. Interest rates average 25% and loan terms vary from 6 to 18 months. On average, each one of these RFEs has approximately 200 members and a portfolio of US\$30,000. In addition, based on an analysis of recent RFE financial statements, these RFEs have arrears levels of 2%, a return on equity of about 5%, liquidity levels of between 15% and 50%, and relatively low operational costs.
- 3.12 The demand for this product from the RFEs is strong. For 2005, Codesarrollo has estimated the demand to be close to \$1.1 million. Annex XIV provides a clear breakdown of the projected demand for *Credifinanciero*. Annex VIII provides an estimate of longer term growth of *Credifinanciero* and use of the proposed financing line.
- 3.13 Terms and conditions on the loans to the RFEs. The criteria for lending to individual RFEs, including using the MIF funds, will follow Codesarrollo's guidelines, which include: (i) established governance, as demonstrated by the current bylaws and statutes of the organization and the documentation of the legal representatives; (ii) internal control mechanisms in place, as demonstrated by current financial reports approved by the board and leadership of the organization; and (iii) a healthy financial situation as demonstrated by the following ratios and indicators: (a) loan portfolio not exceeding an 8% arrears level; (b) a provisions expense ratio of between 2% and 7%; and (c) a debt to equity ratio not to exceed 5.
- 3.14 Three other important requirements to access *Credifinanciero* loans must also be met by RFEs: (i) for loans greater than \$20,000, a fixed asset must be signed over to Codesarrollo as collateral; (ii) the RFE must demonstrate a strong capacity to capture savings; and (iii) the RFE must have received specialized technical assistance in loan management from FEPP or another NGO.
- 3.15 Second Tier focus. Codesarrollo will ensure that *Credifinanciero* does not compete with its other first tier lending products. It will do so by focusing into other markets, which are different and geographically distant from its first tier lending operations.

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<sup>9</sup> The main distinction between the cooperatives and the groups is the level of organizational development and the size of their portfolio. Groups tend to be less developed and with smaller loan portfolios.

- 3.16 Rural focus. Codesarrollo will continue to target the operations of its *Credifinanciero* line of credit to rural underserved markets. In particular, Codesarrollo will ensure that the RFE's that borrow from the *Credifinanciero* line of credit, continue to include, as they have so far, members of indigenous groups, and Afro-Ecuadorian descendants. Women, who also make up a large percentage of the end clients of the RFEs, should also maintain a favorable share of the level of lending. While minimum levels of client diversification will not be set, this emphasis will be monitored through the quarterly progress reports.
- 3.17 Local savings mobilization. All the RFEs served by Codesarrollo require that their members have a minimum amount of savings deposited in the institution in order to access loan services. This has established the basis for the savings and loan groups, and the growth in remittances and non-farm labor activities has further strengthened the capacity for local rural savings mobilization. Many RFEs have capitalized on these trends by improving their external image as a savings cooperative, and by more rigorous management of funds, which has translated in increased trust in the local institution. In this regard, MIF financing for this project will not crowd out local savings, but rather strengthen the image of the RFEs and enhance their ability to market themselves as more solid local financial structures.

#### IV. BORROWER

##### A. Institutional analysis

- 4.1 *Background.* Codesarrollo is a regulated savings and loan cooperative that dates back to 1972, when it was first incorporated. Having survived the various financial crisis that hit Ecuador, in 1997 the cooperative was restructured with a new group of membersmembers who adopted a new set of bylaws and formed what today is Cooperativa de Ahorro y Credito "Desarrollo de los Pueblos Ltda." - Codesarrollo.
- 4.2 The most important feature that makes Codesarrollo unique among its peers is its social mission of working towards the development of the marginalized rural segments of Ecuador's population, through the promotion and strengthening of local financial systems. Codesarrollo's main clients are small agricultural producers and rural microentrepreneurs who have very limited access to rural financial services. Today, Codesarrollo has very little competition from regulated institutions in the rural areas<sup>10</sup>.
- 4.3 Codesarrollo is the financial services arm of the non profit organization Fondo Ecuatoriano Populorum Progressio (FEPP). FEPP was founded in 1970 and was initially devoted to providing credit to rural groups. Over time, the FEPP has spun

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<sup>10</sup> The only other sizable competition comes from the National Banco del Fomento which is known to have subsidized interest rates but also a very slow disbursement process.



off its microfinance activities to Codesarrollo, and has expanded its service offerings through affiliated companies that it has created. The services that FEPP currently provides include: marketing, training, education, housing construction, and other infrastructure development. FEPP operates through 10 regional offices directly employing 184 people, with another 164 people employed by the affiliated service companies.

- 4.4 Codesarrollo and FEPP are members in pursuing their social objectives and leveraging each other in a number of ways. Most importantly, FEPP and Codesarrollo have established a strong network of RFEs throughout Ecuador, many of which have expanded the reach of financial services into underserved rural areas. Currently, about 60 of these RFEs, are receiving financing through the *Credifinanciero* line of credit of Codesarrollo.
- 4.5 *Governance.* Codesarrollo's governance follows the structure of most cooperatives, with a general assembly at the top of the hierarchy, a Board of Directors underneath it, and the general manager in charge of the day-to-day operations. The institution has an Internal Overseeing Committee (Consejo de Vigilancia), as well as an internal auditing function. The Board of Directors (Consejo de Administracion) is made up of 5 members. The Board meets on a monthly basis to monitor the cooperative's operations and management, set credit policies, approve relevant budgets, and make appropriate personnel decisions. (See Annex III for an Organizational Chart of Codesarrollo). The Board members are elected by the general assembly to a two year term, which can be renewed for an additional two years. Decisions by the Board are made by voting on issues and decisions. Anyone can become a member of the cooperative, and in turn, be elected to the Board, as long as they comply with the bylaws and the Banking authority approval.
- 4.6 As of 31 March 2004, Codesarrollo has 95 members each of which holds the following percentage of shares. Codesarrollo has an additional US\$787,000 in donations to its equity base:

Members	Shares	%
Fondo Ecuatoriano Popularum Progressio	343,400	34%
Il Canale	100,000	10%
Central Ecuatoriana de Servicios Agricolas	61,600	6%
Francisco Roman	42,000	4%
91 other minority members	448,800	45%
TOTAL	995,800	100%

- 4.7 In addition to the managing director, the rest of the managerial staff is comprised of a team of 7 professionals responsible for the general coordination of operations, logistics, finances, accounting, systems, equipment and marketing. The remaining staff is made up of 49 employees, 18 of whom are credit officers.
- 4.8 *Geographic coverage and product positioning.* Codesarrollo's headquarters are in Quito and it has agencies in 8 other locations including Ibarra (Imbabura), Latacunga (Cotopaxi), Guaranda (Bolívar), Lago Agrio (Sucumbios), Riobamba (Chimborazo), Portoviejo (Manabí), Cuenca (Azuay) and Loja. Two more agencies in Ambato (Tungurahua) and Coca (Orellana) are in the process of being opened.
- 4.9 A review of the main credit products offered by Codesarrollo, reveals a commitment to small and micro enterprenuers and low income households.

CODESARROLLO: Outstanding balance by loan products in USD							
Product	Description	2001	%	2002	%	2003	%
Credidesarrollo	Microentrepreneurial and commercial activities, to individuals, groups or solidarity loans in rural areas.	2.305.340	55%	3.424.570	51%	5.390.883	42%
Credivienda	Large home construction, improvement, land for home	184.554	4%	965.400	14%	3.810.107	29%
Credirol	Small home construction, improvement, land for home	463.221	11%	711.958	11%	1.204.987	9%
Crediparticular	Consumption	382.487	9%	576.231	9%	980.044	8%
Credimicroemp.	Microentrepreneurial and commercial activities, to individuals, groups or solidarity loans in peri-urban areas.	668.646	16%	663.844	10%	940.198	7%
Credifinanciero	Line of Credit for Rural Financial Institutions	89.721	2%	262.537	4%	452.718	3%
Credicorporativo	Institutional strengthening	89.403	2%	109.467	2%	157.013	1%
Total			100%		100%		100%

- 4.10 Codesarrollo's emphasis on the provision of rural financial services is reflected in the large percentage of its credit portfolio and savings products which are concentrated outside the capital city of Quito. Close to 63% of the loan portfolio and 55% of its deposits are in predominantly rural areas where its agencies are located.

## B. Financial Analysis

4.11 Codesarrollo's financial performance has been good, especially considering their overarching mission of reaching out to those segments of the population most underserved by existing microfinance players.

4.12 Between 1999 and 2003, Codesarrollo experienced very strong growth. The number of clients with loans increased from 425 to 6,896, clients with savings accounts increased from 1,561 to 19,611 and total assets increased from US\$0.7 million to US\$15.2 million.

	1999	2000	2001	2002	2003
Members	24	24	28	70	91
Total Assets ('000)	\$695	\$2.141	\$5.060	\$9.068	\$15.156
No. Clients w/ Loans	425	1.509	3.325	4.232	6.896
No. Clients w/ Savings	1.561	3.571	5.629	12.699	19.611

4.13 While Codesarrollo's rapid growth was not unique – the cooperative sector as a whole grew by 52% per year between 1999 and 2003 as measured by assets – it significantly outperformed the rest of the industry. Codesarrollo was able to progressively improve its standing vis-à-vis other cooperatives during this timeframe. For example it moved from 26<sup>th</sup> place to 12<sup>th</sup> place measured by its level of assets, and from 26<sup>th</sup> to 9<sup>th</sup> place measured by the size of its portfolio. Today, within a highly fragmented industry made up of 4 large players, 12 medium players, and 15 small players, Codesarrollo is comfortably positioned within the group of medium sized cooperatives (See Annex VI).

4.14 Below is a summary of the recent evolution in Codesarrollo's liability structure.

Source of Liabilities	2001	%	2002	%	2003	%
Public Deposits	3.931.144	90%	6.404.556	82%	9.321.221	70%
External Financing	231.406	5%	1.235.121	16%	3.375.936	25%
Other	229.428	5%	143.291	2%	624.254	5%
Total Liabilities	4.391.978	100%	7.782.968	100%	13.321.411	100%

4.15 Although the level of public deposits did not grow as fast as the level of external financing, Codesarrollo was nevertheless successful in increasing its deposits which rose by an average of 55% a year from 2001 to 2003, slightly outpacing the cooperative sector where deposits rose 46% during that timeframe.

4.16 Codesarrollo's growth has been accompanied throughout by healthy financial and operating results:

- i. **Portfolio quality:** Codesarrollo's portfolio quality calculated according to the parameters established by the Superintendency of Banks<sup>11</sup> accounted for 8.83% of its total portfolio as of June 2004. Although this is somewhat higher than the average delinquency rate of the cooperative system, which was 4.95% on the same date, it must be balanced against the fact that Codesarrollo has a much heavier exposure to the more volatile agricultural and livestock sectors in comparison to peer institutions that focus on relatively safer urban and peri-urban clients. Because of Codesarrollo's particularly high exposure to the risky rural segment, the institution has recently put into place a number of simple but effective management tools to better control the level of bad debt. These include a new incentive structure that penalizes loan officers for past due amounts in their portfolios. Loan officers are also now required to prepare a plan for how they will collect past due amounts from each account holder and these plans are a tool that management can use to track their progress. These simple processes will help enforce sound lending practices and track the success in the collections area.
- ii. **Operating Performance:** Despite its focus on the more difficult to serve rural population, Codesarrollo has strong operational performance metrics. Its ratio of operating costs over total assets was 5.06% in June 2004, which compares very favorably with its peer group, which had operating costs

<sup>11</sup> The bad debt level is calculated by taking the sum of the portfolio classified in the risk categories B, C, D, and E whereby microcredit loans are considered in the B category after 6 days of being past due while consumption, housing and commercial loans are considered in the B category after 30 days of being past due.

that amounted to 11.08% of total assets. Codesarrollo has recently implemented strong mechanisms that allow it to track performance by each product line. Codesarrollo benefits from its low personnel costs as well as its membership with FEPP, which provides significant support in assessing and monitoring loan clients. Codesarrollo's loan portfolio per credit officer stands at about US\$829,000, which puts Codesarrollo among the most productive cooperatives in the country. A May 2004 risk analysis performed on Codesarrollo by the ratings agency *Microfinanzas Rating*, suggests that the support received by Codesarrollo from FEPP amounts to the equivalent of three loan officers, which would increase Codesarrollo's ratio of operating costs to total assets on the order of 1% to 2%. This shows that while FEPP's contribution is important, Codesarrollo's positive results do not depend on FEPP's support.

- iii. **Deposits:** Although Codesarrollo has been able to increase deposits from the public at a good pace relative to its credit portfolio and compared with the rest of the industry, in the future, the institution will seek to increase the rate of growth of its deposits by developing a comprehensive strategy and implementing it with the appropriate dedication of resources. Specifically, Codesarrollo is planning to hire a marketing manager in charge of identifying target markets, developing appropriate deposit products, creating appropriate promotional material in view of increasing the amount of deposits but also of matching the terms of the deposits with the terms of the asset side of the balance sheet.
- iv. **Funding sources:** Thanks to its favorable relationship with the network of credit cooperatives in Italy, Codesarrollo has been able over the last 3 years to obtain several rounds of financing totaling US\$8.4 million and which today have an outstanding balance of US\$3.4 million. These loans represent the totality of the institution's liabilities to financial entities and are dollar denominated, thereby eliminating potential currency risk. In addition to providing financing, these lending institutions have also supported Codesarrollo through technical assistance in systems development and technology enhancements and has helped Codesarrollo improve its financial and operational performance. The goal going forward will be for the cooperative to diversify its sources of financing, in order to reduce its dependency on the Italian credit cooperatives.
- v. **Capital Base:** Between 2002 and 2003, Codesarrollo added 21 new members, so that its member institutions numbered 91 by the end of last year, a yearly increase of 30%. In the past four months, Codesarrollo has obtained an additional US\$ 114,800 in equity, the equivalent of a 6.5% increase in their equity base. Indeed, Codesarrollo's equity base has been able to keep up with the institution's rapid portfolio growth in recent years. Codesarrollo has an unusually concentrated shareholder structure for a

cooperative, exceeding the regulatory limit of 5% ownership by any single shareholder. However, the majority members (FEPP, Il Canale and CESA), have agreed to reduce their interest in Codesarrollo over time. Prior to the first disbursement, Codesarrollo will deliver a legal opinion addressing this issue. Since lack of capital has the capacity of limiting the institution's growth going forward, and in order to diversify its equity base, Codesarrollo plans to target additional institutional and individual investors, aiming to increase the number that are members. The proposed project will not only provide technical assistance to Codesarrollo for developing a strategy for strengthening its equity base but the MIF will also condition the disbursement of the financing to improvements in the size and dispersion of Codesarrollo's equity base.

- vi. **Financial Management:** Codesarrollo maintains a conservative provisioning policy with a ratio of loan-loss provisions over past-due portfolio that is 6% over its peer group at 87.8% in June 2004. In addition, Codesarrollo has a healthy level of liquidity: its ratio of liquid assets and investments over total deposits and short-term funds stands at 37.4%. Although its current ratio is less than one, indicating a slight mismatch between deposit and borrowing terms (especially due to the increased weight of long term mortgage lending on the total portfolio), overall liquidity is sufficient given the low projected volatility of deposits. Finally, financial efficiency is good, with productive assets amounting to 95.7% of the cooperative's total assets, 4% higher than its peer group. Despite sound financial management, Codesarrollo's performance measured by ROE and ROA is consistently lower than other medium sized cooperatives. Because of its social mission, the active interest rates that Codesarrollo charges its clients fall at the low-end of the rates offered by the market and this is what ultimately affects the cooperative's bottom line.

#### Summary of Codesarrollo's financial history (US\$)

	12/31/2001	12/31/2002	12/31/2003	06/30/2004
Total assets	5.060.659	9.068.071	15.156.143	18.824.908
Uncommitted funds and temporary investments	777.370	2.379.262	2.600.939	3.364.248
Net portfolio	4.048.884	6.442.948	12.080.119	14.937.946
Total liabilities	4.391.978	7.782.968	13.321.411	16.712.405
Deposits	3.391.144	6.404.556	9.321.221	10.700.428
Credit from banks and other institutions	231.406	1.235.121	3.375.936	6.173.909
Equity capital	668.681	1.285.103	1.834.732	2.112.502

Net financial income	713.463	1.197.451	2.208.261	1.444.726
Provisions	16.477	148.408	606.158	437.233 <sup>12</sup>
Net earnings from operation	94.081	91.316	86.670	58.564
Final earnings	29.118	46.213	57.419	40.495

- 4.17 The following financial indicators characterize an institution that is performing below its peer group. While Codesarrollo has certain financial weaknesses (as detailed in 4.16) they need to be analyzed against the fact that Codesarrollo's focus is on a unique market that is more costly to serve than the markets targeted by other mid-sized cooperatives. In addition, Codesarrollo has sound financial management which provides the institution the financial stability to weather the higher risks that rural lending entails.

#### Most important financial indicators

06/30/2004	Codesarrollo	Peer Group Mid-size Cooperatives
Equity capital/Total assets	11,0%	21,1%
Average rate of return on assets	0,47%	5,15%
Average rate of return on equity capital	4,21%	24,4%
Past-due portfolio/Total portfolio	8,83%	4,95%
Loan-loss provisions/Past-due portfolio	87,8%	81,8%
Productive Assets/Total Assets	95,7%	91,7%
Liquid assets + investments / Total deposits + short-term funds	37,43%	15,45%
Intermediation Margin/Average Total Assets	0,69%	5,4%
Operating Costs / Total assets	5,06%	11,08%

## V. PROJECT TERMS AND CONDITIONS

### A. Technical Assistance

- 5.1 The objectives of the technical assistance component will be to support Codesarrollo's efforts to provide second tier lending to rural financial entities. The two main components will be: (i) to strengthen *Credifinanciero*, the second tier lending product of Codesarrollo; and (ii) to enhance the institutional capacity of Codesarrollo in order to become a more competitive rural financial service provider.

<sup>12</sup> Provisions to June 2004. Projected provisions to December 2004 are \$1.2 million.

- 5.2 *Strengthening of the second tier-lending product Credifinanciero.* As a pilot loan product, *Credifinanciero* has grown to a portfolio of US\$500.000, or 3% of the total Codesarrollo loan balance. While the product is offered in all 8 branch offices, the systems and procedures under which it operates, still need fine tuning and increased security. Policies, procedures and technical support aspects need to be strengthened, in order for the product to grow and reach optimum scale. The technical assistance component will finance consulting in three key areas: (i) external consulting to enhance the effectiveness and design of the *Credifinanciero* lending policies and the other rural methodologies which are offered by Codesarrollo; (ii) external consulting for the development of the appropriate tools for management and monitoring of the *Credifinanciero* product and training credit analysts in these tools; and (iii) an assessment of *Credifinanciero*'s target market (in depth demand study) and the rollout of an adequate marketing campaign. Additionally, the technical assistance funds will be used to finance seminars and specialized training for mid level analysts and credit analyst as well as exchange visits to other successful microfinance agencies working in rural credit.
- 5.3 *Strengthening of Codesarrollo.* The recent rapid growth of the organization has outpaced the relevance of the existing strategic and business plan documents and processes. New products, new staff and an increased pressure on management to deal with more rigorous supervision on the part of the Banking regulator, has put the organization on a path of growth with few tools and technologies to support this process. The technical assistance in this area will assist Codesarrollo in (i) developing a new business plan which takes into account new market conditions and the growth of the organization across product lines; (ii) external consulting and training in the development of a new corporate culture in tune with the challenges of a growing financial entity; (iii) training key senior managers in strategic planning and financial management; and (iv) exchange visits by key managers to other financial organizations in the region.
- 5.4 Finally, funds from the technical assistance component will be used to enhance the current portfolio and cash flow information systems, intended on working on top of the existing portfolio management platform.
- 5.5 The total cost of the technical assistance component is US\$475.000, of which the MIF will fund US\$290.000 and Codesarrollo the remainder US\$185.000. The itemized budget for the program can be found in Annex XI.
- 5.6 MIF disbursements will be tied to Codesarrollo's disbursements under a *pari passu* clause. The financing portion of the project will be conditioned on the institution making progress along the dimensions tracked in the technical assistance component. The technical assistance also calls for an audit and an analysis of its results, to be financed by the MIF and carried out in accordance with the IDB's policies. The execution schedule for the technical-assistance project will be 30 months and the disbursement schedule will be 36 months.



- 5.7 Expected results: The expected results of the technical and financial assistance from the MIF are outlined in the log frame in Annex I.

**B. Line of Credit**

- 5.8 **Amount:** The proposed line of credit will make an amount of up to US\$1.2 million available on a revolving basis. The first loan will be capped at US\$400,000. Thereafter, Codesarrollo will be able to borrow up to US\$800,000 in one or two more tranches, on the condition that all financial and developmental indicators are met. Once each tranche is paid back in full (including principal and interest), Codesarrollo will be able to once again borrow that amount, up to a maximum of US\$1.2 million.
- 5.9 **Loan Timing.** The line of credit will be made available for up to six years. Individual loans may be disbursed for terms of no more than three years. The second tranche will be disbursed no sooner than 12 months and no later than 36 months from the disbursement of the first tranche. The maximum period of time allowed for paying back each loan will be such that the principal and interest of the last loan that Codesarrollo takes out must be paid off by the sixth year after the inception of the program.
- 5.10 **Amortization Period:** The loan will be repaid on a semi-yearly basis.
- 5.11 **Interest rate:** Each loan will be priced at the reference passive interest rate for private banks set by Ecuador's Central Bank + 3% (See Annex XII for historical trend). The interest rate was set taking into account the current market conditions, making sure that it does not crowd out Codesarrollo's own deposit-taking but also low enough to enable Codesarrollo to profitably onlend to the target RFEs in their network who are the beneficiaries of this operation. The interest rate was also set in accordance with similar operations the MIF has carried out in the past.
- 5.12 **Use of resources.** Codesarrollo will be required to apply the revolving line of credit resources solely to increasing its loan portfolio through its *Credifinanciero* product line. In addition, Codesarrollo will be required to apply the resources strictly to rural RFEs. If Codesarrollo does not meet the guidelines for the use of the resources, the line of credit will be terminated and all amounts will become immediately due.
- 5.13 **Eligibility conditions.** In order to access the line of credit, Codesarrollo will: (i) submit a plan for placement of the requested resources among rural RFEs that belong to their network, providing quantifiable targets and objectives; (ii) demonstrate compliance with the financial and development variables; and (iii) be current with MIF information requirements. The line of credit will be tied conditionally to the technical cooperation in such a way that the failure to meet the

conditions and objectives set for the latter will result in the automatic suspension of the line of credit. Before the disbursement of each tranche, the following conditions will need to be met:

First Tranche Up to US\$ 400.000	Conditions: <ul style="list-style-type: none"><li>- Codesarrollo has submitted a plan for placement of requested resources</li><li>- Financial covenants for Year 1 are met (See 5.14)</li><li>- Favorable legal opinion including on the validity and enforceability of the Loan Agreements and transactions thereunder and addressing the concentration of membership;</li></ul>
Additional Tranches Up to US\$ 800.000	Conditions: <ul style="list-style-type: none"><li>- Codesarrollo has submitted a plan for placement of requested resources</li><li>- Credifianciero's development variables for the first disbursement have been met</li><li>- Financial covenants continue to be met</li><li>- The second tranche will be disbursed no earlier than 1 year and no later than 3 years following the disbursement of the first tranche.</li><li>- Codesarrollo is satisfactorily implementing the recommendations of the technical assistance component in terms of strengthening its institutional capabilities, and the administration of the <i>Credifianciero</i> product.</li><li>- Development and Implementation of equity growth strategy (for broader capital base and diversification)</li><li>- Development and Implementation of deposit growth strategy</li><li>- Improvements in corporate governance</li><li>- Codesarrollo first tier operations will not enter regions that are already being served by Credifianciero clients.</li></ul>

5.14 Codesarrollo must comply with two sets of variables in order to access the line of credit resources:

- (i) **Financial covenants.** The aim of these variables is to reduce the financial risk to which the MIF is exposed. The line of credit will be suspended if Codesarrollo fails to comply with any of these variables. Codesarrollo may begin to access the resources again once it returns to compliance with all these conditions. (See Annex X for all covenants and indicators that will be tracked in monitoring reports)

Financial Covenants	Year 1*	Year 2	Year 3**
<b>Profitability</b>			
Return on Equity		>5%	
Return on Assets		>1%	
Financial Self-Sufficiency <sup>1</sup>		>100%	
<b>Asset Quality</b>			
Past due ratio of total assets (Super. defined method <sup>13</sup> )	<8%	<7%	<6%
Past-due portfolio <i>Credifinanciero</i> (>30 days) / Total portfolio <i>Credifinanciero</i>		< 2%	
Risk Coverage Ratio (>30 days) <sup>2</sup>		>100%	
<b>Capitalization</b>			
Dispersion of equity base <sup>3</sup>	<50%	<40%	<30%
Capital adequacy <sup>4</sup>	>12%	>12.5%	>13.5%

1. = (Adjusted Financial Income + Other operational Income)/(Adjusted Financial Expenses + Adjusted Provision Expenses + Adjusted Operating Expenses)

2. = Accumulated Reserves / Past due portfolio (>30 days)

3. = % Paid in capital of top 4 members

4. = Total Equity/Total Assets

\* Year 1 financial covenants are to be met before the disbursement of the first tranche and throughout the first year after disbursement of the first tranche.

\*\* The Year 3 financial covenants will continue in place throughout the six-year life of the credit line and a failure to meet these covenants will constitute events of default.

- (ii) **Development variables.** The aim of these variables is to ensure that the use of MIF resources has a positive social impact on the beneficiary sector: rural micro enterprises and families in Ecuador. These figures are based on the projected demand today for the *Credifinanciero* product. The success of each loan tranche will be assessed in comparison with these projections and subsequent tranches will not be disbursed until satisfactory development indicators are achieved from the prior tranche.

<i>Credifinanciero</i>	June 2004 Actual	Year 1 <sup>14</sup>	Year 2	Year 3
Number of RFE members reached by <i>Credifinanciero</i>	12.540	18.800	26.200	29.900
Number of RFEs financed by <i>Credifinanciero</i>	66	110	160	185
Total Credit Provided Through <i>Credifinanciero</i>	\$499.949	\$900.000	\$1.640.000	\$2.385.000

<sup>13</sup> Reported as "morosidad de la cartera" by the Superintendencia de Bancos.

<sup>14</sup> From date of disbursement of first tranche of loan.

- 5.15 **Supervision.** The MIF will carry out the supervision of the proposed lending program in accordance with its usual procedures for loans to microfinance institutions. The MIF will carry out at least two site visits a year to monitor the progress of the loan (financial indicators, developmental indicators etc.) and will hire a specialized consultant on the ground to carry out the supervision. Codesarrollo must also submit regular progress reports on a quarterly basis to the MIF, the contents of which are detailed in Annex X, as well as annual audited financial statements.

**C. Environmental considerations**

- 5.16 The Committee on Environment and Social Impact (CESI) reviewed and approved the proposed program and made recommendations that will be taken into account during program implementation.

## **VI. RISKS AND MITIGATING FACTORS**

- 6.1 **Financial risk:** Codesarrollo's impressive growth in the past three years has been primarily financed through debt, putting its debt to equity ratio at a relatively high level. **Mitigating factors:** There are three factors that help mitigate this risk. (i) Codesarrollo has been in a campaign to enlist a greater number of members. Institutional and private investors have been contacted and from 2002 to 2003, 22 new members have joined the membership of the organization and the project will further support Codesarrollo's effort to increase and lower the concentration of its capital base. (ii) Codesarrollo has a well-balanced liability structure with 68% of it in deposits and 28% in loans from external sources. On average, Codesarrollo pays a 4.5% on these liabilities, which is an acceptable interest rate that has allowed it to mitigate the financial exposure and risk. Additionally, Codesarrollo has established an innovative and strong relationship with a group of Italian commercial banks and credit unions which will be further strengthened by this project. These institutions have provided key support for the growth of the institution and are currently assisting the cooperative to diversify its membership and shareholder base. (iii) Finally, an important mitigating factor to the financial risk, is the fact that 54% of its depositors are large institutional investors close to the organization and committed to the same social mission of Codesarrollo. This commitment from a limited number of depositors who hold a large percentage of the liabilities, limits the organization's exposure to sudden sector or economic fluctuations and allows it to better manage its short term liquid assets.
- 6.2 **Misuse of credit:** Codesarrollo could on-lend MIF resources to some of the other product lines, such as housing or commercial lending. **Mitigating factor:** Codesarrollo will have a contractual obligation to use resources granted under this program to expand its *Credifinanciero* portfolio. The line of credit may only be

renewed if there is evidence of the growth in the number of RFEs who borrow from Codesarrollo and the loan amounts. Codesarrollo is committed to maintaining levels of coverage and achieving goals that are consistent with its mission to serve the rural sector and specifically the development of the RFEs. Codesarrollo is aware that its competitive advantage lies in the services it provides to these rural entities. The line of credit will be made at competitive market rates in order to prevent situations in which Codesarrollo could use resources to substitute liabilities. If this were to occur, the line of credit would be terminated for failure to fulfill the goals agreed on for assisting Ecuadorian rural financial intermediaries.

- 6.3 **Risks of operating as a second tier lending agency:** Codesarrollo is aware of the risks involved in providing first tier and second tier lending to its clients. **Mitigating factor:** Codesarrollo has well-established products primarily for rural micro enterprises and low-income families. It has built a strong reputation in part due to its alliance with the FEPP, a non government organization working in rural credit for the past 30 years. In this regard, the management of the cooperative has prudently entered with the *Credifinanciero* product in a pilot phase and has experienced a good level of success and impact. *Credifinanciero* does not compete with Codesarrollo's other products because the markets they serve are different and geographically distant from each other. While Codesarrollo recognizes that other MFIs and itself may some day tap into these remote rural markets with direct lending operations, it is also aware that this will not happen in the near future. In addition, Codesarrollo sees this rural penetration as an essential first step to educate and prepare rural populations, before more financial services become available in rural areas.
- 6.4 **Management risks:** Codesarrollo has seen significant growth across its three product lines in the past two years. Each one of these lines has its own set of markets, mechanics, analytical requirements and expertise. The growth in these products and in its deposit taking has come with increased levels of interaction and supervision from the Superintendency of Banks. All these activities have put a great deal of pressure on management at all levels, and may pose a risk in terms of its capacity to sustain this level of growth while maintaining its overall good performance. **This risk will be mitigated** by two key factors. On the one hand, the organization has already started to put in place a series of actions aimed at managing growth, such as hiring key personnel in local branch offices, working on incentive mechanisms that are based on overall performance by product line, and contracting technical expertise in various financial and systems areas. On the other hand, the Technical Cooperation grant of this project, will be directed at strengthening the organizations capacity to manage the growth of not only the *Credifinanciero* product, but also of the organization as a whole.
- 6.5 **Risk of portfolio deterioration:** Codesarrollo's recent rapid growth increases the risk of portfolio deterioration in the future, which could lead to losses for the institution and an inability to service its debt. **Consideration.** In order to keep its

past due portfolio under control Codesarrollo has adopted a number of management tools including a new incentive structure that penalizes loan officers for past due amounts in their portfolios and requires that they prepare a plan for how they will collect past due amounts from each account holder. In addition, the project's financing component will be disbursed in tranches so as to limit the MIF's exposure and to condition the disbursements on the institution's continuing financial health. The MIF will carry out regular supervision activities (site visits) in order to ascertain the institution's financial situation.

## **VII. EXCEPTIONS TO THE BANK'S POLICIES**

7.1 None.

## ANNEX I: LOG FRAME

### Supporting an Innovative Mechanism for Providing Rural Credit to Underserved Communities (EC-M1006)

NARRATIVE SUMMARY	INDICATORS	MEANS OF VERIFICATION	ASSUMPTIONS
GOAL	IMPACT		SUSTAINABILITY
Expand the provision of financial services to rural underserved communities in Ecuador.	<p>After the conclusion of the project:</p> <p>At least 29.900 rural microfinance clients will be served by Codesarrollo and its member RFEs.</p>	<ul style="list-style-type: none"> <li>Codesarrollo annual report.</li> <li>Portfolio Reports from information system.</li> <li>MIF evaluation report.</li> </ul>	Monetary, fiscal, fiscal and foreign trade policies do not adversely affect loan demand from the rural microenterprise sector, or stability of financial system, for a significant period of time.
PURPOSE	OUTCOMES		PURPOSE TO GOAL
Strengthen Codesarrollo to deliver expanded microfinance services through its Credifinanciero line of credit to RFEs.	<p>At the conclusion of the project the following outcomes will be verified:</p> <ul style="list-style-type: none"> <li>Credifinanciero's portfolio has reached US\$2,3 million and less than 3% loans in arrears.</li> <li>Codesarrollo has expanded Credifinanciero to 185 RFEs throughout Ecuador.</li> </ul>	<ul style="list-style-type: none"> <li>Portfolio Reports from information system</li> <li>Codesarrollo monthly reports and annual report.</li> <li>Monthly financial statements.</li> <li>MIF evaluation report.</li> </ul>	<p>Government policies do not distort competitive conditions in the rural microlending sector.</p> <p>There continues to be a strong demand from RFEs for the Credifinanciero line of credit, offered by Codesarrollo</p>
COMPONENTS	OUTPUTS		OUTPUTS TO PURPOSE
<p><u>Component I. Technical assistance grant for strengthening Codesarrollo and the Credifinanciero line of credit.</u></p> <p>Strengthening of Codesarrollo to manage the growth of Credifinanciero and its other rural microfinance products.</p>	<p>The following will be verified:</p> <p><i>At the end of year 1:</i></p> <ul style="list-style-type: none"> <li>Business plan process has been completed</li> <li>Training needs of key senior managers have been identified</li> <li>Three year financial projections have been developed and</li> </ul>	<p>Board minutes approving updated business plan</p> <p>Board minutes approving three year projections</p>	<p>Consultants and trainers are accessed in a timely manner.</p> <p>Codesarrollo employees available</p>

NARRATIVE SUMMARY	INDICATORS	MEANS OF VERIFICATION	ASSUMPTIONS
	<p>approved by Codesarrollo board of directors, studying sensibility analysis on different scenarios.</p> <p><i>Upon project completion:</i></p> <ul style="list-style-type: none"> <li>• Codesarrollo will have established effective financial management systems to manage the expected growth of the Credifinanciero line of credit.</li> <li>• Diagnostic assessment of Codesarrollo's current operations has been completed.</li> <li>• Business and operational planning and monitoring policy has been approved.</li> <li>• Clear operating manuals have been created.</li> <li>• Less than 8% of Codesarrollo loans more than 30 days past due.</li> <li>• At least 29.900 active clients through RFEs</li> <li>• \$20&gt; overall portfolio of Codesarrollo</li> <li>• \$2.3 &gt; Credifinanciero portfolio</li> </ul>	<p>Codesarrollo monthly report</p>  <p>Codesarrollo monthly report</p>	at appropriate times.
<p><u>Component II. Revolving Line of Credit.</u> MIF will provide USD\$1.2 mm revolving line of credit to Codesarrollo to expand its Credifinanciero line of credit.</p>	<p>The following outputs will be verified:</p> <p><i>At the end of year 2:</i></p> <ul style="list-style-type: none"> <li>• Credifinanciero will have 160 RFEs borrowing from its line of credit.</li> <li>• Average loan size to the RFEs will be \$10.250</li> <li>• The RFEs will reach an estimated 26.000 members</li> </ul>	<ul style="list-style-type: none"> <li>• Portfolio Reports from information system</li> <li>• Codesarrollo monthly reports and annual report.</li> <li>• Monthly financial statements.</li> </ul>	



NARRATIVE SUMMARY	INDICATORS	MEANS OF VERIFICATION	ASSUMPTIONS
Strengthening of Credifinanciero Line of Credit	<p>The following will be verified:</p> <p><i>At the end of year 1:</i></p> <ul style="list-style-type: none"> <li>• Credifinanciero operational procedures have been audited</li> <li>• Market studies have been implemented</li> <li>• Training needs of credit analysts and branch level managers has been assessed.</li> <li>• Marketing implementation plan has been developed and approved, based on results of marketing study.</li> <li>• Strategic plan for Credifinanciero included in Annual report of Codesarrollo</li> </ul> <p><i>Upon project completion:</i></p> <ul style="list-style-type: none"> <li>• Credifinanciero approval process, loan execution and supervision has been enhanced</li> <li>• Average Credifinanciero arrears does not surpass 2%</li> <li>• Marketing strategy based on market studies has been approved.</li> <li>• Adjustments made to Credifinanciero and other rural finance products based on market survey results</li> <li>• Credit officers have been trained in delivery of enhanced rural credit products.</li> </ul>	<p>Board resolution approving marketing strategy.</p> <p>Codesarrollo monthly reports to the Board</p> <p>Board minutes approving enhanced lending policies for Credifinanciero.</p>	<p>Codesarrollo maintains commitment to grow Credifinanciero</p>
Support for Upgrades to Information Systems	<p>The following will be verified:</p> <p><i>At the end of year 1:</i></p> <ul style="list-style-type: none"> <li>• Systems audit and technical specifications for upgraded information system have been completed.</li> </ul> <p><i>Upon project completion:</i></p> <ul style="list-style-type: none"> <li>• Upgraded information system operational in all Codesarrollo branches</li> <li>• Staff have been trained and are capable of using system</li> </ul>	<p>Reports from upgraded information system.</p>	<p>Qualified consultants and trainers are available.</p> <p>Staff can operate information system.</p>

NARRATIVE SUMMARY	INDICATORS	MEANS OF VERIFICATION	ASSUMPTIONS
ACTIVITIES	INPUTS		ACTIVITIES TO OUTPUTS
<b>Component I: Technical assistance grant for strengthening Codesarrollo and the Credifinanciero line of credit.</b>			
<b>Strengthening of Codesarrollo Management and Financial Management</b>			
Business Plan enhancement	Business Plan process executed and new Operational planning and monitoring policy developed and two operational planning workshops provided for staff and managers	Project reports  Financial performance reports	Codesarrollo allocates sufficient resources for business plan process.
Institutional change and corporate culture	Business and operational planning and monitoring policy has been approved  Diagnostic assessment of Codesarrollo's internal weaknesses and vision. Strategic planning workshop with key staff completed.	Consultant reports  Final evaluation	Timely contracting compatible with the project execution timetable.
Training seminars	Training needs assessment have been completed. Training has been delivered in the areas of financial management for key senior managers.		
Exchange visits	Exchange to well known microfinance institution in the Andean Region		
<b>Strengthening of Credifinanciero</b>			

NARRATIVE SUMMARY	INDICATORS	MEANS OF VERIFICATION	ASSUMPTIONS
<p>Development of new and revised operating manuals for Credifinanciero</p> <p>Develop staff training manuals</p> <p>Strengthen internal controls for Credifinanciero</p> <p>Conduct market studies</p> <p>Design marketing strategy</p> <p>Training seminars</p> <p>Technical exchanges</p>	<p>Operating procedures evaluated. Operating manuals developed.</p> <p>Training needs assessment conducted. Training manuals developed.</p> <p>Internal auditor and staff in charge of internal control instruments trained using new policies and procedures manuals.</p> <p>Market studies conducted for expansion branches.</p> <p>Marketing strategy with annual implementation plan developed by Codesarrollo's marketing department and approved.</p> <p>At least one training seminar for managers in credit management and at least two seminars for credit agents in credit appraisal, delivery mechanisms and credit management</p> <p>Technical exchange to well known microfinance institution in the Andean Region.</p>	<p>Project reports</p> <p>Financial performance reports</p> <p>Consultant reports</p> <p>Final evaluation</p>	<p>Codesarrollo devotes sufficient resources for Credifinanciero to maintain profitability.</p> <p>Timely contracting compatible with the project execution timetable.</p>
<p><b>Support for Upgrades to Management Information Systems</b></p> <p>Maximize existing accounting/MIS system</p> <p>Conduct system audit</p> <p>Purchase hardware and software</p>	<p>Needs assessments on information for decision making by credit analysts and branch managers. Training seminars conducted.</p> <p>Systems audit completed. Business processes changed as necessary. Project management plan developed</p> <p>New hardware purchased. Customization of more adequate systems within existing platform. Software identified and developed.</p>	<p>Project reports</p> <p>Financial performance reports</p> <p>Consultant reports</p> <p>Final evaluation</p>	<p>Codesarrollo devotes sufficient resources for MIS enhancement.</p> <p>Timely contracting compatible with the project execution timetable.</p>

NARRATIVE SUMMARY	INDICATORS	MEANS OF VERIFICATION	ASSUMPTIONS
<b>Component II: Revolving Line of Credit for Codesarrollo</b>			
Line of credit for the expansion of Credifinanciero.	MIF disburses funds according to the terms of the loan	Codesarrollo and MIF reports	Conditions for disbursement have been met. Disbursement of funds compatible with the financial requirements of Codesarrollo.

## Annex II

### MIF Projects in Ecuador

Ecuador			
MIF Number	Project Name	Approval Date	Status
Unknown	Secured Finance Facility Backed with Diversified Payment Rights	(No approval date)	Pipeline A
Unknown	International Accounting and Auditing Standards	(No approval date)	Pipeline A
Unknown	Development of the textile and clothing sector	(No approval date)	Pipeline A
Unknown	Development of Rural Financial Institutions	(No approval date)	Pipeline A
MIF/AT-41	Modernization of State (Transport Component)	24-May-95	Completed
MIF/AT-40	Manpower Adjustment Program	24-May-95	Completed
MIF/AT-44	Modernization of the Water and Sanitation Sector	19-Jul-95	Completed
MIF/AT-57	Trade Modernization	01-Nov-95	Completed
MIF/AT-48-1	Program to Strengthen Technical and Vocational Training for Low Income Women	27-Nov-95	Canceled
MIF/AT-105	Mediation and Arbitration Center	11-Dec-96	Completed
MIF/AT-124	Employment Services and Training	02-May-97	Completed
MIF/AT-132	Voucher Program for Entrepreneurial Service	25-Jun-97	Approved (not yet completed)
MIF/AT-156	Strengthening the Savings and Credit Cooperative System	25-Feb-98	Approved (not yet completed)
MIF/AT-157	Transport Concessions	25-Feb-98	Completed
MIF/AT-242	Local Development and Support for Private Initiatives	21-Apr-99	Approved (not yet completed)
MIF/AT-346	Development of Health Franchises	17-Jul-00	Approved (not yet completed)
MIF/AT-388	E-commerce Pilot Project for Small-Scale, Artisanal, and Agricultural Producer Groups	22-Dec-00	Approved (not yet completed)
MIF/AT-398	Banco Solidario	06-Mar-01	Approved (not yet completed)
MIF/AT-421	Privatization of the Assets of the Ministry of Tourism	13-Jul-01	Approved (not yet completed)
MIF/AT-425	Support of Local Participation in the Galapagos Tourism Sector	24-Jul-01	Approved (not yet completed)
MIF/AT-436	Support Micro-Enterprises Utilizing a Line of Credit	19-Sep-01	Approved (not yet completed)
MIF/AT-448	Improving competitiveness for micro and small enterprises in textile sector	05-Dec-01	Approved (not yet completed)
MIF/AT-449	Sociedad Financiera Ecuatorial S.A.	12-Dec-01	Approved (not yet completed)
MIF/AT-454	Strengthening Intellectual Property	20-Dec-01	Approved (not yet completed)
MIF/AT-463	Promoting Cleaner Production Among SMEs	03-Apr-02	Approved (not yet completed)
MIF/AT-505	Institutional Strengthening Cooperative Jardin Azuayo	28-Oct-02	Approved (not yet completed)
MIF/AT-559	Mitigate market access barriers under the Andean Trade Act	03-Dec-03	Approved (not yet completed)
MIF/AT-565	Institutional strengthening of Finca Ecuador	09-Dec-03	Approved (not yet completed)
MIF/AT-567	Job competencies certification system in the tourism sector	10-Dec-03	Approved (not yet completed)

## Annex X List of Indicators

Indicators to be Tracked and included in Monitoring Reports	Conditions for Line of Credit	2004	Year 1*	Year 2	Year 3**
<b>Profitability</b>					
Return on Equity	x	4.20%		>5%	
Return on Assets	x	0.50%		>1%	
Financial Self-Sufficiency <sup>1</sup>	x			>100%	
<b>Asset Quality</b>					
Past due ratio of total assets (Super defined method)	x	8.83%	<8%	<7%	<6%
Risk Coverage Ratio (>30 days) <sup>2</sup>	x	87%		>100%	
Past-due portfolio Credifinanciero (>30 days) /Total portfolio Credifinanciero	x	0%		< 2%	
<b>Financial Management</b>					
Return on Portfolio <sup>3</sup>					
<b>Capitalization</b>					
Dispersion of equity base <sup>4</sup>	x	55%	<50%	<40%	<30%
Capital adequacy <sup>5</sup>	x	11%	>12%	>12.5%	>13.5%
<b>Operating Expenses</b>					
Average # loans per loan officer					
Average cost per loan					
Operating Costs/Total Assets					
<b>Outreach</b>					
Inclusion of minority groups such as women and indigenous people.	No set indicator, but % will be tracked.				
Number of RFE clients reached ('000)	Should prove that it will reach an adequate number of RFI and members through placement plan and should have satisfactorily placed the money from the previous tranche before next tranche disbursed***	12.5	18.8	26.2	29.9
Number of RFEs reached		66	110	160	185
Portfolio of Credifinanciero		\$499.949	\$900.00	\$1.640.000	\$2.385.000
Interest Rate Spread	Difference between average active rate of RFEs and Credifinanciero rate to be no more than 12% and no less than 5% (including all commissions)	10.50%			
<b>Management and Governance</b>					
Improvements in corporate governance	x				
Development and Implementation of equity growth strategy	x				
Development and Implementation of deposit growth strategy	x				

1. = (Adjusted Financial Income + Other operational Income)/(Adjusted Financial Expenses + Adjusted Provision Expenses + Adjusted Operating Expenses)

2. = Accumulated Reserves / Past due portfolio (>30 days)

3. = Interest Income from Portfolio / Average Gross Portfolio

4. = % Paid in capital of top 4 shareholders

5. = Total Equity/Total Assets

\* Year 1 financial covenants are to be met before the disbursement of the first tranche and throughout the first year after disbursement of the first tranche.

\*\* The Year 3 financial covenants will continue in place throughout the six-year life of the credit line and a failure to meet these covenants will constitute events of default.

\*\*\* The numerical targets are indicative based on projected demand

**ANNEX XI**  
**Detail Budget for the Technical Assistance Component**  
**EC-M1006**  
**CODESARROLLO (in US\$)**

	<b>MIF</b>	<b>Codesarrollo</b>	<b>Total</b>
<b>Strengthening of Codesarrollo Management and Strategic Planning</b>	<b>85,000</b>	<b>110,000</b>	<b>195,000</b>
Technical Assistance Services	60,000	100,000	160,000
Update of Business Plan and Ongoing Support	40,000	0	40,000
Consulting in Marketing Strategy and Support to Marketing Operations	10,000	55,000	65,000
Long term consulting for implementation of strategic and marketing recommendations, institutional change, and corporate culture (Coach)	10,000	45,000	55,000
Exchange visits and Seminars	25,000	10,000	35,000
Training seminars for Senior Managers in management and financial management	15,000	5,000	20,000
Exchange visits to other Latin American top MF agencies in rural and second tier experiences	10,000	5,000	15,000
<b>Strengthening of Credifinanciero Second Tier Lending Program</b>	<b>105,000</b>	<b>10,000</b>	<b>115,000</b>
Technical Assistance Services	75,000	0	75,000
Short term consulting in credit policy enhancement for Credifinanciero and other rural methodologies	25,000	0	25,000
Short term consulting for development of analytical tools (monitoring, risk management etc.) for Credifinanciero	25,000	0	25,000
Short term consulting for market assessment and roll out of marketing strategy for Credifinanciero	25,000	0	25,000
Exchange visits and Seminars	30,000	10,000	40,000
Training seminars for credit analysts	20,000	5,000	25,000
Exchange visits and Seminars	10,000	5,000	15,000
<b>Management Information Systems</b>	<b>70,000</b>	<b>20,000</b>	<b>90,000</b>
Technical Assistance Services	45,000	10,000	55,000
Development of a timely portfolio analysis and cash flow analysis system.	45,000	10,000	55,000
Hardware and Software	25,000	10,000	35,000
Equipment	25,000	5,000	30,000
Software Update	0	5,000	5,000
<b>Audit, Evaluation and Project Management</b>	<b>30,000</b>	<b>45,000</b>	<b>75,000</b>
Project Management	0	45,000	45,000
Monitoring	15,000	0	15,000
External Audits	10,000	0	10,000
Unforeseen	5,000	0	5,000
<b>Total</b>	<b>290,000</b>	<b>185,000</b>	<b>475,000</b>
	61%	39%	100%

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MULTILATERAL INVESTMENT FUND  
NOT FOR PUBLIC USE

DRAFT RESOLUTION MIF/DE-\_\_\_/04

Ecuador. Loan \_\_\_\_\_-EC and Nonreimbursable Technical-Cooperation Funding  
ATN/ME-\_\_\_\_\_-EC to Cooperativa de Ahorro y Crédito Desarrollo de los Pueblos Ltda.  
“Codesarrollo” to Support an Innovative Mechanism for Providing Rural  
Credit to Underserved Communities

The Donors Committee of the Multilateral Investment Fund

RESOLVES:

1. That the President of the Inter-American Development Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, as Administrator of the Multilateral Investment Fund, to enter into such agreements and to take such additional measures as may be necessary to execute and administer the operation referred to in the Donors Memorandum document MIF/AT-\_\_\_\_\_, in order to:

- (a) provide a renewable line of credit to Cooperativa de Ahorro y Crédito Desarrollo de los Pueblos Ltda. “Codesarrollo” (“Codesarrollo”) in Ecuador to support an innovative mechanism for providing rural credit to underserved communities; and
- (b) finance a technical cooperation assistance to strengthen Codesarrollo and its Credifinanciero product line.

2. That up to US\$1,200,000 is authorized for the purposes indicated in paragraph 1(a), chargeable to the Small Enterprise Investment Fund of the Small Enterprise Development Facility of the Multilateral Investment Fund.

3. That up to US\$290,000, on a nonreimbursable basis, is authorized for the purposes indicated in paragraph 1(b), chargeable to the technical cooperation resources of the Small Enterprise Development Facility of the Multilateral Investment Fund.

(Approved on \_\_\_\_\_ 2004)

[EC-M1006]