

**MULTILATERAL INVESTMENT FUND
PROJECT ABSTRACT
EC-M1006**

ECUADOR

I. BASIC PROJECT DATA

Country/Region:	Ecuador		
Program Name/Number:	Development of Rural Financial Institutions in Ecuador		
Team Leader/Members:	Alejandro Escobar (SDS/MSM), team leader; Valentina Sequi (MIF/INV); Edgar Carvajal (COF/CEC), pending (LEG).		
Date of Request:	March 2004		
Beneficiaries:	Ecuadorian rural microfinance institutions and rural Microenterprises		
Executing Agency:	Cooperativa de Ahorro y Crédito “Desarrollo de los Pueblos” Ltda. (Codesarrollo)		
Financing Plan:	MIF (IIIB)	US\$	1,200,000
	Codesarrollo	US\$	<u>1,030,000</u>
	Total	US\$	2,230,000
Tentative Dates:	MIF technical assistance (IIIA)	US\$	290,000
	Codesarrollo	US\$	154,000
	POC	July 2004	
	Donors	July 2004	

II. BACKGROUND AND PROBLEM STATEMENT

A. Background

- 2.1 The financial system in Ecuador is in the process of recovering from the severe crisis that it faced in 1998-1999. Only 22 of the 48 banks existing in 1998 still exist today but banking sector liquidity, which was reduced by more than half during this crisis, has recovered. By November of 2003, the total assets of the banking system reached \$6.704 million, representing 74% of the total financial system. Other financial entities, including financial companies, cooperatives and microfinance institutions make up the remainder 26%.
- 2.2 In January 2001, Ecuador “dollarized” its economy, thereby stabilizing the inflation rate but bringing on a significant increase in unemployment and a fall in purchasing power. More recently, the economy has begun to recover, with rising GDP, and inflationary pressures easing, bringing inflation down to 6.1%. In addition, unemployment rates fell to 9% in 2003 and real wages grew by 6.4%. Borrowing costs, however, are still high, because of banks’ weariness to lend in the aftermath of the 1998-1999 systemic crisis.
- 2.3 Amidst these changes in the economy, the microfinance sector has performed reasonably well. By the end of 2003, the outstanding microfinance portfolio in Ecuador, which included cooperatives, banks and NGOs, reached \$260 million, a significant growth from \$159 million, a year prior. It also had savings of \$144 million, and a combined arrears rate of 3.9%, much better than the banking sector’s 9.36% arrears level as of November

2003. The total number of clients served by microfinance institutions reached 335.000, compared to 265.000 in 2002.

B. The Problem

- 2.4 In spite of the growth in supply of microfinance, coverage is still limited, when compared to potential demand. 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. 40-50% of these micro enterprises are located in rural areas. It is estimated that no more than 15% of this potential clientele is being served by rural financial institutions, much fewer than other countries in the region. The rest either rely on their own resources or obtain financial services from informal sources such as shopkeepers and suppliers.
- 2.5 There are limited financial sources available for the rural population, and there has not been a systematic approach to replicate successful experiences and mechanisms. Formal financial institutions possess little knowledge of the productive dynamics in the rural sector, and therefore do not adapt their credit delivery methodologies accordingly.
- 2.6 There are some 28 regulated cooperatives, approximately 300 smaller cooperatives enrolled in the National Directory of Cooperatives and hundreds of less formal organizations, operating primarily in rural areas of the country. Many of these informal rural financial institutions (RFIs) are organized in networks, such as the Red de Estructuras Financieras Locales, which are currently clients of Codesarrollo. These networks in total represent 5% of the loan balance in the Ecuadorian financial system. While they currently offer financial services in most rural areas, they still lack sources of financing for growth, support for the incorporation of best practice principles and adequate technology.

C. Program Rationale and Additionality

- 2.7 This project seeks to provide medium term financing, as well as technical assistance and training to local RFIs. Technical assistance and training would focus on strategic planning, financial management, internal controls, and technology. This operation is a priority for the private and public sector in Ecuador, as there is an increasing understanding that rural economies must be better served with financial and non financial services, in order for them to grow.
- 2.8 The MIF's participation in the project is consistent with its mission of deepening the rural financial systems, and expanding access to financial services to micro and small enterprises. MIF's engagement in this project will demonstrate the feasibility of a two tier rural financial structure, which can be successfully implemented in an underserved market. This project will support a structure already in place, which finances small savings and loan groups, many of which have no other sources of funding other than their own savings. The executing agency's experience in this area will serve as a platform from which similar experiences can be replicated.
- 2.9 It should be noted that in 2002, the Bank approved a rural financial project (SP/TC-0202032-EC), currently being executed by the *Red Financiera Rural (RFR)*. However, these two projects have two different mechanisms, objectives, and clients, which do not overlap or compete. On the one hand the RFR responded to a specific demand for medium to long-term rural investment projects. RFR designed a loan product for rural

associations and enterprises, within and around rural commercial corridors, who needed to borrow amounts ranging from \$10,000 to \$60,000. The design of this product and its delivery cannot be changed or adapted to meet the demand for micro loans, which is at the core of Codesarrollo's proposal. This is the market that Codesarrollo wants to target through its network of RFIs, responding to a growing demand for decentralized microloans, which have shorter terms and much smaller amounts averaging \$450, and which require a different design. While the end clients of RFR are rural enterprises and associations, which provide production and marketing services in rural areas, the end clients of Codesarrollo are farmers and rural families who need access to short term microloans.

III. PROGRAM OBJECTIVES AND DESCRIPTION

A. Objectives

- 3.1 The main objective of this project is to deepen and expand the provision of financial services in rural areas in Ecuador through the deployment of a second tier line of credit housed in a nationally recognized financial institution. This deepening process will improve the access of lower-income households to financial services, and as such indirectly improve their incomes and also improve the overall competitiveness of the rural economy,.
- 3.2 The specific objectives of the project are to: (i) enable Codesarrollo to expand and consolidate a specialized line of credit, which will lend to at least 120 local RFIs and reach an approximate 15,500 clients in rural areas; (ii) strengthen the technical capacity of Codesarrollo as a second tier lending organization; and (iii) strengthen and improve the sustainability of the RFIs that primarily deliver microfinance services to the rural population.

B. Description

- 3.3 Codesarrollo has developed a pilot program to support approximately 60 RFIs that belong to the Red de Estructuras Financieras Locales network, to which they provide financing through their second tier financial instrument called *Credifinanciero*. On average, each one of these small rural Cooperatives has approximately 400 members, a portfolio of USD\$90,000 and provides credit lines for productive activities, commercial activities, and consumption, at interest rates of approximately 25%. On average, bad loans amount to 2-6% of the portfolio.
- 3.4 The project will expand, strengthen, bring to scale and improve on this financial instrument, by implementing three components:

Component I. Loan. The MIF will provide USD\$1.2 mm revolving line of credit with an exposure of no more than three years, at market interest rates. The overall availability of the loan will be five years. The loan will enable Codesarrollo to expand its *Credifinanciero* line of credit, to lend to at least some 120 RFIs by 2006, with a loan size average of \$24,000, and to reach 15,500 members.

Component II. Technical assistance grant for RFI strengthening. A technical assistance grant will be made to improve the sustainability of the RFIs through training of their managerial staff and upgrading their administrative, credit and financial management

operations. This same grant will serve to promote the formation of networks of RFIs that would serve as forums to share and coordinate issues of common interest, disseminate best practices and overall strengthen this alternative financial system.

- 3.5 In order to receive the *Credifinanciero* funds, the RFIs will have to satisfy specific criteria and receive training and technical assistance. Basic qualifying criteria would include: (i) governance, as measured by their legal status, their internal controls and management; (ii) financial strength, as measured by the health of their portfolio, and administrative costs (iii) internal capacity in terms of systems and resources; (iv) external potential, as measured by their capacity to grow and expand their markets; and (iv) prioritization of lending towards productive investments.

IV. COST AND FINANCING

- 4.1 The total cost of the project and its structure is estimated to be \$2.674.000. The MIF contribution, divided into two components, includes a \$1.200.000 loan and \$290.000 technical assistance grant to strengthen the local RFIs. Counterpart funds of \$1.030.000 will be provided by Codesarrollo, and \$154.000 by the local RFIs.

V. EXECUTING AGENCY AND EXECUTION STRUCTURE

- 5.1 Codesarrollo is a cooperative that dates back to 1972, when it was first incorporated. Having survived the various financial crisis that hit Ecuador since that time, in 1997 the cooperative was restructured with a new group of shareholders who adopted a new set of bylaws and formed what today is Cooperativa de Ahorro y Credito “Desarrollo de los Pueblos Ltda.” - Codesarrollo. Codesarrollo’s mission is to work towards the development of marginalized segments of Ecuador’s population through the promotion and strengthening of local financial systems. Codesarrollo has its headquarters in Quito and has agencies in 8 other cities.
- 5.2 Codesarrollo offers its clients savings accounts, fixed term deposit accounts, consumer loans, loans for home construction and improvements, lines of credit for local RFIs, loans to micro entrepreneurs and loans to rural cooperatives for productive operations. Close to 70% of the loan portfolio is made up by home construction and improvement loans and loans to rural cooperatives. The one featured product which will be at the core of this project is the line of credit for local RFIs, called *Credifinanciero*. At present, this product represents only 7% of the total portfolio of loans, or about \$450.000.
- 5.3 Between 1999 and 2003, the cooperative has experienced a significant level of growth. Clients with savings accounts has increased from 1.561 to 19.611. Total portfolio has increased from \$1.3 million to \$11.4 million, as of October 2003. In addition, in 2003, Codesarrollo made 6.607 loans at an average loan size of \$1.884, which demonstrates its commitment to serve the micro and small enterprises its mission calls to serve. Codesarrollo is a sustainable, profitable institution with a credit risk of 2.1%, and sufficient levels of liquidity at 27.9%.
- 5.4 To the end of September of 2003, Codesarrollo presented a diversified liability structure, with 46% of the total under savings deposits, 16% under certificates of deposits, 3% on accounts payables, and 34.6% under long-term loans. Most of the loans have terms between 36 and 48 months, and an average interest rate of 4%. These are held primarily with Italian financing agencies and cooperatives, the most important of which are Cassa

Raiffeissen, Pool Banche Di Credito and Pool Bolzano. Summarized financial statements are presented in the Attachment at the end of this document.

- 5.5 Codesarrollo's governance follows the structure of most cooperatives, with a general assembly at the top of the hierarchy, the management board underneath it, and the general manager in charge of the day-to-day operations. The organization has 56 employees, 18 of which are credit officers.
- 5.6 In 2003, Codesarrollo was given a BBB+ rating, by BRC Investor Services, a local rating agency. With this rating, Codesarrollo "*clearly showed evidence of being a good credit risk. Even though some minor obstacles are evident, these are not serious and are perfectly manageable in the short term*"¹. Codesarrollo ranks around 12 among the 30 or so regulated cooperatives, and in terms of all of its financial indicators, it compares well with most institutions within its peer group, including microfinance institutions. The rapid expansion of its portfolio has had an impact on its arrear levels. However, there has been an evident improvement in this indicator from June of 2003 to 2004, where currently the arrears stand at 8.02%.

VI. MAJOR ISSUES

- 6.1 The key issues to address during the analysis of the project, center around the capacity of the executing agency to maintain the up until now, good management of the *Credifinanciero* line of credit. While the overall good performance of the cooperative has been sustained in the past few years, a recent growth in external borrowing, coupled with the financing proposed for this project, will bear significant pressure on management to maintain and even improve its financial indicators.
- 6.2 With seven distinct credit products, all with different terms and objectives, the cooperative will need to maintain a good balance in terms of fund management. How the cooperative plans to do this will be another issue to address.
- 6.3 At the end of 2002, the Superintendency of Banks adjusted the criteria to measure arrears in microfinance institutions. Careful analysis should be undertaken to estimate the impact of further more rigorous adjustments that the Superintendency may implement, in light of the apparent growth of the microfinance sector.
- 6.4 Codesarrollo needs to further strengthen its capacity to analyze the RFIs who access its line of credit *Credifinanciero*. The project should take good practice and lessons learned from other successful rural financial organizations who do second tier lending in the region.
- 6.5 Finally, the following issues must be analyzed in greater detail in the due diligence mission for this project: (i) the performance of the local RFIs and their legal and governance structure, (ii) the appropriate market interest rate and appropriate loan terms, (iii) required loan collateral, and (iv) the potential impact of a new financial crisis.

VII. ENVIRONMENT AND SOCIAL ISSUES

- 7.1 Codesarrollo will contractually enforce that the local RFIs lend to projects that do not have a negative impact on the environment. While little effective capacity exists to

¹ Translated from the original report's explanation of the rating.

monitor and enforce this, experience in lending to this sector has demonstrated that productive activities are for the most part small in nature and do not pose serious threats in terms of waste and contamination. About 40% of Ecuadorians living in extreme poverty are located in rural areas, and the greatest impact of this condition affects children, of which 52% live with chronic malnutrition. The rural emphasis of this project presents a strong social impact, by presenting increased opportunities for rural dwellers and families to sustain and improve their livelihood.

VIII. ACTION PLAN

The following is a preliminary schedule for the project's approval process:

CESI	July 2004
Due Diligence	August 2004
Donors Committee	September 2004

ATTACHMENTS

Summarized financial statements Codesarrollo

EVOLUCION Y PROYECCION DEL BALANCE GENERAL
COOPERATIVA DE AHORRO Y CREDITO "DESARROLLO DE LOS PUEBLOS" LTDA.
(en dólares americanos)

		EVOLUCION		
CONSOLIDADO	DATOS AL:	31-dic-01	31-dic-02	31-Dic-03
1 ACTIVO				
FONDOS DISPONIBLES		606.805	1.792.394	2.599.484
INVERSIONES		170.565	586.868	1.455
CARTERA DE CREDITOS		4.048.884	6.442.948	12.080.119
Cartera de credito por vencer		3.944.815	6.219.313	12.014.435
Creditos vencidos		54.604	160.614	248.758
Cartera que no devenga intereses		183.953	334.080	672.758
(Provision para creditos incobrables)		-134.488	-271.059	-855.932
CUENTAS POR COBRAR		2.326	75.295	221.406
PROPIEDADES Y EQUIPO		95.689	92.659	168.128
OTROS ACTIVOS		135.790	77.907	85.551
TOTAL DEL ACTIVO		5.060.659	9.068.071	15.156.143
2 PASIVO				
OBLIGACIONES CON EL PUBLICO		3.931.144	6.404.556	9.321.221
Depositos a la vista		2.398.388	4.064.291	6.393.340
Depositos a plazo		1.532.756	2.340.266	2.927.881
CUENTAS POR PAGAR		40.932	142.702	584.321
OBLIGACIONES FINANCIERAS		231.406	1.235.121	3.375.936
OTROS PASIVOS		188.496	589	39.933
TOTAL PASIVOS		4.391.978	7.782.968	13.321.411
3 PATRIMONIO				
CAPITAL SOCIAL		550.800	777.200	923.400
Aportes de socios		550.800	777.200	923.400
RESERVAS		39.709	78.070	104.456
Legales		12.052	21.295	28.365
Especiales		-	29.118	48.434
Revalorizacion del patrimonio		27.657	27.657	27.657
OTROS APORTES PATRIMONIALES		49.054	392.863	756.992
Donaciones		49.054	392.863	756.992
SUPERAVIT POR VALUACIONES		-	-	3.950
RESULTADOS		29.118	36.970	45.935
TOTAL DEL PATRIMONIO		668.881	1.285.103	1.834.732
TOTAL PASIVO + PATRIMONIO		5.060.659	9.068.071	15.156.143

EVOLUCION Y PROYECCION DEL ESTADO DE RESULTADOS
COOPERATIVA DE AHORRO Y CREDITO "DESARROLLO DE LOS PUEBLOS" LTDA.
(en dólares americanos)

EVOLUCION				
CONSOLIDADO	DATOS AL:	31-dic-01	31-dic-02	31-Dic-03
INGRESOS FINANCIEROS		713.463	1.197.451	2.208.261
Intereses y descuentos ganados		580.388	1.042.313	1.940.058
Comisiones ganadas		133.075	147.483	254.069
Utilidades financieras		-	-	-
Ingresos por servicios		-	7.654	14.134
EGRESOS FINANCIEROS		271.291	471.164	768.685
Intereses causados		271.291	434.962	760.559
Costos Financieros externos		-	36.202	-
Pérdidas financieras		-	-	8.126
MARGEN BRUTO FINANCIERO		442.172	726.287	1.439.576
OTROS INGRESOS Y GASTOS OPERACIONALES		-218.858	-439.331	-685.915
INGRESOS OPERACIONALES		21.092	-	-
EGRESOS OPERACIONALES		239.950	439.331	685.915
Gastos de operación		239.950	439.331	685.915
MARGEN OPERACIONAL ANTES PROVISIO		223.314	286.956	753.662
PROVISIONES, DEPRECIACIONES Y AMOR		129.233	195.640	666.992
Provisiones		16.477	148.408	606.158
Depreciaciones		18.059	22.938	34.280
Amortizaciones		59.544	24.294	26.553
MARGEN OPERACIONAL NETO		94.081	91.316	86.670
INGRESOS Y GASTOS NO OPERACIONALES		-1.072	-16.755	5.237
UTILIDAD ANTES DE IMPUESTOS Y PARTI		58.472	74.561	91.907
Participación trabajadores		8.771	11.184	13.786
UTILIDAD ANTES DE IMPUESTOS INNFA		49.701	63.377	78.121
Impuesto INNFA		744	1.268	1.562
BASE IMPONIBLE IMPUESTO A LA RENTA		36.465	62.109	76.558
Impuesto a la renta		12.493	15.897	19.140
RESULTADOS A DISPOSICION DE ACCION		29.118	46.213	57.419