

GLOBAL MICROENTERPRISE CREDIT PROGRAM

(PE-0035)

EXECUTIVE SUMMARY

BORROWER,
GUARANTOR AND
BENEFICIARY:

Republic of Peru

EXECUTING AGENCY:

Corporación Financiera de Desarrollo S.A. [Development Finance Corporation] (COFIDE)

Technical cooperation

Components A, B and C

Component D:

COFIDE

Superintendencia de Banca y Seguros [Superintendency of Banking and Insurance] (SBS)

AMOUNT AND SOURCE:

IDB: US\$25.0 million (FSO/local currency)

Local counterpart funding: US\$10.7 million

Total: US\$35.7 million

Technical cooperation

Cofinancing: US\$2.75 million (Swiss francs)

Local contribution: US\$1.20 million

Total: US\$3.95 million

By letter of September 6, 1995, the Swiss government, through the Swiss Development Cooperation Agency (COSUDE), confirmed that it was prepared, in principle, to cofinance the technical cooperation program. Because of internal approval procedures, the Swiss government's final decision cannot be taken before December of this year.

FINANCIAL TERMS
AND CONDITIONS:

Amortization period: 30 years

Grace period: 7 years

Disbursement period: 3 years

Commitment period: 2.5 years

Interest rate: 2%

Inspection and supervision: 1%

Technical cooperation

Execution period: 3.5 years

Disbursement period: 4 years

OBJECTIVES:

General: To expand access to institutional credit for formal and informal urban, suburban and rural

microenterprises, with the aim of fostering the ability of low-income persons with entrepreneurial talent to make the most of economic opportunities offered by the country. Specific: To enable the participating intermediary financial institutions (IFIs) to meet, on a self-sustaining basis, a growing proportion of the credit demand from microenterprises, with due observance of environmental requirements and also utilizing local resources.

Technical cooperation

General: To help develop an efficient institutional framework that will ensure continued access to credit for microenterprises. Specific: (i) to increase the operational and monitoring capability of COFIDE as regards its financing operations for microenterprises; (ii) to strengthen the operating and administrative capacity of the participating IFIs in their lending operations with microenterprises, and foster loan officers' awareness of gender issues in microenterprise lending; (iii) to increase the environmental awareness of the participating IFIs, and especially that of their microenterprise loan officers; and (iv) to expand the range of credit information services offered by the SBS to the formal financial sector, especially for lending operations involving less than US\$4,500 equivalent.

DESCRIPTION:

The program resources will be used, in keeping with the multisectoral nature of the program, to finance short- and medium-term loans to eligible individuals and juridical persons in the microenterprise sector.

Technical cooperation

The technical cooperation resources would be used to finance, primarily, consultancy services in four areas: (i) advisory services and training for COFIDE personnel in topics connected with credit technology for microenterprise financing and support for the IFIs participating in the program in their tracking and monitoring work; (ii) advisory services and transfer of credit technology to the IFIs participating in the technical assistance, and training of their microenterprise loan officers, including the instillment of an awareness of issues having to do with the importance of women microentrepreneurs in credit programs; (iii) advisory services and training for COFIDE personnel and the loan officers of the IFIs participating in the program, on topics connected with protection of the environment in microenterprise credit programs; and (iv) advisory services to the SBS

for expansion of its Central Risk Data Unit as regards the recording of lending operations in the formal financial sector involving amounts of less than US\$4,500 equivalent.

**ENVIRONMENTAL
CLASSIFICATION:**

At its March 21, 1995, meeting, the Environment Committee classified this as a Category III operation. The environmental summary was approved on August 15, 1995.

BENEFITS:

For microenterprises: The proposed program will help to broaden, diversify and increase the future credit supply from the financial sector for microenterprises. It will also increase competition in the microenterprise segment of the bank loan market, which will bring effective interest rates and transaction costs down for the banks' microentrepreneur clients. These effects, plus the opportunity to lessen the target group's dependence on informal sources of financing, will generate a significant redistributive impact. The program also will have a positive impact on women, given their extensive involvement in the microenterprise sector. Lastly, it will represent an important step for increasing microenterprise owners' environmental awareness, by involving them in ensuring safety, hygiene, occupational health, and protection of the environment.

For IFIs: The program will bring about a sustained deepening of the financial sector, since the participating IFIs will contribute to the development of a new segment of the loan market. The impact on the financial market will consist in widespread availability of a new lending product in a context of competitiveness and efficiency. By making microentrepreneurs part of the bank credit market it will increase the banking system's operating base, thereby facilitating diversification of risk and lessening its reliance on medium-sized and large enterprises as clients. In addition, with the increase in the number of clients the demand for other types of banking services will also increase. The small nonbank IFIs, given access to stable and long-term financing, will be able to reduce the volatility factor and diversify their liabilities, plan the growth of their loan portfolios and lengthen the average term of their microenterprise lending. The growth of their loan portfolios will enable this group of IFIs to improve their institutional credibility in the financial markets, which is a basic requirement for mobilizing more of the public's savings and for issuing corporate bonds in the medium and long term.

- POVERTY TARGETING:** The great majority of the program beneficiaries will be poor, according to the criteria set by the Bank.
- RISKS:** The greatest risk to accomplishment of the program's expected impact in financial and economic terms would derive from absence of the economic, financial and institutional environment necessary for the efficient channeling of stable credit resources to the microenterprise sector. This risk is low because the medium-range prospects for the Peruvian economy are very favorable, given that the new government will continue with its economic program. The operation proposed herein includes measures to help make certain that the institutional and financial environment needed for its implementation will be in place.
- THE BANK'S COUNTRY AND SECTOR STRATEGY:** The Bank's operating strategy in Peru is focused on support for five priority areas: (i) consolidation of the adjustment program and structural reforms; (ii) institutional strengthening of the public sector; (iii) privatization and development of the private sector; (iv) mitigation of poverty and fostering of social progress; and (v) rehabilitation of the productive sectors and of economic infrastructure. The proposed operation will directly promote the aims of points (iii) and (iv) of the Bank's strategy.
- SPECIAL CONTRACTUAL CONDITIONS:**
- a. Before the first disbursement from the loan, the borrower, through COFIDE, shall submit to the Bank:
 - The agreement concluded between the borrower and COFIDE for the transfer of resources and execution of the program (see paragraph 3.3)
 - Evidence that the program Credit Regulations have been put into effect (see paragraph 3.5)
 - At least five subsidiary participation agreements concluded with IFIs eligible to participate in the program (see paragraph 3.5)
 - The environmental materials that are to be available to the IFIs from the start of the program to use in the credit analysis of their subborrowers (see paragraph 3.28).
 - b. Agreement between the borrower and the Bank that the Bank will not process any disbursement request that, when added to other disbursements effected, would exceed 30% of the proceeds of the loan, until the executing agency has demonstrated to the Bank that the consulting services for component B of the technical cooperation have been engaged (see paragraphs 3.26 and 3.33).

- c. Agreement between the parties that the advance of funds will not exceed 20% of the loan amount (see paragraph 3.26).
- d. A commitment that proceeds of the loan will not be lent to any applicant of those listed in paragraph 3.23.
- e. A commitment to use funds deriving from the interest spread and from loan repayments for the specified purposes and for the prescribed period of time (see paragraphs 3.24 and 3.25).
- f. COFIDE shall submit to the Bank, within the first six months of each calendar year, beginning the calendar year following the first disbursement under the program, an environmental evaluation of a sample of microenterprises financed with program resources, for the purpose of verifying compliance with the environmental safeguards recommended by the IFIs and agreed upon with the subborrowers (see paragraph 3.29).
- g. COFIDE shall submit to the Bank, as part of the semiannual progress reports, the information specified in paragraph 3.40.
- h. COFIDE shall submit its financial statements, and the financial statements for the program, each year throughout the program disbursement period and for seven years after the end of that period (see paragraph 3.41).
- i. COFIDE shall submit to the Bank the findings of the ex post evaluation of the program, in accordance with the terms and conditions laid down in paragraphs 3.42 and 3.43.

Technical cooperation

- a. Before the first disbursement from the resources of components A, B and C of the technical cooperation, the beneficiary, through COFIDE, shall submit to the Bank:
 - The agreement for transfer of the resources and execution of these components (see paragraph 3.4)
 - Evidence that the consulting services required for the component designed to raise the IFIs' environmental awareness have been engaged (see paragraph 3.35).

- b. Within six months after the date of signature of the technical cooperation agreement, COFIDE shall engage the services of consultants required for the for follow-up and monitoring of the IFI microenterprise loan portfolios financed with program resources (see paragraph 3.32).
- c. Before proceeding with a final selection of IFIs that are to benefit from component B (advisory support and transfer of credit technology to IFIs), COFIDE shall submit to the Bank for approval the Rules for Selection of IFIs, which are to be drawn up in concert with the consulting firm to be hired to carry out this component (see paragraph 3.34).
- d. COFIDE shall undertake to sign a participation agreement with each IFI eligible to take part in the technical cooperation, using the model agreed upon with the Bank (see paragraph 3.36).
- e. Before the first disbursement from the resources of component D of the technical cooperation, the beneficiary, through the Superintendency of Banking and Insurance, shall submit to the Bank:
 - The agreement for transfer of the resources and execution of this component (see paragraph 3.4)
 - Evidence that the consultancy services for the expansion of the Central Risk Data Unit have been contracted (see paragraph 3.37).

EXCEPTIONS TO BANK
POLICY:

None

I. FRAME OF REFERENCE

A. Macroeconomic setting

- 1.1 As a result of the stabilization program and structural reforms initiated by the Peruvian government in August 1990, Peru's economy moved into a recovery phase as of 1993. Rebounding from the recession of 1988-1992, the gross domestic product (GDP) grew by 6.5% in 1993 and by 12.9% in 1994. Inflation was brought down from its peak of 7,650% in 1990 to 39.5% in 1993 and 15.4% in 1994. The dynamism displayed is largely explained by greater use of installed capacity, without any significant expansion of the country's productive base; it is important to emphasize that real GDP at the end of 1994 was still 7% below the 1987 level.
- 1.2 There is today a propitious environment for increasing investment, which is also favored by the prevailing political stability, the surge in external investment, and the fact that terrorism has been brought under control, combined with the reduction in violence. The recovery posted in 1993-1994 has been accompanied by an upturn in investment, from 15.5% of GDP in 1990 to 21.3% in 1994. The conditions would therefore appear to be being created for a transformation of the productive base that will complement the important structural reforms and be conducive to economic growth in the medium term.
- 1.3 Despite the success achieved with the economic program and the reestablishment of peace and public order, structural poverty still persists. It is estimated that around 50% of Peru's total population is poor, and that about 20% lives in extreme poverty.
- 1.4 The economic recovery of the last two years has not yet given rise to any sizable increase in demand for labor from the modern sector of the economy, despite the fact that conditions in the labor market can be considered favorable given the drastic decline in real wages during the recession years. 1/
- 1.5 The past two decades have witnessed a significant expansion of the formal and informal microenterprise sector, as a means for coping with what was virtually a permanent economic crisis and also as a strategy for family survival. This expansion is therefore closely bound up with the deepening of structural poverty. The sector's ranks have been swollen by persons displaced by the downsizing of government and by privatization moves. They have been joined by

1/ In 1992, the real income of private sector wage-earners was only 35% of the 1981 level; for public sector wage-earners the figure was only 10%.

others who have moved into the cities from the mountain and rural areas because of the lack of economic opportunities in those parts of the country and their recent history of violence.

- 1.6 In this context, financial support for urban and rural microenterprises as envisaged in the program proposed in this document assumes great importance because of its contribution to employment and income generation in the low-income sectors, especially since the bulk of the country's future investment will be concentrated in highly capital-intensive sectors such as mining, oil, industry, construction and telecommunications. It is very unlikely that the growth of these modern sectors will generate sufficient semiskilled and unskilled jobs to combat poverty effectively.

B. The microenterprise sector in Peru

1. Characteristics and significance of the sector

- 1.7 As is the case elsewhere in Latin America, there are few empirical studies available on the magnitude and economic importance of the microenterprise sector in Peru. Moreover, the informal nature of the great majority of these economic units makes it difficult to present empirical data encompassing the complete universe of business operations. Accordingly, to illustrate some basic characteristics of the sector, use has been made of unofficial estimates and the findings of a survey made in October 1989 of small-scale productive units in the metropolitan Lima area, published by the Central Reserve Bank of Peru (BCR) in 1992. ^{2/} While this research was limited to metropolitan Lima, it can be assumed that the basic structural features of the sector in the other major urban centers in the country's coastal region are similar.
- 1.8 There are estimated to be around 1.4 million urban microenterprises (one to nine persons), and some 1.4 million economic units operating in rural areas (smaller than 10 hectares). The majority of these enterprises fall in the informal category. Microenterprises employ around six million persons, i.e. 75% of the economically active population (EAP). The sector is estimated to account for 40% of GDP. Although nationally the percentage of women in the EAP is 32%, their participation in the informal sector's economic activities is put at between 45% and 50%. These indicators are among the highest in Latin America.
- 1.9 The first basic characteristic of the sector is that the vast majority of microenterprises are operated by just one person. In October 1989 there were around 768,000 microenterprises in

^{2/} Central Reserve Bank of Peru (1992). Statistical Compendium. Survey of Small-Scale Commercial Units in Metropolitan Lima.

metropolitan Lima, 67% of which (some 515,000) were operated by a single person; 30% employed between two and four persons, and only 3% had five to nine employees. 3/

- 1.10 A second important feature is that a significant proportion of microenterprises are run by women. According to the survey, 43% of the enterprises belonged to women. This percentage varied by sector: in the commerce sector women owned 51% of the enterprises, while in services and industry the figures were 38% and 37% respectively. Only about 9% of the enterprises classified in "other activities" were owned by women. As regards enterprise size, 47% of the one-person enterprises and 38% of those employing two to four persons were run by women.
- 1.11 Microenterprises provide employment for a significant percentage of the population, the October 1989 estimate being that around 55% of metropolitan Lima's EAP worked in microenterprises.
- 1.12 The great majority of microenterprises operate in the trade sector. According to the sector breakdown of the survey, 67% of the enterprises were engaged in commercial trade, 12% in services, 9% in industry, and 12% largely in transportation and construction. The breakdown by size shows that the one-person enterprises accounted for the same percentage in the trade sector, but were slightly fewer in the industry and services sectors and somewhat more prominent in the "other activities" category.
- 1.13 Regarding the subbranches of activity, there is a high concentration of microenterprises in a small number of economic activities. In the metropolitan Lima retail trade sector, microenterprises selling foodstuffs and beverages (25%), fruit, vegetables and other unprepared foods (20%) and clothing and footwear (16%) predominated. In services, restaurants and cafés (37%), repairs (27%) and miscellaneous personal services (20%) led the field. The most important subbranches of the industrial sector were garment-making (44%), woodworking (23%), footwear (6%) and metalworking (8%).
- 1.14 The available information shows the socioeconomic importance of the sector, in that it provides employment for a significant number of women and largely unskilled workers. Employment opportunities for low-income workers are particularly dependent on development of microenterprise activities. This means that measures to strengthen the sector will have a positive impact on the country's socioeconomic situation.

3/ According to the BCR, only 1% of all the enterprises surveyed employed between 10 and 50 persons. For presentation purposes, this group of "small enterprises" has been disregarded.

2. Main problems of the sector

- 1.15 The microenterprise sector's capacity to operate effectively in increasingly competitive markets has been limited by, among other factors, lack of access to appropriate technology, business training and advisory services, appropriate financial services, quality inputs, domestic and external markets and information services. There is little security in the sector with regard to property titles and it needs a simple and stable regulatory framework. The future development of the microenterprise sector will accordingly require multiple actions on different fronts. The proposed operation is designed to resolve the problems connected with access to financial services.

3. Demand for and access to credit and appropriate credit technology

a. Demand for credit

- 1.16 Very few of the 2.8 million urban and rural microenterprise units in Peru (probably no more than 50,000, or less than 2% of the total, according to estimates) have access to formal or semiformal financial services. This figure includes microenterprises served by municipal savings and loan banks, rural savings and loan banks, commercial banks extending "personal credit", and nongovernmental organizations. The vast majority of these economic units have to rely on a series of very costly informal financing arrangements, or simply have no outside financing available to them. The very small number of those that are being served by the formal and semiformal market suggests that there is a large demand for microenterprise credit that is not being met in Peru.
- 1.17 The chief reasons for such minimal access to more formal financing sources are (i) the limited institutional capacity of financial institutions, and (ii) the fact that these institutions do not have in place credit technologies tailored to microentrepreneurs' needs. These factors have impeded the development of a massive, self-sustaining supply of credit to this sector. Furthermore, absent any real competition among formal and semiformal lenders for the microenterprise market, the few financial institutions that specialize in such lending can charge relatively high effective interest rates (though the rates are still well below those prevailing in the informal market). ^{4/}

^{4/} At the end of March 1995, the municipal banks, without charging any additional fee, were realizing real effective interest rates of 3.5% per month (i.e., 51% per annum) on local-currency loans. By charging flat fees, coupled with forced saving in the case of the rural savings and loan banks, most of the lending NGOs and rural banks were able to charge real effective interest rates of a minimum of 6% to 8% per month (101% to 152% per annum). This bespeaks the scant competition in the market and operating inefficiencies. Similar minimums in the informal market were around 15% monthly (435% per annum).

- 1.18 The aim of the proposed operation is to attend to the massive demand for microenterprise credit by introducing an appropriate lending product which will allow financial institutions to lower their administrative costs. As more competition is introduced into the formal microenterprise lending market, interest rates should come down considerably, and this in turn will stimulate the target group's demand for this type of credit. One illustration of the vast potential that exists for lending to microenterprises is the spectacular growth of the microenterprise portfolio in the municipal savings and loan banks: between December 1992 and July 1995, portfolios of the municipal savings and loan banks (CMACs) soared from US\$2.7 million (and fewer than 4,000 microenterprise clients) to US\$23 million (with 30,000 clients). Given the unmet demand for credit in this market segment, it can be expected that the financial sector will be able to onlend the program resources within the proposed commitment period.

b. Access to credit

- 1.19 One of the main obstacles to microenterprise development is formed by the constraints and barriers they have to surmount to obtain timely access to the formal credit market. Until quite recently Peruvian banks were reluctant to lend to microenterprises because they perceived such operations as risk-fraught and costly. Moreover, the vast majority of microenterprises were unable to provide the guarantees traditionally required by the banks.
- 1.20 At the same time, the positive experience of the CMACs has shown that with well-designed credit technology and properly trained loan officers, microenterprise credit can be profitable business and portfolio quality can be maintained.
- 1.21 Furthermore, experience shows that microenterprise credit demand is not very elastic with respect to interest rates, so that interest costs are not the chief obstacle to access to formal credit. In addition, credit programs with subsidized interest rates reach only a small percentage of the total target group and do not permit coverage of the intermediaries' operating costs, so maintaining a sustainable credit supply under this approach is difficult.
- 1.22 The financial system does not at this time have data on the credit history of microenterprise clients served by formal financial institutions. This is because the Central Risk Data Unit operated by the Superintendency of Banking still does not record formal financial system lending operations in amounts of less than US\$4,500 equivalent. Having access to this information would help the financial institutions to reduce the risks in their lending to microenterprises, and would assist the microenterprises in developing banking relations with the financial sector.

- 1.23 The difficulties in obtaining access to formal credit in particular have made it hard for low-income individuals with an entrepreneurial bent to seize economic opportunities. This constraint has also served to aggravate the inequality in income distribution, since it leads to a significant resource transfer from the low-income population to informal credit sources, such as moneylenders, input suppliers, wholesalers and carriers. The program described in this document seeks to help reverse this process, by developing a competitive lending product for use by the formal financial sector.

c. Appropriate credit technology

- 1.24 Taking into consideration that microenterprises cannot normally offer the type of information or guarantees required by traditional banks, the main characteristic of an appropriate credit technology in Peru would consist in making it possible for financial institutions to obtain more information about the applicant and the guarantees he or she can give. Herein lies the conceptual distinction between credit programs for microenterprises and traditional credit programs.
- 1.25 Microenterprise financing should be based on credit analysis and monitoring of the "credit recipient", rather than analysis and appraisal of the creditworthiness of the "project" to be financed. Appraisal of the creditworthiness of a "project" to be financed is very difficult in itself in the case of working capital financing and is even less feasible for microenterprises, i.e. when the borrower is the owner of an economic unit characterized by indivisibility of the household unit and the business proper. The credit regulations for a microenterprise credit program should accordingly take this distinctive feature of the microenterprise sector into account.
- 1.26 In short, the fundamental components of a credit technology effective for Peru are: (i) strictly individual loans; (ii) credit analysis focusing on the applicant's family economic unit and only marginally on the project to be financed; (iii) flexibility and adaptability of guarantee requirements; (iv) a phased approach that allows for progressive increases in loan amounts as the beneficiary honors his or her obligations; (v) personalized client/loan officer relationship; (vi) loan officers operating under a monetary incentive system that motivates them to administer a large number of loans in their respective portfolios and seek to maintain portfolio quality, i.e. to keep delinquency to a minimum; (vii) a strict and effective policy of following up on delinquent borrowers; and (viii) standardization of procedures using software that supports the analysis, approval, monitoring and recovery process for microenterprise credit.

C. The financial system and funding for microenterprises

1. Reforms, legislation, and regulations

- 1.27 The program of structural reforms in the economy has had a profound impact in the financial sector, which has helped to overcome financial restraints by changing the structure and ground rules of financial intermediation. Interest rates have been decontrolled and reserve requirements lowered, the State-owned commercial banks have been privatized and the development banks have been liquidated. A new Banking Law has been passed, prudential regulations have been reformulated and both the Central Reserve Bank (BCR), which now has as its sole function the maintaining of monetary stability, and the Superintendency of Banking and Insurance (SBS) have been strengthened.
- 1.28 The chief characteristics of the new Banking Law of October 1993 (D.L. 770) are: (i) equal treatment of all financial institutions, whether public or private, as regards authorized operations, required reserves, minimum capital and limits on concentration of credit; (ii) minimum capital requirement, application of the Basle rules, automatically adjustable to take account of inflation and not modifiable at the authorities' discretion; (iii) elimination of the BCR's discretionary authority to establish directed credit programs; (iv) market freedom for setting borrowing and lending rates; and (v) authorization for establishment of consumer credit companies and of rural savings and loan banks (CRACs).

2. Financial intermediaries important for microenterprises

a. Commercial banks

(i) Financial performance

- 1.29 The banking system has improved in recent years and, according to the indicators submitted by the SBS, the financial position of the majority of the commercial banks is good. The average rate of return on capital in 1994, after taxes in real terms, was 12.57%. Of the 22 commercial banks operating at the end of 1994, only two posted a loss, one of them since it has only recently begun operation.
- 1.30 The profits earned by the majority of the banks have not been solely due the charging of relatively high interest rates, but have also been a result of increased operating efficiency. Thus, since 1992 the commercial banks' assets have increased by 81% in real terms, while the number of employees has been reduced. In 1993, the ratio of operating costs to earning assets was 12.5% on average for commercial banks, whereas at the end of 1994 this indicator was down to 8.9%, i.e. a substantial improvement.

- 1.31 Loan portfolio quality also improved in the commercial banks. As of the end of 1994 the average delinquent portfolio stood at 7%, compared with almost 19% in 1993. Six of the commercial banks had a delinquent portfolio exceeding 15% over this period. The average overdue portfolio as of the end of 1994 was 75% provisioned.
- 1.32 Pursuant to the Basle accord, since October 1994 the Peruvian authorities have been prescribing minimum bank capital requirements of 8% of assets, risk-weighted. In compliance with this requirement, as of the end of 1994 the commercial banks showed average effective capital equivalent to 9.3% of their risk-weighted assets.
- 1.33 In brief, the evaluation of performance and solvency based on ratios such as return on capital, portfolio delinquent and in process of collection by legal means under 7%, and compliance with the Basle accord, leads to the conclusion that of the total number of 22 private banks, 11 can be considered financially sound, six are less secure, and three are in trouble. Ratios for two recently established banks are not yet available.

(ii) Commercial banks and small business and microenterprise

- 1.34 The commercial banks' experience with lending to small firms and microenterprises is basically limited to financing provided through COFIDE's different lines of credit. In 1994, a total of 529 loans aggregating US\$17 million were granted through the PROPEM-CAF line. However, this figure only included 22 loans of less than US\$5,000, and the number of loans of between US\$5,000 and US\$10,000 was also very small, namely 93 in 1994. Although in theory this COFIDE credit line allows lending to microenterprises, since it has a lower limit of US\$2,000, in practice none of the banks uses this option. The amounts of the loans made under the COFIDE program suggest that the beneficiaries are generally small and medium-sized enterprises with access to the banking system.
- 1.35 Up to the end of 1994, the commercial banks had made very few direct loans to the microenterprise segment; when they did so, it was usually in cooperation with an NGO lender, and in some instances they limited themselves to disbursement and collection of the loans. The credit risk was always placed with a trustor and the NGO was responsible for the approval and monitoring process. Banco Continental, Banco Wiese, Banco del Sur, Banco del Norte and Banco Financiero have operated in this way, in conjunction with NGOs.
- 1.36 Since the end of 1994 a change has been taking place in the commercial banks' business strategy with respect to the microenterprise sector. They are increasingly finding themselves obliged to extend their services to this segment of the market because of the competitive pressure that is developing in the more traditional segments. In addition, the positive example of the municipal

savings and loan banks has made them realize that lending to microenterprises can be profitable. Some commercial banks, including Banco de Crédito, Banco del Sur and Banco Latino, have made the decision to serve this segment directly, assuming all the risks themselves. Banco del Trabajo, a new bank concentrating primarily on consumer lending in metropolitan Lima, plans to start lending to microentrepreneurs in four major provincial cities. 5/

- 1.37 In the course of the interviews conducted during preparation of this operation it was ascertained that certain commercial banks in the "financially sound" group were interested in developing micro-enterprise credit operations. The commercial banks can accordingly be considered an important group for implementation of the proposed operation, which is a most positive development since this time a year ago. It has also been confirmed that the main obstacle for the banks is lack of know-how, i.e. the fact that they do not possess credit technology suited to the characteristics of the microenterprise sector or staff with the required training.

b. Municipal savings and loan bank system

- 1.38 The municipal savings and loan banks (CMACs) are formal, regulated financial institutions which operate on a nonprofit basis, with juridical personality under public law and possessing economic, financial and administrative autonomy. The legal owner of each CMAC is the respective Provincial Council, i.e. the local administrative authority. They are governed by special legislation, the requirements of which have been incorporated into the Banking Law. Each bank is run by an executive committee in which representatives of local civil society appointed by the mayor form a majority. The 12 CMACs currently in operation in 15 cities, with 35 provincial offices, were established in the 1980s and do not lend to enterprises or public institutions. 6/

(i) Financial performance

- 1.39 At the end of 1994 the CMACs' total assets amounted to some US\$38 million and their liabilities to banks and other financial

5/ Banco Wiese is experimenting for the first time with direct lending to microentrepreneurs. It has obtained US\$400,000 from the Microenterprise Development Fund (FONDEMI) for this purpose, with the bank carrying 50% of the risk.

6/ Caja Municipal de Crédito Popular de Lima [Lima Municipal Loan Bank] (CMCPL) does not belong to the CMAC system. It is governed by specific legislation and has different characteristics from the CMACs. Owing to CMCPL's considerable economic difficulties it is not considered in this document and would not participate in the program.

institutions totaled US\$7 million. Their menu of lending products includes business loans, credit against chattel mortgages and personal loans. As of July 1995 the system had 114,000 borrowers, close to 30,000 of whom were microentrepreneurs. Their business portfolio totaled US\$23 million, or more than 64% of their total loan portfolio of US\$35.7 million. Their average microenterprise loan was less than US\$1,000.

- 1.40 The CMACs attract savings from the public, either in the form of current savings accounts or fixed-term deposits, but they are not permitted to offer current accounts. As of July 1995 they had over 59,000 savings customers with a total of some US\$27.1 million on deposit.
- 1.41 The CMACs' strong financial performance is also noteworthy, comparing well with that of the commercial banks. In 1994 the system posted a real rate of return, after taxes, of 6% on earning assets and 28% with respect to capital of some US\$7.8 million. It should be noted that this relatively high figure is due to the sacrifice of the CMACs' workers, since the Peruvian government has not authorized any increase in CMAC wages since 1994.
- 1.42 With business loans more than 15 days overdue representing only 4.2% of that part of their portfolio (and such overdues amounting to 5.7% of their total portfolio) as of the end of 1994, a figure that was even lower than the figure for the banking system, the CMACs' loan operations with microenterprises were clearly of sound quality. In terms of effective capital in relation to risk assets, the CMACs show a better margin since they have so far done less intermediation than the banks and their risk-weighted assets are of good quality. This is the result of applying appropriate credit technology that enables them to strike a balance between the principles of targeting and efficiency. This technology was introduced with the assistance of the German government through the German Agency for Technical Cooperation (GTZ) and the Bank. The results achieved also reflect the control and supervision work done by the Federación Peruana de Cajas Municipales de Ahorro y Crédito [Federation of Municipal Savings and Loan Banks of Peru] (FEPCMAC), to which all CMACs are required to belong.
- 1.43 CMAC lending to microenterprises entails particularly high personnel and administrative costs, which are passed on in the form of relatively high interest rates for microenterprise clients. The ratio of administrative costs to average portfolio in 1994 was 17.6%; however, compared with the figure of 32% for 1993 it is apparent that the CMACs have managed to improve their operating efficiency. The high administrative costs observed are due primarily to the following reasons: (i) their institutional focus on serving the low-income population obliges the CMACs to operate at the edge of the financial market; (ii) their scale of credit operations is still small; (iii) there is little competition in this segment of the credit market; (iv) there is a lack of

structural incentives in CMACs (ownership structure, executive committee) for keeping costs down; and (v) as a result of the preceding point, and especially in some of the larger CMACs, there is no effective internal control system.

(ii) Municipal Savings and Loan Banks Fund

- 1.44 The CMAC system also has a Municipal Savings and Loan Banks Fund (FOCMAC), the main purposes of which are to stimulate balanced growth of the resources intermediated by the CMACs and ensure equitable allocation of the funds they attract, taking into account the CMACs' liquidity needs and their participation in FOCMAC. In addition, FOCMAC forms the institutional base for a future clearinghouse and liquidity-equalizing mechanism for the CMAC system. Currently, because they contributed the initial capital, the CMACs are the sole owners of the FOCMAC. However, the FOCMAC Law permits private sector participation in the share capital up to 49%. In 1994 FOCMAC administered total assets amounting to some US\$589,000 and memorandum accounts totaling US\$1.5 million. The current portfolio amounted to almost US\$2 million (including funds in trust). At the close of the fiscal year the portfolio was arrears-free. The real rate of return on capital was 21%, on capital of US\$94,000. As of the end of June 1995 the capital stood at about US\$640,000 and the CMACs are prepared to increase it to US\$1.5 million by June 1996.

(iii) Future challenges

- 1.45 Now that the commercial banks are beginning to move into the micro-enterprise segment of the credit market even in the provinces, it is vital that the CMAC system start to take steps to hold and expand its share of this market against this future competition.
- 1.46 So far the CMACs have been concentrating mainly on short-term loans, because of the limited resources available to them: up to the end of 1993 virtually their only sources of funds were savings - for the most part 90-day fixed-term deposits - and their own corporate capital. To reduce the high volatility of CMAC liabilities and diversify them, and also to be able to plan the growth of lending operations better while lengthening the average maturity of portfolios, the CMAC system needs to secure greater access to long-term funding, inter alia by borrowing more from COFIDE.
- 1.47 Under the CMAC system's existing legal framework, there is no way to institute the measures that would be needed to bring down the system's administrative costs. Among other options, the merging of various CMACs into a single institution at departmental level should be considered, since this would significantly reduce fixed costs. Thought should also be given to (partial) private sector participation in the system's share capital, thereby in one stroke prompting vigorous control of administrative costs, greater

operating efficiency and efficient internal control, features that two of the largest CMACs currently lack.

- 1.48 In short, the CMACs have become the main suppliers of financial services for microenterprises and for Peru's low-income population in general. Likewise, given their sound economic situation, it is to be expected that they will play an important role in the implementation of the proposed operation.

c. Rural savings and loan banks

- 1.49 In order to fill the institutional vacuum left in the rural financial sector by the closing of Banco Agrario del Perú, in 1992 the rural savings and loan banks (CRACs) were established under Decree-Law 25,612 to serve small-scale rural entrepreneurs. A CRAC can be set up as a corporation with a minimum capital of some US\$250,000. CRACs are permitted to accept savings from the public, but may not offer current-account services. Their income-earning business consists mainly of lending and guarantee and bond services. The first CRAC opened for business in 1993; by the end of 1994 there were nine such institutions operating.

(i) Financial performance

- 1.50 The CRACs are supported by two public sector agencies: the Ministry of Agriculture and Corporación Financiera para el Desarrollo S.A. [Development Finance Corporation] (COFIDE). The ministry's function is limited to promotion of the CRACs, and financing for the initial stage of the project. COFIDE's influence on the CRACs is greater. Depending on the findings of the institutional and financial appraisal of a given CRAC, COFIDE may make available to each CRAC authorized by the SBS a line of credit of up to three times the capital of the respective bank.
- 1.51 As of the end of 1994 there were nine CRACs operating in rural Peru, with total assets of about US\$12 million and capital of some US\$3 million. ^{1/} The total assets of the eight CRACs in operation amounted to approximately US\$12 million. Their total loan portfolio stood at nearly US\$7 million and their indebtedness to banks and other financial institutions was some US\$5 million. As of the end of March 1995 they reported more than 8,000 savers who had deposited some US\$2.7 million.
- 1.52 Because most of the CRACs have only been in operation a short time, it would be premature to make an evaluation of their economic performance. However, at the Peruvian government's request the Bank financed a diagnostic study of the CRAC system, the

^{1/} These figures refer to eight rural banks. The ninth only started operation in December 1994. As of the end of April 1995 the SBS had authorized 14 rural banks.

preliminary findings of which are not very encouraging. They can be summarized as follows: (i) almost all CRACs have problems concerning paid-in capital; (ii) the CRACs are controlled by a small group of shareholders; (iii) a large proportion of their loans have been granted to private enterprises having ties to leading shareholders, for amounts equivalent to the ceiling permitted by the law; (iv) overdue loans have been renewed, in spite of being longer overdue than authorized by the respective bank's board; (v) a number of loans have been granted that exceed legal ceilings and loans have also been given to directors with overdue debts; (vi) the majority of CRACs have quite high delinquency ratios but have not to date set aside provisions to cover these doubtful debts; (vii) as they are only just starting up they have not yet gained credibility in the market for attracting savings; (viii) forced saving and mandatory share purchases do not necessarily enhance the CRACs' image or give rural communities a sense of ownership of "their" rural bank; and (ix) the CRACs are short on management and operating capability.

(ii) Future challenges

- 1.53 Up till May 1995, SBS supervision of the CRACs was virtually nil; the SBS's work in this regard was for the most part confined to authorizing the operation of the 14 CRACs. In addition, it has allowed various CRACs to expand their service areas and has authorized the creation and organization of another 10 CRACs at the request of entrepreneurs in the different localities. Since March 1995 the SBS has included CRAC financial data in its quarterly bulletins. However, as the CRACs are not adequately provisioning their overdue and doubtful debts, the figures published by the SBS do not reflect their real situation, which could be misleading both for potential investors in the system and for COFIDE.
- 1.54 Two of the most salient risks for the CRAC system lie in its lack of effective oversight bodies and its almost total financial dependence on COFIDE. In March 1995 COFIDE financed 80% of the CRACs' portfolio, granting loans that were double their respective subscribed capital at the time. In view of the slow growth of their savings, COFIDE has become de facto the sole significant provider of financing for the CRACs.
- 1.55 Since almost all the existing CRACs have already reached the exposure limit set by COFIDE for its lending operations with them, and in view of the CRACs' financial performance, it is improbable that they would meet the eligibility requirements for participating in the channeling of the resources of the proposed operation. Likewise, in light of their deficiencies, it can be considered rather unlikely that they will be able to efficiently perform their intended role of filling the institutional gap in the rural financial sector or offer a financial product suited to small rural entrepreneurs' needs.

- 1.56 At the same time, the complexity of the conceptual, institutional and operating problems noted in the CRACs calls for a major reorganization that ought also to include strengthening of their internal control and external supervision mechanisms, together with a review of the legislation governing them. The project team accordingly determined that it would be impossible to address these problems in the context of the parallel technical cooperation envisaged for the proposed operation. The possibility of some future action by the Bank aimed at strengthening the CRAC system is being examined separately from the operation proposed in this document.

d. System of savings and loan cooperatives

- 1.57 Peru's system of savings and loan cooperatives is currently faced with the most serious crisis in its history, not only because of the 1992 liquidation of the largest cooperative bank, Banco CCC, but also because, between the end of 1991 and 1992, the country's largest saving and loan cooperatives, in particular those of Lima, Arequipa and northern Peru, had to be shut down because they were no longer in a position to return their members' deposits. At the end of 1994 the 130 institutions that report to the Federation of Savings and Loan Cooperatives declared total assets of US\$120 million. However, the fact that over 30% is concentrated in three large cooperatives belonging to the Japanese community puts the importance of the rest in perspective, particularly since they are basically closed cooperative institutions.
- 1.58 The few open cooperatives provide financial services to a very small number of microenterprises. There are not at present any indications that these cooperatives are significantly stepping up their lending to the target group defined for this operation.

e. Small business and microenterprise development institutions

- 1.59 To enable formalization of the considerable number of NGO lenders, at the end of 1994 the SBS permitted establishment of a new type of financial institution, the Entidades de Desarrollo para la Pequeña y Micro Empresa [Small Business and Microenterprise Development Institutions] (EDPYMEs). These are corporations whose charters require a minimum capital of US\$250,000 and which are to devote themselves mainly to providing loans to small firms and microenterprises. Since they are not authorized to receive savings from the public they will rely mainly on external resources and could, in fact, become "windows" of COFIDE. The great challenge for the EDPYMEs, within the conceptual constraints, will be to establish financial intermediaries that operate with a true bank focus. Any other approach could lead to a repeat of the Mexican "credit union" experience, in which groups of businessmen founded financial institutions solely to gain access to external second-tier funds, to lend them to their companies. In June 1995 the SBS issued the first organization authorization for CREDINPET, promoted by the NGO

called Instituto de Promoción para el Desarrollo Solidario [Institute for Promotion of Cooperative Development] (INPET). It should be noted that INPET was found to have the best operating and financial performance and also the strongest institutional capacity of the 16 NGOs analyzed during the preparation of the operation described in this document.

f. Lending NGOs

- 1.60 In Peru there are a large number of semiformal intermediaries in the form of NGOs that provide services to microenterprises. Although their institutional focus is not always clearly defined, they all share the common objective of promoting microenterprises by means of credit, training, marketing services and assistance in the formalization process.
- 1.61 The lending NGOs' main sources of financing include in some cases the Bank's Small Projects Financing Program. They also receive funding from the microenterprise financing programs of Fondo Nacional de Compensación y Desarrollo Social [National Social Development and Compensation Fund] (FONCODES) and Fondo para el Desarrollo de la Microempresa [Microenterprise Development Fund] (FONDEMI). These two second-tier credit programs largely comprise the semiformal financial sector in Peru. As of the end of 1994, they had made some US\$12.2 million available to lending NGOs in the form of trust funds. 8/
- 1.62 Despite the fact that the NGOs are dedicated to serving the target group, in the majority of cases the credit technology they apply is ill-designed. The deficiencies are apparent in their credit analyses and loan tracking and, in general, in their management and control structures, giving rise to a high level of delinquency in their loan portfolios. All these factors tend to result in a low level of institutional and financial efficiency. As an average valid for the universe of lending NGOs analyzed, decapitalization in 1993 amounted to 38% in terms of average portfolio, even though the NGOs evaluated were charging effective interest rates that ranged between 90% and 170% per annum, with annual inflation of 39.5% in 1993.

8/ Aside from having placed the credit risk in FONCODES and FONDEMI, these two programs had another design weakness due to the preset financial margins for NGOs; in other words, the interest rates payable by the end borrowers were fixed in advance, which meant that the margin left for the participating NGOs was insufficient to cover their operating costs. It should be mentioned that, with effect from 1995, FONCODES and FONDEMI have changed their operating policies, so that whether or not NGOs break even or achieve surpluses in their lending operations now depends on their operating efficiency.

1.63 In view of the operating and financial performance observed in the case of lending NGOs, it is hard to predict at this time the future of the lending NGO model in the medium and long term in Peru. The possibility might open up for some of them to acquire stock interests in EDPYMEs to be set up, while others could concentrate on geographic areas in which formal financial institutions do not operate. It can be anticipated that lending NGOs will find it increasingly difficult to meet the growing competition in their traditional markets in the large and medium-sized cities in the coastal region.

1.64 To sum up, since lending NGOs are not formal-sector financial institutions they are not eligible to participate directly in the credit program proposed in this document. They would be able to participate indirectly if a formal financial intermediary were to grant them a line of credit. However, this possibility seems unlikely to materialize, given the banking sector's readiness to move into the microenterprise segment of the credit market at its own risk.

D. Strategy of the Peruvian government

1.65 The present government has determined that one of the next administration's main emphases will be promotion of small business and microenterprise as an alternative for improving the employment and income levels of the poorer segments of society, combating poverty and providing a solid social foundation for the structural reforms already implemented. In this context, the government's central strategic objectives would be to increase the competitiveness of small firms and microenterprises by providing them with more and better financial and nonfinancial services, and to strengthen the institutional capacity of the agencies and institutions furnishing such services.

1.66 At the end of 1993 the government set up the Small Business and Microenterprise Program in the Ministry of Industry, Tourism, Integration and International Trade Negotiations (MITINCI). The new program was placed under the Deputy Minister for Industry and charged with formulating policies for the sector, coordinating the activities of the public and private institutions involved and promoting expansion of the markets for nonfinancial services.

E. The Bank's experience in the sector

1.67 Since 1992, the Bank has approved 27 operations aggregating US\$12.7 million under its Small Projects Program for financing loans to microenterprises, plus US\$3.7 million for institutional strengthening of the intermediaries involved (16 lending NGOs and 10 municipal savings and loan banks plus the Municipal Savings and Loan Banks Fund). Experience has varied depending on the intermediaries: besides disbursing the funds, the municipal banks have succeeded in strengthening themselves financially and

operationally; in the case of the lending NGOs, such strengthening efforts have on the whole been less successful.

F. The Bank's country and sector strategy

- 1.68 The Bank's operating strategy in Peru is focused on five priority areas: (i) consolidation of the adjustment and structural reform program; (ii) institutional strengthening of the public sector; (iii) privatization and private-sector development; (iv) alleviation of poverty and fostering of social progress; and (v) rehabilitation of the productive sectors and of economic infrastructure. The proposed operation will directly further points (iii) and (iv) of the Bank's strategy.
- 1.69 At the same time, the Bank is preparing various technical cooperation operations requested by the private sector, which would be financed by the Multilateral Investment Fund and will be designed to expand nonfinancial services in support of development of small business and microenterprise (TC-95-03-43-5, Network of Business Development Centers, and TC-95-04-22-7, Technology Dissemination Unit).
- 1.70 The MITINCI has requested short-term nonreimbursable technical cooperation from the Bank for defining the strategy and central mechanisms necessary for implementing its policy as set forth in paragraphs 1.65 and 1.66.
- 1.71 In view of these technical cooperation operations to be carried out in the future, and given the limited funds available, the project team is proposing that the technical cooperation program that would be financed in conjunction with the global credit program for microenterprises described herein, be limited to components relating to financial services.

II. THE PROGRAM

A. Objectives

- 2.1 The general objective of the program is to broaden access to formal credit for formal and informal urban, suburban and rural microenterprises, with a view to fostering the ability of the low-income population with entrepreneurial talent to utilize the economic opportunities available in the country.
- 2.2 Its specific objective is to equip the IFIs participating in the program to be able to meet, in a self-sustaining fashion and to an increasing degree, the credit demand of microenterprises, also using local resources for this purpose.
- 2.3 Benchmarks for verifying the program's accomplishments are specified in Annex II.

B. Description

- 2.4 The proposed program consists of two components: (i) a credit component, which will be implemented through the formal IFIs given access to program funds through COFIDE, by means of a financing mechanism based on advances, and (ii) a technical cooperation component.

1. Credit component

- 2.5 The program funds will be used to grant short- and medium-term loans to individuals or juridical persons in the microenterprise sector who request such loans for financing working capital and purchase of fixed assets for establishing, consolidating, expanding and/or increasing the productivity of their economic activities. The program is multisectoral in nature.
- 2.6 COFIDE, acting as a second-tier public bank, will allocate the program funds to eligible IFIs by means of a financing mechanism based on advances and applying strict ex post controls. The same procedures will be used as COFIDE is now employing in its lines of credit for microenterprises.
- 2.7 The multisectoral nature of the program, the allocation of the funds on market terms and their intermediation by the most efficient IFIs, will make it possible for the program resources to be channeled in a quick and timely fashion without need for cumbersome administrative procedures. The IFIs will assume the full credit risk entailed by the subloans, which will be granted on financial conditions freely agreed upon by the parties.

2. Technical cooperation component

- 2.8 The main purpose of the technical cooperation component is to support the development of an institutional framework that will ensure uninterrupted access to credit for microenterprises. Specifically, this component would: (i) strengthen COFIDE, particularly in microenterprise lending; (ii) transfer appropriate credit technology to the IFIs, with due regard to gender issues in the area of microenterprise credit; (iii) expand the Central Risk Data Unit operated by the Superintendency of Banking and Insurance (SBS), and (iv) enhance the IFIs' environmental awareness, and especially that of their microenterprise loan officers.
- 2.9 To achieve the specific objective of the proposed program, the technical cooperation's main emphasis will consist in transferring appropriate credit technology to the IFIs, through a specialized consulting firm with experience in this area. This offer will also be extended to IFIs that would not be using program funds, or would do so only on a small scale, because they currently have resources of their own to lend to the microenterprise sector.
- 2.10 From a strategic standpoint, the technical cooperation program would foster the deepening of Peru's financial system, would develop the microenterprise segment of the formal lending market, and would boost competition in that market by introducing a lending product tailored to microenterprises, to be delivered efficiently by IFIs operating in the formal financial sector. Since microenterprise-tailored credit technology is not freely available in Peru, its introduction in interested IFIs should be seen as a fairly expensive institutional learning process. Furthermore, entering an unknown segment of the loan market entails certain risks to IFIs in Peru's banking sector. And lastly, given the nature of microenterprise loan business, the IFIs will not immediately realize acceptable returns on these operations. At a microeconomic level, then, these IFIs are not necessarily prepared to voluntarily develop a lending product suited to microenterprises, however desirable this might be at a macroeconomic level. Accordingly, the technical cooperation program envisages the partial subsidization, for a limited time, of the costs incurred by IFIs at the early stage of their lending operations with microenterprises.

C. Dimension of the credit component

- 2.11 One segment of the aggregate minimum demand for the program has been estimated at US\$5 million per year: the segment comprising the municipal savings and loan bank (CMAC) system. The strategic plans for expansion of the CMAC system are based on a net increase in its microenterprise loan portfolio of some US\$15 million per year. Provided these banks maintain the rate of increase in savings deposits by the public and that they continue intermediating their resources efficiently, in the three-year period

scheduled for execution of the proposed program the CMAC system could absorb at least US\$15 million of the program funds.

- 2.12 It is estimated that 30% of all urban and rural microenterprises operating in Peru (i.e., some 850,000 economic units) would be acceptable IFI clients but do not now have access to the formal market. One indicator of the strong demand for credit by microenterprises is the fact that, in the first six months of 1995, COFIDE approved the equivalent of US\$15 million in loans under its credit line for nontraditional financial intermediaries, through the municipal and rural savings and loan banks and savings and loan cooperatives. Given the number of banking-sector IFIs expected to take part in the program, and the anticipated future availability of a competitive microenterprise lending product through the IFIs participating in the technical cooperation program, it should be possible to commit all of the program funds within the time-frame envisaged, and perhaps even earlier. However, since the proposed operation would be the first IDB-financed global microenterprise credit program in Peru, and given the limited institutional capacity of the traditional IFIs, and with a view to testing the efficiency of the proposed resource-allocation mechanism, the project team has been very conservative in scaling the program.

D. Cost and financing

1. Credit

- 2.13 The financing plan would be as follows (in US\$ million equivalents):

CREDIT	IDB	LOCAL CONTRIBUTION	TOTAL
a. Loanable funds	24.75	10.7	35.45
b. Inspection and supervision (1%)	0.25		0.25
Total	25.00	10.7	35.70
Percentage	70%	30%	100%

- 2.14 The total cost of the credit component of the proposed program would be US\$35.7 million equivalent. Up to the equivalent of US\$25 million (70%) will be financed by the Bank, on a reimbursable basis, in new soles, chargeable to the Fund for Special Operations. COFIDE will finance up to the equivalent of US\$10.7 million (30%) as the local counterpart.
- 2.15 In this way the IFIs will be assured of financing for 100% of their microenterprise lending. It is proposed that all funds channeled by COFIDE to the target group from its credit lines for

microenterprises after the date of approval of the operation be recognized as counterpart funds, provided the IFIs onlend these funds in accordance with the Credit Regulations for the proposed program.

2. Technical cooperation

- 2.16 The financing plan would be as follows (estimate in US\$ million equivalents):

TECHNICAL COOPERATION	IDB	LOCAL CONTRIBUTION	TOTAL
a. Advisory services to COFIDE	0.35		0.35
b. Transfer of credit technology to IFIs	1.90	1.2	3.10
c. Environmental awareness	0.20		0.20
d. Central Risk Data Unit	0.25		0.25
e. Contingencies	0.05		0.05
Total	2.75	1.2	3.95
Percentage	69%	31%	100%

- 2.17 The total cost of the parallel technical cooperation is estimated at US\$3.95 million equivalent, of which up to US\$2.75 million equivalent will be financed by the Bank, on a nonreimbursable basis, in Swiss francs from cofinancing provided by the Swiss government. ^{9/} The local contribution from the IFIs benefited by the technical cooperation is put at US\$1.2 million equivalent.

^{9/} By letter dated September 6, 1995, the Swiss government, through the Swiss Development Cooperation Agency, confirmed that it was prepared, in principle, to cofinance the technical cooperation program. However, given the internal procedures to be followed, the Swiss government cannot take a final decision on the matter before December of this year.

III. EXECUTION OF THE PROGRAM

A. Borrower and executing agency

- 3.1 The borrower and guarantor for the program will be the Republic of Peru, represented by the Ministry of Economy and Finance (MEF).
- 3.2 The executing agency for the credit program will be Corporación Financiera de Desarrollo S.A. [Development Finance Corporation] (COFIDE). COFIDE will channel the program funds to subborrowers through formal intermediary financial institutions (IFIs) which meet the eligibility requirements set for the program.
- 3.3 Before the first disbursement from the loan funds, the borrower and COFIDE will conclude an agreement by which the former will transfer the program resources to the latter in accordance with the conditions laid down in the loan contract with the Bank.
- 3.4 The beneficiary of the technical cooperation will be the Republic of Peru, represented by the MEF. The executing agencies for the technical cooperation will be COFIDE and the Superintendency of Banking and Insurance (SBS). Prior to the first disbursement from the technical cooperation resources, the beneficiary will conclude with each of the two executing agencies an agreement for transfer of the technical cooperation funds and execution of components A, B and C in the case of COFIDE, and component D in the case of the SBS. For the execution of the technical cooperation see section F of this chapter and Annex I to this document (plan of operations).

B. Program Credit Regulations

- 3.5 The Credit Regulations for the program (see Annex III) will provide for allocation of the resources to participating eligible IFIs by means of a financing mechanism based on advances, in accordance with the requirements of financial prudence. COFIDE will conclude a subsidiary participation agreement with participating eligible IFIs. It will be a prerequisite for the first disbursement from the loan funds that COFIDE has put into effect the Credit Regulations negotiated with the Bank; it will also be required to submit to the Bank at least five subsidiary participation agreements concluded with participating eligible IFIs. The most important components of the Credit Regulations proposed for this operation are set forth below.

1. IFI eligibility

- 3.6 All IFIs that are subject to SBS oversight and inspection will be eligible to take part in the program. However, to lessen the possibility of adverse selection and to ensure efficient intermediation of program funds, an IFI will only be considered

eligible if COFIDE has verified that it meets the following requirements:

- a. Is in compliance with the regulations, circulars and directives put out by the SBS and other pertinent inspection and supervision agencies.
- b. Is not under any penalty system, special surveillance or financial rehabilitation plan required by the SBS or other pertinent inspection and supervision agencies.
- c. Is in compliance with the minimum reserve requirements set by the competent authority.
- d. Does not have any legal proceedings pending with COFIDE.

3.7 In addition, COFIDE must verify that the IFI satisfies the following ratio requirements:

- a. The ratio of its delinquent portfolio ("overdue" and "in collection by legal means" categories) to its total gross loans outstanding must not exceed 12.5%, or the average value of the corresponding ratio in the banking system, disregarding the maximum and minimum values, plus 30%.
- b. The net profit figure of an IFI may not be negative in real terms.
- c. The aggregate balance of the IFI's obligations to COFIDE may not:
 - (i) In the case of a commercial bank, finance corporation, leasing company or consumer credit company, exceed 33% of its total liabilities.
 - (ii) In the case of municipal savings and loan banks (CMACs), exceed the total amount of its deposits. If the funds are channeled through the Municipal Savings and Loan Banks Fund (FOCMAC), the total deposits of the CMAC system will be considered. In both cases, the policies on exposure limits set by COFIDE will be observed.
 - (iii) In the case of rural savings and loan banks (CRACs), exceed three times their capital. CRACs that have been operating longer than two years must demonstrate that their financial debt to COFIDE is 60% or less of their total liabilities.
 - (iv) In the case of Small and Microenterprise Development Institutions (EDPYMEs), exceed three times their capital.

- (v) In the case of savings and loan cooperatives, exceed the total amount of their deposits. If the funds are channeled through the Central de Cooperativas (Federation of Cooperatives), the total deposits of the Federation's members will be considered. In both cases, the policies on exposure limits set by COFIDE will be observed.
- 3.8 If the Investment Rating Commission for Pension Fund Investments rates short-term savings instruments issued by an IFI in categories I or II, the IFI concerned will not be required to meet the delinquent portfolio requirements specified in paragraph 3.7(a).
- 3.9 The information required for application of the above-detailed eligibility requirements will be the latest information available, furnished by the SBS. COFIDE may also take into account information supplied by the Federation of Municipal Savings and Loan Banks of Peru (FEPCMAC) and other pertinent inspection and supervision agencies.
- 3.10 COFIDE will verify participating IFIs' compliance with the eligibility criteria on a quarterly basis, using the data most recently published by the SBS for the purpose.

2. Transfer of funds

- 3.11 COFIDE will be responsible for channeling and transferring program funds to eligible IFIs, by approving loans. ^{10/} The time limit for using the proceeds of approved loans (commitment period) will be one year. COFIDE will charge a commitment fee on approved undisbursed loan balances, at a rate of not less than 0.75% per annum.
- 3.12 Loans that COFIDE approves for an IFI will be disbursed by means of advances of funds to be agreed upon between the parties. The IFI will have 90 days, from the date of each disbursement, in which to demonstrate the onlending of the disbursed loan funds. Within five days after the end of that 90-day period, the IFIs are to return any difference between the amount disbursed from each loan and the amounts for which supporting information was furnished as afore-said. The microenterprise subloan portfolio of each IFI must aggregate, during the life of each loan, at least the IFI's outstanding balance to COFIDE financed with program resources.
- 3.13 The maximum term of COFIDE's loans to eligible IFIs will be four years, with a grace period not to exceed one year, during which the IFI will pay quarterly interest on the debt. COFIDE will

^{10/} Participation in the credit technology transfer to IFIs component will not be a prerequisite for an IFI to participate in the credit program.

denominate its loans to IFIs in U.S. dollars, and disbursements and amortization payments for the loans will be made in that currency.

3. Interest rate

a. Rate to IFIs

- 3.14 To prevent unfair competition for national savings and enable COFIDE to cover its administrative costs, the minimum interest rate it will charge on the loans to IFIs may not be lower than the average rate payable on fixed-term deposits of over 360 days, in foreign currency, adjusted for purposes of the statutory reserve requirement. COFIDE will review and, if necessary, adjust its minimum lending rate to IFIs quarterly.

b. Rates to subborrowers

- 3.15 The IFIs and their subborrowers will freely agree on the interest rates that they consider to be appropriate for each subloan.

4. Other subloan terms and conditions

- 3.16 The repayment term of subloans will be set by the IFIs on the basis of the subborrower's estimated ability to repay. The IFI and the subborrower will agree freely on the amortization schedule for the subloan. Disbursements of subloans, and repayments by subborrowers, will be made as agreed between the IFI and the subborrower.
- 3.17 To ensure that the bulk of the program resources go to subborrowers classified as poor, the following rules are proposed: (i) individual subloans exceeding US\$10,000 equivalent will not be financed, and (ii) the average amount of all subloans granted by an IFI from program funds may not exceed US\$5,000 equivalent.

5. Subborrowers

- 3.18 For this program, the end borrowers will be individuals or juridical persons engaged in economic activities involving production, trade or provision of services in the microenterprise sector.
- 3.19 Eligible subborrowers will be required to meet the following conditions: (i) have not more than 10 employees, including the owner; and (ii) have total assets not exceeding the equivalent of US\$20,000, excluding real property (buildings). In the case of farmers, the subborrower must not own or have legal possession of more than 10 arable hectares. If a business classified as a microenterprise is part of a parent company or enterprise, such as a branch or subsidiary, for instance, the credit analysis must include an analysis of the parent company or enterprise, to determine the subborrower's eligibility.

- 3.20 Subborrowers may or may not be formally registered as companies. For the purposes of this program, it will be understood that it is sufficient for the IFI to be satisfied that the loan applicant belongs to an economic unit engaged primarily in income-generating microentrepreneurial activities. It can therefore grant a microenterprise loan from this line in the form of a personal loan. Nevertheless, the IFIs will be required to keep separate statistics of the subloans granted from program funds, noting whether said loans are granted to individuals or legal persons.

6. Other operating aspects

- 3.21 An IFI will cease to be eligible for the program if COFIDE determines that the institution no longer meets the program's eligibility requirements. The IFI also could be excluded from the program if COFIDE determines ex post, as it monitors IFI microenterprise loan portfolios and environmental assessments, that the program funds have not been onlent in accordance with the Credit Regulations.
- 3.22 The penalties that COFIDE will apply can vary from a warning to temporary or definitive suspension from the program. In the event of a definitive suspension, the outstanding balance of loans made to an IFI with program funds will become immediately due and payable.
- 3.23 Program funds may not be used to finance the following categories of subborrowers: (i) individuals whose main source of income is not a microenterprise activity but paid employment; (ii) juridical persons (enterprises) that are part of or dependent on an economic unit that is not eligible in accordance with the rules on subborrower eligibility; (iii) persons whose normal microentrepreneurial activities fall into Environmental Category IV (significant potential adverse environmental impact); and (iv) individuals and juridical persons whose aggregate outstanding debt to the financial system exceeds the equivalent of US\$10,000 financed with program resources.

C. Use of the interest spread and recoveries

- 3.24 Funds corresponding to the difference between the amount obtained by COFIDE from the spread between the "COFIDE cost" - defined as the sum of the effective annual rate of interest charged by the Bank on its loan, plus points equivalent to the annual COFIDE administrative margin - and interest income received by COFIDE on its loans to IFIs, are to be used to fund new loans of the same nature as those provided for in the Credit Regulations. Funds repaid by IFIs for loans made with program resources that are in excess of the sums needed to service the Bank's loan may be used only to finance new loans for the same kind of activities provided for in the Credit Regulations.

- 3.25 The proceeds of the spread and loan recoveries referred to in the foregoing paragraph will be used as provided therein, unless seven years after the date of the last disbursement of the Bank's loan the Bank and the borrower, through COFIDE, agree to another use for the spread or recoveries, which must conform to the original basic objectives of the loan, or agree to shorten the period of validity of this obligation.

D. Advance of funds and disbursements

- 3.26 In order to satisfy the demand for program funds at the outset without administrative delays, it is recommended that disbursements take the form of an initial advance of funds of 20% of the total amount of the loan. To ensure the prompt commencement of activities for component B of the technical cooperation (advisory support and transfer of credit technology to IFIs), before the processing of any disbursement that would, when added to previous disbursements, exceed 30% of the loan, it would have to be demonstrated that the consulting services needed for this component have been engaged.

E. Environmental considerations

- 3.27 In view of the multisectoral nature of the operation, at its meeting of March 21, 1995, the Environment Committee classified the program in Category III; at its meeting of August 15, 1995, it approved the environmental summary. The Committee's recommendations will be included in the final version of the summary.
- 3.28 The operation seeks to help raise environmental awareness among both the IFIs and the subborrowers. The planned environmental training for loan officers, to be provided by environmental consultants as part of the technical assistance, is a process that will take time. To ensure that right from the start of the program the IFIs have environmental tools that can be used during the credit analysis of prospective subborrowers, it will be a prerequisite for the first disbursement from the loan that COFIDE have submitted to the Bank the practical environmental materials that COFIDE will be distributing to IFIs, in accordance with the Credit Regulations.
- 3.29 COFIDE will be required to submit to the Bank, within the first six months of each calendar year, starting the calendar year following the first disbursement of the loan proceeds, an environmental evaluation of a sample of microenterprises financed with program funds, to verify their compliance with the environmental safeguards recommended by the IFIs, in conformity with the Credit Regulations.

F. Technical cooperation

- 3.30 The technical cooperation program will comprise four components: (i) strengthening of COFIDE for its institutional analysis and

monitoring of IFIs taking part in its microenterprise lending operations; (ii) advisory support and transfer of credit technology to the IFIs, and instilling in loan officers an awareness of gender issues in microenterprise lending; (iii) increasing of environmental awareness in the IFIs, and especially among their microenterprise loan officers; and (iv) expansion of the Central Risk Data Unit operated by the SBS to enable it to also record loans of amounts less than US\$4,500 equivalent.

- 3.31 COFIDE will be responsible for execution of components A, B and C, and the SBS will execute component D.
- 3.32 For the monitoring of microenterprise loan portfolios of the IFIs participating in the program (component A), COFIDE will engage the professional services of audit firms and/or individual auditors within six months after the signature of the technical cooperation agreement, pursuant to terms of reference agreed upon previously with the Bank. This component is particularly important, especially during the first 24 months of the program, for verifying ex post, among other things: (i) whether the microenterprises financed really belong to the target group defined by the program; (ii) whether the IFIs have diverted funds; and (iii) whether the IFIs have adequately assessed the borrowers "in situ".
- 3.33 For the advisory services and credit technology transfer to IFIs (component B), COFIDE will, before the processing of any disbursement that would, when added to previous disbursements, exceed 30% of the loan, engage the professional services of a consulting firm with experience in organizing and institutional strengthening of financial institutions involved in microenterprise financing, in accordance with terms of reference agreed upon previously with the Bank.
- 3.34 Before proceeding with a final selection of IFIs that are to benefit from component B, COFIDE is to submit to the Bank for approval the Rules for Selection of IFIs, which are to be drawn up in concert with the consulting firm to be hired to carry out this component.
- 3.35 For execution of component C, consisting primarily of environmental training for loan officers in participating IFIs, COFIDE will engage the professional services of an institution and/or individual consultants specialized in protection of the environment, in accordance with terms of reference agreed upon in advance with the Bank. It will be a prerequisite for the first disbursement of the technical cooperation funds for components A, B, and C that COFIDE have demonstrated to the Bank that it has engaged the consultants for advisory support to IFIs on environmental issues.
- 3.36 COFIDE must submit to the Bank for approval a model of the participation agreement it will sign with IFIs that are to receive technical assistance. The model agreement must set out, inter

alia, the IFI's undertaking to furnish counterpart resources, and the rights of the parties in connection with the technical cooperation program.

- 3.37 For the execution of component D the SBS will hire the professional services of a consulting firm in computerized information processing and/or individual consultants (systems analysts and programmers) for the design and programming of the expansion of the Central Risk Data Unit's database. By means of this component, the Bank will complement the institutional strengthening of the SBS begun with the technical cooperation included with the financial sector adjustment program. It will be a condition precedent to the first disbursement for component D of the technical cooperation that the beneficiary, through the SBS, demonstrate to the Bank that it has engaged the consultancy services needed for implementing this component, in accordance with terms of reference agreed upon previously with the Bank.
- 3.38 Consultancy services will be engaged in accordance with the Bank's procedures, rules and policies in this regard.
- 3.39 The details of the technical cooperation program are presented in the plan of operations (Annex I), which also contains the basic provisions of the terms of reference for the consulting firm to be hired for advisory support and transfer of credit technology to the IFIs and for the services of consultants specializing in environmental protection.

G. Monitoring

- 3.40 The supervision of the program will be the responsibility of the Bank's Country Office in Peru, with assistance from the project team. In addition to the monitoring that the Bank will carry out through its normal procedures, COFIDE undertakes to submit to the Bank semiannual progress reports, broken down by IFI, showing the following: (i) program funds actually placed; (ii) the use made of the spread and recoveries; (iii) the effective interest rates charged to the IFIs; (iv) the number of subloan contracts executed; (v) the number of subborrowers served, showing which were individuals and which were juridical persons, broken down also by economic activity, subloan term, region, sex and environmental category; and (vi) the arrears rate of the program subloan portfolios (payments more than 15 days overdue). COFIDE will also be required to report on the performance of the other indicators to be specified for monitoring the program's achievements.
- 3.41 In the above-mentioned reports COFIDE also is to provide details on the microenterprise portfolio in terms of ranges (in U.S. dollar equivalents): (i) 1 to 1,000; (ii) 1,001 to 3,000; (iii) 3,001 to 5,000, and (iv) 5,001 to 10,000.

- 3.42 COFIDE is to submit its financial statements, and the financial statements for the program, each year throughout the program disbursement period and for seven years after the end of that period. The statements must have been duly audited by a firm of independent public accountants acceptable to the Bank.

H. Ex post evaluation

- 3.43 The ex post evaluation of the program will be done within one year of the date of the last disbursement by the Bank to COFIDE. It will be performed by independent private consultants specially engaged for the purpose by COFIDE, and will be based on data collected from the subborrowers by the IFIs participating in the program. Thirty days after having completed the evaluation, COFIDE will submit the report to the Bank.
- 3.44 The methodology to be used for the ex post evaluation will be agreed on by COFIDE and the Bank. This evaluation will include an analysis of the following aspects: (i) the operating and financial efficiency of the IFIs participating in the program; (ii) movements in effective interest rates charged to the program subborrowers, and (iii) an analysis of the economic, social and environmental impact of the program subloans, based on a random sample of at least 500 subborrowers.

IV. PARTICIPATING INSTITUTIONS

A. COFIDE

1. Nature and objectives

- 4.1 Corporación Financiera de Desarrollo S.A. [Development Finance Corporation] (COFIDE) is a public financial institution established under private law, the entire capital of which is held by Corporación Nacional de Desarrollo S.A. [National Development Corporation] (CONADE). COFIDE is organized as a corporation and has administrative, economic and financial autonomy. It is governed by D.L. 206, as amended by D.L. 25,382, by D.L. 25,694 and by its by-laws.
- 4.2 The government, pursuant to the principles of the Bank's financial sector adjustment loan, has converted COFIDE into the country's sole public second-tier institution, authorized to grant loans exclusively through other IFIs, to channel funds to the private sector. At the end of 1994, COFIDE's direct portfolio was "sold" to the Ministry of Economy and Finance by Supreme Decrees 124-94-EF and 140-94-EF, thereby clearing COFIDE's portfolio.
- 4.3 COFIDE's basic function consists in contributing to Peru's all-round development by attracting and intermediating funds to finance investment and public and private infrastructure throughout the country. D.L. 25,694 adds to COFIDE's corporate purpose the funding of small entrepreneurs and farmers, through IFIs or other development organizations that effectively support rural economic activity and small entrepreneurs in general.

2. Organizational structure

- 4.4 Since 1990, under the program for restructuring State financial agencies, work has been in progress to modernize COFIDE to increase its efficiency by means of steps such as new management technologies, procurement of new information-processing technology and institutional rightsizing. A new organization has been established that is aligned on the corporation's new role and is based on three main units: the Finance, Loan and Development Departments. A drastic personnel reduction plan has been carried out, with the result that the number of staff has been cut from 570 in 1990 to 114 as of the end of 1994.
- 4.5 In terms of formal organization, COFIDE's general manager and audit unit report to a board appointed by the meeting of shareholders. The manager's office has under it three line and three support departments. The line departments are: (i) the loan department, responsible for the placement of the corporation's resources in the financial system; (ii) the development department, responsible for the selection and qualification of intermediaries and the

performance of nonfinancial activities; and (iii) the finance department, responsible for the corporation's financial policy, the securing of resources and internal control by profit and cost centers.

- 4.6 The support departments are: (i) legal counsel, and (ii) information processing and administration, which provides administrative support and formulates policies on personnel and procurement of goods and services.

3. Sources of funds and main operations

- 4.7 COFIDE's main source of funds is the Andean Development Corporation, an organization that finances various lines aggregating US\$200 million. To expand credit availability for foreign trade activities, in the course of 1994 COFIDE obtained financing from Banco Latinoamericano de Comercio Exterior, Fondo Latinoamericano de Reservas, the Export-Import Bank of Japan, and Standard Chartered Bank, which together have contributed US\$95 million to the Corporation. In addition, on March 1, 1995, the Bank signed a loan contract for up to US\$100 million with the Republic of Peru, under the multisector credit program, for which COFIDE is executing agency.
- 4.8 As of the end of 1994 COFIDE was managing a total of six programs or lines of credit for the IFIs of the Peruvian financial sector: (i) the multisectoral investment program, made up of PROMICRO, PROPEM and PROBID, according to the size of the beneficiary enterprise; (ii) multisectoral working capital lines, available to enterprises needing short- and medium-term financing; (iii) rural sector support programs; (iv) foreign trade programs; (v) multisectoral privatization credit program; and (vi) the credit line for nontraditional financial intermediaries, intended exclusively for financial intermediaries with registered corporate capital of up to 500,000 new soles.
- 4.9 The pace of loan approvals in 1994 was particularly dynamic, the total for the year being US\$279 million, which was practically double the 1993 figure. ^{11/} However, 82% of the loans granted were to mid-sized and large enterprises, 12.7% to small businesses and only 5.2% (US\$14.4 million) to microenterprises. Almost 70% of the latter went to a total of eight CRACs and four CMACs. Ninety percent of the financing approved by COFIDE in 1994 was granted to commercial banks, among which Banco Continental and Banco Wiese, with 15% of the total portfolio, were COFIDE's main clients.

^{11/} If the operations chargeable to the Ministry of Economy and Finance's financial restructuring programs for the productive sector, executed by COFIDE in 1993 in its capacity as trustee, are excluded.

- 4.10 For the financing of small firms and microenterprises there exist mainly the PROMICRO line (for microenterprises), PROPEM (for small businesses), the working capital lines and especially the credit line for nontraditional financial intermediaries. COFIDE uses a definition of the target group different from that employed in the current legislation. For COFIDE, a microenterprise can have assets of up to US\$20,000 and annual sales of up to US\$40,000, while the figures for small businesses are up to US\$300,000 and US\$750,000, respectively. COFIDE's most successful line of credit has been the facility for nontraditional financial intermediaries, primarily because of the simplification of the administrative procedures: COFIDE dropped the requirement that each individual loan be approved and instead instituted control of lending out of the line as a whole by participating institution, a procedure that enabled a reduction of the IFIs' transaction costs.

4. Main financial indicators

- 4.11 The financial and operating efficiency achieved by COFIDE in 1994 was clearly better than in the preceding year. The main reasons for this improvement were the drastic rationalization program carried out and the "sale" of the delinquent direct portfolio to the Ministry of Economy and Finance at the end of 1994.
- 4.12 At the close of fiscal 1994 COFIDE showed total assets of US\$544 million, 83% of which were earning assets, hence an improvement of 10 percentage points in this indicator since 1991. Moreover, the rigorous streamlining of staffing levels resulted in a simultaneous increase in the average volume of earning assets managed per employee to US\$2.6 million (the 1991 figure was US\$1.2 million). This is evidence of an improvement in operating efficiency, reflected specifically in the operating margin, which in 1994 was 2.8%, i.e. down by almost half compared with 1991, when it was 5%.
- 4.13 An analysis of the loan portfolio reveals COFIDE's positive performance even more clearly. At the end of 1993, before the sale of its direct portfolio, COFIDE had an overdue portfolio of 36%. Now, however, its arrears rate is 3%, which is quite acceptable. Both the increase in operating efficiency and the clearing of the loan portfolio contributed to a positive rate of return on capital (2.9%) again in 1994, after having broken even in 1993, while the corporation's unprovisioned portfolio stood at 0% as of the end of 1994, compared with 30% at the end of 1993.

V. VIABILITY AND RISKS

A. Socioeconomic viability

1. For microenterprises

- 5.1 The proposed program will help to broaden, diversify and increase the future availability of credit from the financial sector for microenterprises. By expediting the introduction of appropriate credit technology, especially in the banking sector, it will help equip banks to meet, in a self-sustaining fashion and to an increasing degree, the credit demand from the microenterprise sector, while also lending their own funds.
- 5.2 By broadening access to formal credit for urban, suburban and rural microenterprises, offering them a timely financial product tailored to their needs, the program will help to foster the ability of the entrepreneurially gifted low-income population to make maximum use of the economic opportunities offered by the country.
- 5.3 There is little competition in the credit market for the microenterprise segment, so a significant number of microenterprises do not have access to appropriate formal financial services. The absence of competition often translates into high administrative costs for IFIs, which means that they have no option but to continue charging high interest rates to the target group. The growing participation by the banking sector in this market will help to increase the IFIs' administrative efficiency, thereby also lowering transaction costs for subborrowers.
- 5.4 At the same time, having stable access to a timely lending product offered efficiently by IFIs in a segment of the increasingly competitive credit market will help the target group to raise its level of disposable liquidity. In other words, for microenterprises which have already been able to develop a relationship with a bank or banks, the effective cost of borrowing will decrease, while those that have not to date had access to formal credit will have the opportunity to reduce their dependence on costly informal financing.

2. For women

- 5.5 As noted in chapter I, women as microenterprise owners play an important role in the sector. They also participate in the sector's work force as paid workers and as unpaid family labor. In view of the multisectoral nature of the proposed operation it will also benefit women traders and merchants, who feature prominently in the sector.

- 5.6 Since this program seeks to broaden access to credit for microenterprises, a special effort will be made to ensure that women have equal access to program resources. Gender issues will be included in the training for loan officers that will be part of the technical cooperation. The participation agreements between COFIDE and the IFIs will moreover specify that the IFIs shall not discriminate by gender. In addition, the IFIs will be urged to employ and train women to work as loan officers.

3. For the environment

- 5.7 The program will represent an important step forward for raising the environmental awareness of microenterprise owners so as to involve them in ensuring safety, hygiene and occupational health and in environmental conservation. Starting from a realistic and workable approach aimed at easing the moderate potential adverse environmental impact of certain economic activities of the microenterprise sector, the program will seek to gradually introduce improvements, beginning with the most simple and low-cost measures and/or those that will generate benefits in the short term.
- 5.8 The microentrepreneurs will be obliged to take such actions as are necessary to mitigate the environmental impact of activities that produce moderate potentially negative environmental effects. The microenterprise loan officers of the participating IFIs will also be trained under the technical assistance component, receiving basic instruction from an institution specialized in protection of the environment, so they can better identify and assess ecological impacts when analyzing loan requests from microentrepreneurs.

4. Poverty targeting

- 5.9 The operation is designed to foster development of Peru's formal and informal microenterprise sector; it will help to consolidate and increase microenterprise earnings and to generate employment in the sector, and will complement the Peruvian government's efforts to reduce poverty.
- 5.10 The program beneficiaries will be men and women microenterprise owners, members of their families and wage-earners dependent on the employment offered by the sector.
- 5.11 By way of illustration, the following table presents average monthly income figures for microenterprises in metropolitan Lima in October 1989, by size of enterprise and economic sector. It should be borne in mind that one-person microenterprises (I) and those employing two or four persons (II) made up 97% of all microenterprises. In addition, 79% of all microenterprises were operating in trade and services. Within the sectors, the economic subbranches that accounted for the least and most monthly net income are

presented. Finally, per capita income has been calculated assuming a four-person family. ^{12/}

MEDIAN MONTHLY NET INCOME OF ONE-PERSON MICROENTERPRISES (I) AND OF THOSE EMPLOYING 2-4 PERSONS (II), BY SECTOR

SECTOR	I (US\$)	II (US\$)	PER CAPITA REVENUE (US\$)	
			I	II
<u>Trade</u>				
- Prepared foods, bread/pastries	40	32	10	8
- Groceries, beverages	104	138	26	34
<u>Services</u>				
- Related services	28		7	
- Repairs	98	164	24	41
- Restaurants, cafés		148		37
<u>Industry</u>				
- Footwear	31		8	
- Metalworking	111	699	28	175
- Printing		43		11
<u>Other activities</u>				
- Unspecified	67		17	
- Transport	180	692	45	173
- Construction		87	22	

5.12 Since in 1989 the poverty line was set at US\$70, and in light of the per capita figures shown in the table, it is clear that the great majority of the program beneficiaries will be classified as poor, assuming that the net per capita incomes of beneficiaries located in the rural areas of the coastal and upland regions do not change these data.

5.13 To ensure that the bulk of the program resources is lent to poor microenterprise owners, the program Credit Regulations will stipulate that the ceiling per loan granted will be the equivalent of US\$10,000, and that the average loan granted per participating IFI may not exceed US\$5,000 equivalent.

^{12/} For 1989, the Bank defined those with a per capita monthly income of US\$70 or less as poor.

B. Institutional viability

- 5.14 At the second-tier level, the program's institutional viability will be guaranteed by COFIDE's experience in managing external credit lines, its healthy economic condition, which will enable it to operate in a timely and efficient manner, and the transparency and flexibility of the proposed financing mechanism.
- 5.15 Apart from the municipal banks, the readiness of the banking sector IFIs to participate in the program is a crucial requirement. A continuous dialogue was accordingly maintained during the preparation of the program with Banco del Sur, Banco del Trabajo, and Banco Latino, and with Banco de Crédito, the country's most important IFI. Discussions were also held with representatives of Banco Continental, Banco Wiese and Banco del Norte. In general, these IFIs reacted favorably to the basic concept of the program and indicated interest in participating in it. Some of them, especially those in the first group, displayed considerable interest in the technical assistance component, which would also help them in placing their own funds, as a result of which funding for the microenterprise sector in future would not be exclusively dependent on external loan flows.
- 5.16 The program will foster sustained deepening of the financial sector, since the participating IFIs will contribute to the development of a new segment of the credit market. The impact on the financial market will consist in introduction and widespread adoption of a new product in an environment of competitiveness and efficiency.

C. Financial viability

- 5.17 The general principles on which the program is based are such as to ensure its financial feasibility and also the additionality of the counterpart resources from COFIDE, together with interest rate flexibility allowing for quarterly adjustments to adapt to changing financial conditions. The minimum effective rate that COFIDE will charge the IFIs in the financing mechanism will ensure generation of the financial revenues needed by COFIDE to service its debt to the Bank and defray its administrative costs. Any surplus from the interest spread will be used to capitalize the program.
- 5.18 For their part, the IFIs, whose efficiency and solvency the program seeks to ensure by means of the eligibility criteria applied, will perform the credit analysis of subborrowers, will assume the full credit risk and will freely set the financial terms and conditions for the subloans. This basic approach of the program, which delegates to the IFIs the determining of the costs and of the returns expected, will ensure that the program is viable for the financial sector. By avoiding ex ante bureaucratic controls and delegating responsibilities to the IFIs the market system will be

strengthened and active control will be kept in the hands of supervisory agencies, since the IFIs will be evaluated by the competent authorities.

- 5.19 By bringing microentrepreneurs into the bank credit market, the banking system's operating base will be broadened, thereby facilitating risk diversification and lessening its dependence on operations with medium-sized and large clients. In addition, the increase in the number of clients will heighten the demand for other types of banking services, leading in turn to higher revenues for the IFIs.
- 5.20 Since the program will provide stable and long-term financing for small nonbank IFIs, it will enable them to diversify their liabilities and reduce their volatility, and also to plan the growth of their microenterprise loan portfolios and to lengthen the average term of these operations. Meanwhile, the growth of their portfolios will enable this group of IFIs to achieve economies of scale and thereby attain greater operating and financial efficiency. Finally, the visible growth of their total assets will help these IFIs to continue improving their institutional credibility in the financial markets, which is a basic requirement for them to mobilize more savings from the public and to be able to issue corporate bonds in the medium and long term.

D. Risks

- 5.21 The greatest risk that the program might not have the expected financial and economic impact would arise from an absence of the economic, financial and institutional environment necessary for efficient channeling of stable credit resources to the microenterprise sector. This risk is very small because the medium-term prospects for the Peruvian economy are very favorable, inasmuch as the new government plans to continue with its economic program. The program proposed in this document includes the necessary provisions for helping to make certain that an institutional and financial environment conducive to the program will indeed be in place.
- 5.22 A further risk is that the bank-sector IFIs might not adopt all the operational changes that would ensue from a credit technology suited to microenterprise lending. Though the technology being proposed is being used successfully by Peru's municipal savings and loan banks, and the IFIs in the banking sector understand the concept in theory, it would be new terrain for them. At the center of the process is a new loan officer (a "shirt-sleeves banker") whose day-to-day work takes place in the field, with clients, where the officer ascertains the willingness and ability to pay of the household-cum-economic unit of his or her microenterprise clients. It involves higher interest-rate spreads than those that are typical in traditional IFIs. Since the credit technology is designed mainly to lower administrative costs in this type of

lending, it would be essential that it be properly adopted by the IFIs receiving technical assistance under the proposed operation if their microenterprise lending is to be profitable. With this in mind, it has been decided that advisory support would be provided only to IFIs that are willing, and have sufficient institutional capacity, to contribute to the deepening of the country's financial system within a relatively short period of time.

- 5.23 One final risk is that COFIDE, for reasons beyond its control, may be unable to avoid adverse selection of clients. Though precautions have been built into the Credit Regulations to prevent this from happening, the SBS bulletins that COFIDE will be using as its prime source of information to verify the financial ratio performance of IFIs that wish to take part in the program do not, at this writing, reflect the true economic performance of the rural savings and loan bank (CRAC) group.

PLAN OF OPERATIONS

INSTITUTIONAL STRENGTHENING FOR INSTITUTIONS PARTICIPATING IN THE GLOBAL MICROENTERPRISE CREDIT PROGRAM

(TC-95-05-22-1)

I. BACKGROUND

- 1.1 The development of microenterprises has been limited by the difficulty of access to inputs, appropriate financial services and markets for them, together with uncertainty as to property rights, excessive regulatory hurdles to obtaining legal registration, and the obsolescence of their production technologies.
- 1.2 This plan of operations forms part of the global credit program for microenterprises, which seeks to increase access to formal credit for microenterprises and deepen the Peruvian financial system.

II. OBJECTIVES

- 2.1 The general objective is to contribute to the development of an institutional framework that will ensure that microenterprise has continued access to formal credit.
- 2.2 The specific objectives are: (i) to increase COFIDE's operational and monitoring capacity in its financing operations for microenterprises; (ii) to strengthen the operating and administrative capabilities of participating IFIs for their microenterprise lending operations, and instill in loan officers an awareness of gender issues in microenterprise lending; (iii) to raise the level of the IFIs' environmental awareness, especially on the part of their microenterprise loan officers; and (iv) to expand the range of credit information services offered by the Superintendency of Banking and Insurance (SBS) to the formal financial sector, especially for loans of less than US\$4,500 equivalent.

III. DESCRIPTION

3.1 To achieve the objective of the technical cooperation, activities will be financed in four areas (components A, B, C and D).

A. Advisory services and training for COFIDE

1. Institutional strengthening

3.2 Advisory services and training are planned for COFIDE, and especially for the units responsible for microenterprise financing. For COFIDE to be able to expand its microenterprise loan business, and for its portfolio to be sound, will require a more thorough and continuous process of institutional and financial analysis and tracking and monitoring of small and fledgling IFIs, such as the municipal and rural savings and loan banks and development institutions for microenterprise and small business. It also would be useful for COFIDE to gain more in-depth knowledge of the credit technology that would be introduced in the IFIs. The consultant in bank organization (see paragraph 3.17) would also be responsible for advising COFIDE in these areas.

3.3 To deepen their professional and operating experience, it is also the intention that certain COFIDE technical staff should visit, get to know and share their experience with other Latin American second-tier institutions that operate lines of financing for microenterprises. It is also proposed that COFIDE staff should attend training courses and seminars on microfinancing in Peru and elsewhere. Finally, on-the-job training would be financed for certain officers, on the premises of financial institutions that, with Bank assistance, have successfully applied a credit technology geared to microenterprise.

3.4 Since COFIDE does not have the necessary administrative staff to perform all of the contracting work required to implement and administer the technical cooperation program, the equivalent of US\$40,000 has been included in the program budget for the hiring of temporary consultants.

3.5 The total cost for study grants, air travel and transportation plus per diems financed with the technical cooperation funds is estimated at US\$60,000 equivalent. If COFIDE does not need all of the funds budgeted for consultants for the administrative tasks, the balance could be used to defray costs of training its technical staff.

2. IFI tracking and monitoring

- 3.6 Especially during the first 24 months of the credit program, frequent checks and evaluations will have to be made of the participating IFIs' microenterprise loan portfolios, to ascertain whether they have onlent the program funds in accordance with the rules set for the credit program, and particularly to determine whether the borrowers really are microentrepreneurs. These will not be bureaucratic and legal controls, but in view of the problems that are bound to arise about definition and interpretation of the target group, these evaluations and verifications will have to be considered essential parts of a learning process for both the participating IFIs and for COFIDE.
- 3.7 Up to US\$250,000 equivalent has been earmarked for hiring specialized audit firms and/or independent audit consultants.

B. Advisory services for and credit technology transfer to IFIs

- 3.8 To achieve the expected results a credit technology suited to the needs of microenterprises will be introduced in the IFIs by means of: (i) training of loan officers; (ii) advice on organization; and (iii) software installation.

1. Loan officer training

- 3.9 Training is planned for microenterprise loan officers, especially in promotion, appraisal, monitoring and recovery of loans to microenterprises. It also will address gender issues in microenterprise lending. It is expected that the majority of these loan officers will be hired specially for this purpose, and will only be drawn from the IFIs' regular staff in exceptional cases. The IFIs also will employ and train women to be loan officers in future.
- 3.10 The training activities will require at least two training consultants. In the course of the three years allocated for execution of the technical cooperation it is expected that loan officers of at least six IFIs will be trained. Each trainer would serve one IFI per year, and could train up to 20 loan officers to perform the new functions. Accordingly, during the three-year period a total of up to 120 loan officers would be trained. It is estimated that at least 70% of the trainees would complete the courses successfully.
- 3.11 For loan officer training purposes, the training consultants will: (i) participate with the IFIs in the selection of the future loan officers, and organize a four-week training course; (ii) carry out a practical research exercise with the 20 loan officers per IFI, for one month in Lima, so that the trainees will gain a detailed understanding of the situation of microenterprises and study in particular the present - mostly informal - forms of financing used

by microenterprises; (iii) accompany, for three months, up to 40 trainee loan officers for an on-the-job training course in a financial institution specialized in microfinancing in either Bolivia, El Salvador or Colombia, which has successfully, with support from the Bank, implemented the credit technology that will be introduced in the IFIs; and (iv) train the loan officers in their respective IFIs, and hold various seminars, until the 12-month training period is completed.

3.12 The training of the 80 remaining trainees who are not sent abroad can be organized in Peru, since there are expected to be numerous "showcase" institutions in the country by then.

3.13 It is also expected that the trainers, together with the consultant in bank organization (see paragraph 3.17), will help set up microenterprise credit departments in the respective IFIs and adapt the forms needed for these operations.

3.14 The technical cooperation funds will be used to finance, over the space of three years, up to US\$928,000 equivalent for the training component, broken down as follows: (i) up to US\$720,000 for training consultants; (ii) up to US\$144,000 for study grants for up to six months for the 120 loan officers participating in the training courses; (iii) up to US\$40,000 to fund air travel and transportation for the training of up to 40 officers in other countries; and (iv) up to US\$24,000 to cover the per diems of these 40 officers during their time away from Peru.

3.15 As of the seventh month, the IFIs will undertake to fund for interns a study grant of at least the equivalent of US\$500 a month, thereby giving rise to a counterpart equivalent to US\$360,000 (US\$60,000 per IFI). The IFIs will undertake to hire persons who successfully complete the courses.

3.16 The IFIs will undertake to provide a permanent trainer as local counterpart to the consultants, so that this trainer can learn the core elements of the credit technology and be able to continue training future loan officers after the technical assistance has ended. He/she will also accompany the trainees from his/her IFI who are sent abroad. For the three-year period, the local contribution of the six IFIs in the form of the trainer, including indirect costs, is estimated at about US\$180,000 equivalent (US\$30,000 per IFI). The cost of per diems, air travel and transportation is estimated at the equivalent of US\$44,000.

2. Advisory services on organization

3.17 The intention is to implement in the participating IFIs an organizational, operating and administrative structure suited to lending operations with microenterprises. The outcome should be establishment of a microenterprise lending department.

Accordingly, and in conjunction with the trainers, a consultant specialized in bank organization will be needed to provide advisory services to each IFI for up to six months.

- 3.18 The consultant will be responsible for coordinating all the activities scheduled for component B. Accordingly, he or she will coordinate the work of the training consultants and that of the information processing consultants (see paragraph 3.21), and act as liaison person and organizer for the advisory services component for institutional strengthening of COFIDE (3.2).
- 3.19 Over three years, the total cost of this consultant is estimated at US\$648,000 equivalent. The counterpart expenditure that the six IFIs will incur for adapting their organizational structure is estimated at US\$216,000.

3. Software installation

- 3.20 In order to successfully administer and monitor thousands of small loans, most of them short term and with monthly amortization payments, provision has been made, for all the IFIs taking part in this technical assistance component, for the installation of specialized software, which is designed, among other things, to: (i) enable evaluation of the operating performance of loan officers; (ii) serve as a support tool for reviewing loan applications and preparing contracts; (iii) provide all the data necessary for the effective operation of the SBS Central Loan Risk Data Unit, the services of which will be available to the IFIs; and (iv) incorporate the numerous economic and social parameters required for the ex post analysis of the credit program.
- 3.21 Implementation of this component will require an information processing consultant for a period of 12 months. This consultant will work on: (i) implementing the software package to be provided by the consulting firm; (ii) adapting the software to the requirements of each IFI, though not spending longer with each IFI than the period stipulated; (iii) training the IFIs' information systems staff in the maintenance of the software; and (iv) training loan officers in the applications of the system set up. This consultant will work for up to two months with each IFI.
- 3.22 The cost of the information processing consultant is estimated at US\$276,000 equivalent. Apart from the specialized personnel who will be involved in the implementation of the systems, some IFIs likely will have to procure equipment. The local counterpart for this component is estimated, on a preliminary basis, at the equivalent of US\$400,000.

4. Organization of the execution of this component

a. Hiring of a consulting firm

- 3.23 After evaluating the different alternatives it was concluded that the most workable approach from a technical standpoint, and the one that would yield the best results, would be to hire a consulting firm that would provide all the experts needed for implementing component B of the technical cooperation. This alternative would facilitate the coordination of the work, ensure the consistency and technical quality of the activities to be carried out in the different areas, and establish a clear division of tasks and delegation of responsibilities in order to achieve the desired results.

b. IFI selection

- 3.24 During the preparation of the global credit program for microenterprises a number of commercial banks (Banco del Sur, Banco del Trabajo, Banco Latino and Banco de Crédito) were identified which have already started lending to microenterprises or are just beginning to move into this segment of the credit market, and which have indicated their interest in participating in the technical assistance. It has also been ascertained that these IFIs will be willing, and will have the institutional capacity, to accomplish the objectives set for this component. Finally, providing banking-sector entities with advisory services and transferring credit technology to them will not only help deepen the financial system within a relatively short time, but will also stimulate microenterprise lending with the institutions' own funds.
- 3.25 Given the limited amount of funding available under component B of the technical cooperation program and the time-frame envisaged for its execution, and in order to maximize the desired impact on the IFIs and lend significant volumes of local funds, it has been decided that the only IFIs eligible to take part in this component will be banking institutions, Small Business and Microenterprise Development Institutions, and savings and loan cooperatives that (i) satisfy the eligibility requirements for the global credit program for microenterprises, (ii) have operated as IFIs for at least two years, and (iii) have received no institutional support under bilateral or multilateral technical cooperation or will not be receiving such support in the short or medium term.
- 3.26 The final selection of IFIs that are to benefit from component B (advisory support and transfer of credit technology) will be made on the basis of Rules for IFI Selection, which will be drawn up by COFIDE in concert with the consulting firm hired to carry out this component.

C. Training and environmental awareness

- 3.27 The operation aims to raise environmental awareness in both COFIDE and the IFIs and also among the subborrowers, always with the nature of financial institution business in mind. At the same time, it must be ensured that COFIDE and the IFIs are meeting their environmental responsibilities resulting from their participation in the credit program. Provision is accordingly included for sensitizing and training COFIDE staff who are involved in micro-enterprise credit operations, and particularly the IFI loan officers concerned, since they are the ones who will have to evaluate and classify microenterprises. The loan officers will also be required to recommend to their clients simple, affordable measures for preventing and mitigating moderate potentially adverse environmental impacts resulting from their main economic activities; and subsequently they must be able to verify whether their clients have taken the steps agreed on before they can be considered for a new loan.
- 3.28 At the start of the credit program COFIDE will be required to provide the IFIs with practical, objective information materials on occupational health and protection of the environment in the main microenterprise activities in Peru, to ensure that the IFIs have basic environmental tools available to them during the credit analysis process. In addition, because of the preliminary nature of these materials they will have to be revised and updated during the execution of the credit program. It will also be necessary to revise the detailed criteria and directives and to make the necessary adjustments to the system of initial environmental procedures, and to revise and update the information material that COFIDE would provide to the IFIs for distribution to subborrowers.
- 3.29 Lastly, COFIDE will be required to perform environmental assessments based on samples of credit program clients, with the aim of verifying whether the IFIs have operated in accordance with the environmental rules of the Credit Regulations and whether clients classified in environmental category III have complied with the environmental safeguards recommended by loan officers and agreed upon with the IFI. An IFI could be excluded from the credit program if COFIDE finds that it has failed to comply with its environmental obligations.
- 3.30 For the implementation of these measures COFIDE will be assisted by a consulting firm or organization specializing in protection of the environment and/or by individual environmental consultants. Up to US\$200,000 equivalent of technical cooperation funds will be allocated for financing this work.

D. Expansion of the SBS Central Risk Data Unit

- 3.31 The Risk Data Unit operated by the SBS currently records all formal financial system lending operations in excess of 10,000 new soles (equivalent to about US\$4,500). However, in view of the growing number of loans being made by the formal financial system in amounts below that level (for example through credit card use, personal loans and also the thousands of loans to microenterprises), provision has been included for expanding the range of credit information services offered by the SBS to the IFIs in the formal financial sector. Having this information available would not only help the IFIs to reduce their risks but would enable their microenterprise clients to establish a credit history, which is important for continued access to bank credit.
- 3.32 For the SBS Central Risk Data Unit to record financial system loans of less than US\$4,500, expansion of the database of this register will have to be designed and programmed in close consultation with the IFIs. This will complement the strengthening of the SBS begun by the Bank in the context of the technical cooperation for the financial sector adjustment program (678/OC-PE). To finance these consultant services, which will also include training of Risk Data Unit staff in the management and maintenance of this database, the technical cooperation would make the equivalent of up to US\$250,000 available.

IV. COST AND FINANCING

- 4.1 The total cost of the technical cooperation program is estimated at about US\$3,950,000 equivalent. To finance the program, the Swiss government will provide nonreimbursable cofinancing resources of up to US\$2.75 million equivalent in Swiss francs.^{1/} The local contribution is estimated at about US\$1.2 million equivalent and would be derived primarily from the banking sector IFIs receiving the technical assistance.
- 4.2 The preliminary budget for the technical cooperation (estimates in U.S. dollar equivalents) is shown below. Prices estimated therein for the consulting firm for component B would be lump-sum amounts,

^{1/} The Swiss government, through the Swiss Development Cooperation Agency, by letter of September 6, 1995, confirmed that it was prepared, in principle, to finance the technical cooperation program. However, given the internal procedures involved, the Swiss government will not be able to announce its final decision before December of this year.

including fees, overheads, international and local travel, per diems, and equipment.

COMPONENT	IDB	LOCAL CONTRIBUTION	TOTAL
A. <u>Advisory services to COFIDE and monitoring of IFIs and subborrowers</u>			
- Independent consulting auditors and/or audit firms	250,000		250,000
- Consultants on administration	40,000		40,000
- Study grants, air travel, transportation and per diems for exchange of experiences outside Peru	60,000		60,000
TOTAL COMPONENT A	350,000		350,000
B. <u>Advisory services and transfer of credit technology to IFIs</u>			
- Consulting firms (fees)			
- Experts in bank organization, and coordinator (up to 36 months x US\$18,000/month)	648,000	216,000	864,400
- Loan officer trainers (up to 72 months x US\$10,000/month)	720,000	180,000	900,000
- Information processing specialists (up to 12 months x US\$23,000/month)	276,000	400,000	676,000
- Specialists in gender issues (up to 5 months x US\$10,000/month)	50,000		50,000
<u>Study grant recipients and participants</u>			
- Subsistence (up to 120 grants for loan officers x 6 months x US\$200/month)	144,000	360,000	504,000
- Travel (up to 40 air fares and transportation x US\$1,000)	40,000	14,000	54,000
- Per diems (40 grant recipients x 3 months x US\$200/month)	24,000	30,000	54,000
TOTAL COMPONENT B	1,902,000	1,200,000	3,102,000
C. <u>Environmental awareness</u>			
- Consulting firm or organization specializing in environment and/or individual environmental consultants	150,000		150,000
- Instructional materials, etc.	50,000		50,000
TOTAL COMPONENT C	200,000		200,000
D. <u>Expansion of SBS Central Risk Data Unit</u>			
- Individual consultants and/or consulting firms	250,000		250,000
TOTAL COMPONENT D	250,000		250,000
CONTINGENCIES	48,000		48,000
TOTAL	2,750,000	1,200,000	3,950,000

V. EXECUTION

- 5.1 The proposed technical cooperation program will be carried out in parallel with the global credit program for microenterprises, which would be approved at the same time as the technical cooperation.
- 5.2 The beneficiary of the technical cooperation will be the Republic of Peru, represented by the Ministry of Economy and Finance.

COFIDE will be the executing agency for components A, B and C and the Superintendency of Banking and Insurance (SBS) will execute component D.

- 5.3 Before the first disbursement from the technical cooperation funds for components A, B and C, the beneficiary, through COFIDE, will be required to submit to the Bank the agreement for transfer of the funds and the execution of these components. Before the first disbursement from the technical cooperation funds for component D, the beneficiary, through the SBS, will be required to submit to the Bank the agreement for transfer of the funds and the execution of this component.
- 5.4 For component A, COFIDE will, within six months after the signature of the technical cooperation agreement, engage the professional services of one or more consulting firms with experience in audit work and/or individual consulting auditors, in accordance with terms of reference agreed on in advance with the Bank.
- 5.5 For component B, before the processing of a disbursement request that would, when added to other disbursements, exceed 30% of the loan proceeds, COFIDE will engage the professional services of a consulting firm with experience in organizing and institutional strengthening of financial institutions engaged in microenterprise financing, pursuant to terms of reference previously agreed upon with the Bank. Appendix 1 to this plan of operations presents the basic outline of the terms of reference for this consulting firm. This firm will administer the funds budgeted for the training of IFI loan officers that is to be financed under this component, and must account for the use of these funds to COFIDE.
- 5.6 The consulting firm engaged for component B will provide software suitable for the administration of increasing volumes of lending to microenterprises, as already described, since development of special software will not form part of this component. It is understood that the copyright for this software, as for any other software program, will belong to the consulting firm.
- 5.7 Before proceeding with a final selection of IFIs that are to benefit from component B, COFIDE is to submit to the Bank for approval the Rules for Selection of IFIs, which are to be drawn up in concert with the consulting firm to be hired to carry out this component.
- 5.8 For component C, COFIDE will engage the professional services of a consulting firm or organization specializing in environmental protection and/or individual environment consultants, in accordance with terms of reference agreed upon in advance with the Bank. Appendix 2 to this plan of operations contains the basic provisions for the terms of reference for this consulting assignment. As a condition precedent to the first disbursement from the technical

cooperation funds, COFIDE must have demonstrated to the Bank that the necessary consulting services have been contracted.

- 5.9 COFIDE must submit to the Bank for approval a model of the participation agreement it will sign with IFIs that are to receive technical assistance. The model agreement must set out, *inter alia*, the IFI's undertaking to furnish counterpart resources, and the rights of the parties in connection with the technical cooperation program.
- 5.10 For component D, the SBS will engage the professional services of an information-processing consulting firm and/or individual consultants (systems analysts or programmers) for the design and programming of the expansion of the Central Risk Data Unit database. This firm or individual consultants will be engaged in accordance with terms of reference agreed on in advance with the Bank. Prior to the first disbursement from the technical cooperation funds for component D, the beneficiary, through the SBS, will be required to submit evidence that the consultancy services necessary for the implementation of this component have been contracted.
- 5.11 COFIDE, the IFIs and the SBS will, in each case, provide the consultants with offices and counterpart technical personnel.
- 5.12 Implementation of the technical cooperation is scheduled to take 42 months, counting from the date of signature of the technical cooperation agreement.

VI. SUPERVISION AND RESPONSIBILITY

- 6.1 The components of the technical cooperation program will be supervised by COFIDE and the SBS, as applicable. The Bank will supervise the operation through its Country Office in Peru.
- 6.2 Basic responsibility for the operation will lie with the Bank's Country Office in Peru, and technical responsibility with the Bank's Country Division 5 (OD5).

VII. DISBURSEMENTS AND ADVANCE OF FUNDS

- 7.1 The disbursements under this technical cooperation agreement will be effected over a 48-month period counting from the date of signature of the technical cooperation agreement.

- 7.2 It is recommended that the advance of funds be of 10% of the resources available for the technical cooperation, in order to ensure the liquidity necessary for the effective implementation of the program.

VIII. JUSTIFICATION AND RECOMMENDATION

- 8.1 The technical cooperation will contribute to the sustained deepening of the financial sector. At the level of the IFIs, the institutional and operating foundations will be set for a significant broadening of access to credit for microenterprises and, thanks to the increase in competition, there will also be a positive impact on the level of interest rates charged to these clients. Application of an appropriate credit technology will also result in lower transaction costs for the target group. Microentrepreneurs will have access to financing through the formal system on reasonable terms and conditions and the availability of credit will not be dependent on external loan flows, since participating IFIs will have the tools for financing the target group with their own funds as well.
- 8.2 In addition to providing timely access to formal credit, the proposed operation will help lessen microenterprises' dependency on very expensive informal sources of financing, a development that will have an immediate and significant redistributive impact in favor of the target group.
- 8.3 Development of a new segment of the financial market will be fostered for the commercial banks, this being a segment they are under increasing pressure to operate in because of the competition now beginning to heat up in the traditional segments of the credit market. Bringing microentrepreneurs into the bank credit market will make it possible to expand the banking system's operating base, facilitating risk diversification and lessening its reliance on medium-sized and large clients. The increase in client base will spur demand for other types of banking services and thereby help to boost the IFIs' earnings. The impact on the financial market will consist in widespread availability of a new product in a context of competitiveness, efficiency and transparency.
- 8.4 Focusing credit analysis and monitoring on the microentrepreneur – the "credit recipient" – rather than on the "project" for which financing is sought will be a much better approach, in view of the small size of the economic unit and the fact that it is virtually inseparable from the person's household unit, and will also be a more realistic approach from an environmental standpoint. This method envisages four environmental categories in which to classify the full set of a microenterprise's main economic activities,

independent of the specific activity for which financing is sought from an IFI.

- 8.5 From COFIDE's standpoint, the operation will help it to proceed with a sound and prudent expansion of its financing operations for microenterprises with small and fledgling IFIs.
- 8.6 The expansion of the SBS Risk Data Unit's database will enable IFIs to identify the risks connected with certain borrowers better. For microenterprises, it will make it possible to establish a credit history right from their first contact with the formal financial sector. The SBS will expand its range of services, which could also create attractive possibilities for it to be financially self-sustaining in the future.
- 8.7 On the basis of the foregoing, the Management of the Bank recommends to the Board of Executive Directors that the nonreimbursable technical-cooperation operation proposed in this plan of operations be approved.

PROGRAM PROGRESS BENCHMARKS

The following benchmarks will be used to ascertain the progress made toward the objectives of the loan and parallel technical cooperation programs.

A. General objective

Formal and informal microenterprises in urban, peri-urban, and rural areas have broader access to formal credit, which will allow the low-income population with entrepreneurial talent to take advantage of the economic opportunities offered by the country.

1. Indicators

- Number of, and increase in, IFIs lending to microenterprises
- Volume in U.S. dollars and current operations/contracts in microenterprise portfolios (stocks)
- Total clients served/total new clients (flows)

B. Specific objective

The IFIs taking part in the program are increasingly meeting, on a self-sustaining basis, the demand for credit by the program's target group, using local funds as well.

1. Indicators

- a. Portfolio per credit analyst in 1998 (minimum, all IFIs receiving advisory support)
 - 250 microenterprise loans
 - current portfolio of US\$200,000
- b. Administrative costs in 1998 (as a percentage of total average gross microenterprise portfolio, minimum, all IFIs receiving advisory support)
 - Less than 20%
- c. Growth in microenterprise loan portfolio in real terms
- d. Portfolio diversification:
 - 20% of portfolio in the form of fixed-asset loans, December 1998

- e. Portfolio quality:
 - Loans over 30 days overdue, less than 5% of total microenterprise portfolio (all IFIs receiving advisory support)
- f. Average loan amount approved (during year)
- g. Number of loans approved (by year)
- h. Average amount of current loans
- i. Number of current loans
- j. Current microenterprise portfolio financed with funds raised by lender
- k. Growth in real terms in volume of savings for nonbank IFIs (compared with "before program" situation)
- l. Reduction in Subsidy Dependency Index (Jabob Yaron/World Bank model, 1993)

CREDIT REGULATIONS

GLOBAL MICROENTERPRISE CREDIT PROGRAM (PE-0035)

ARTICLE 1 Purpose

The purpose of these Credit Regulations, hereinafter the "Regulations", is to establish the terms and conditions for the execution of the Global Credit Program for Microenterprises (PE-0035), hereinafter the "Program", partially financed with funds from loan contract /OC-PE, hereinafter the "Loan", concluded between the Republic of Peru and the Inter-American Development Bank, hereinafter the "Bank".

ARTICLE 2 Executing agency

The executing agency for the Program will be Corporación Financiera de Desarrollo S.A. [Development Finance Corporation], hereinafter "COFIDE", with the participation of eligible intermediary financial institutions of the formal financial sector, hereinafter "IFIs", in accordance with the eligibility requirements laid down in these Regulations.

ARTICLE 3 Credit recipients

- a. The credit recipients under the Program will be individuals or juridical persons who perform production, trade or service activities in the microenterprise sector, hereinafter "Subborrowers".
- b. Subborrowers may or may not be formally registered as companies. For the purposes of this program, it will be understood that it is sufficient for the IFI to be satisfied that the loan applicant belongs to an economic unit engaged primarily in income-generating microentrepreneurial activities.
- c. Prospective Subborrowers must meet the following requirements in order to participate in the Program:
 - (i) In the case of individuals and juridical persons, the Subborrower must:
 - A. Have no more than 10 employees, including the owner; and
 - B. have total assets not exceeding US\$20,000 equivalent, excluding real property (buildings).
 - (ii) In the case of a business classified as a microenterprise that is part of a parent company or enterprise, such as a

branch or subsidiary, for instance, the credit analysis must include an analysis of the parent company or enterprise, to determine the Subborrower's eligibility.

- (iii) In the case of farmers, the Subborrower must not be the owner or legal holder of more than 10 arable hectares.

ARTICLE 4 Program resources

The Program resources will comprise the proceeds of the Loan, in an amount of up to US\$25 million equivalent, plus the local counterpart funds contributed by COFIDE, in an amount estimated at up to US\$10.7 million equivalent, from COFIDE credit lines for microenterprise. For purposes of the Program, the portion of COFIDE funds that are lent in accordance with the terms and conditions of these Regulations, including COFIDE loans to IFIs that do not satisfy the requirement in Article 6.c.(ii) of these Regulations, may be considered local counterpart funds.

ARTICLE 5 Use of Program resources

The Program resources will be used, in keeping with the multisectoral nature of the Program, to finance eligible microenterprise borrowers.

ARTICLE 6 IFI eligibility

- a. COFIDE shall, in each quarter, identify and select eligible IFIs to participate in the Program, on the basis of the most recent information published by the Superintendency of Banking and Insurance, hereinafter "SBS".
- b. In determining whether or not an IFI is eligible for the Program, COFIDE shall verify that it satisfies the following general conditions:
 - (i) It is subject to SBS oversight and inspection.
 - (ii) It is in compliance with the regulations, circulars, and directives issued by the SBS and other pertinent monitoring and oversight agencies.
 - (iii) It is not under any penalty or special surveillance system or financial rehabilitation plan required by the SBS or other pertinent monitoring or oversight bodies.
 - (iv) It is in compliance with the legal reserve requirements set by the competent authority.
 - (v) It has no legal proceedings pending with COFIDE.

- c. In addition, the IFI must be in compliance with the following financial ratios, according to the most recent SBS information available:
- (i) The ratio of its delinquent portfolio ("overdue" and "in process of collection by judicial means" categories) to its total gross loans outstanding may not exceed 12.5%, or exceed the average of the corresponding ratio in the banking system, excluding maximum and minimum values, plus 30%.
 - (ii) Its net income may not be negative in real terms.
 - (iii) Its aggregate financial obligations to COFIDE may not:
 - A. In the case of a commercial bank, finance corporation, leasing or consumer credit company, exceed 33% of its total liabilities.
 - B. In the case of the Cajas Municipales de Ahorro y Crédito [Municipal Savings and Loan Banks] (CMACs), exceed the total volume of their deposits. If the funds are to be channeled through the Fondo de Cajas Municipales de Ahorro y Crédito [Municipal Savings and Loan Bank Fund] (FOCMAC), the total deposits of the municipal bank system will be considered. In both cases, the policies on exposure limits set by COFIDE will be adhered to.
 - C. In the case of the Cajas Rurales de Ahorro y Crédito [Rural Savings and Loan Banks] (CRACs), exceed three times their capital. CRACs that have been operating longer than two years must demonstrate that their financial debt to COFIDE is 60% or less of their total liabilities.
 - D. In the case of the Entidades de Desarrollo de la Pequeña y Micro Empresa [Small Business and Microenterprise Development Institutions] (EDPYMEs), exceed three times their capital.
 - E. In the case of the Cooperativas de Ahorro y Crédito [Savings and Loan Cooperatives], exceed the total volume of their deposits. If the funds are to be channeled through the Federation of Savings and Loan Cooperatives, the total deposits of Federation members will be considered. In both cases, the policies on exposure limits set by COFIDE will be adhered to.
- d. If the Investment Rating Commission for Pension Fund Investments rates short-term deposit instruments issued by an IFI in categories I or II, such IFI will be exempt from the arrears provision in paragraph c(i) of this article.

- e. The information necessary for application of the above-described eligibility requirements will be the most recent information available from and furnished by the SBS. COFIDE also may take into account the information supplied by Federación Peruana de Cajas Municipales de Ahorro y Crédito [Federation of Municipal Savings and Loan Banks of Peru] (FEPCMAC), and other pertinent monitoring and oversight agencies.

ARTICLE 7 Participation agreements

- a. Participation in the Program by eligible IFIs will be governed by the Subsidiary Participation Agreements that COFIDE will conclude with each of them. These agreements will specify the conditions and obligations to be met by the parties in accordance with the conditions laid down in the loan contract and in these Regulations.
- b. The main obligations that the IFIs will assume under Subsidiary Participation Agreements will be as follows:
 - (i) Ensure that the Subborrower is in compliance with the eligibility requirements laid down in these Regulations.
 - (ii) Assume all the credit risks arising from the subloans.
 - (iii) Undertake that the average amount of the subloans granted with Program funds will not exceed US\$5,000 equivalent.
 - (iv) Pledge to afford equal treatment to women microentrepreneurs in the granting of loans.
 - (v) Ensure that the Program funds are onlent in accordance with the Program's environmental rules and guidelines.
 - (vi) Undertake that, for the life of each loan with COFIDE, the IFI's microenterprise loan portfolio will be equal to or greater than the outstanding balance of its obligations to COFIDE financed with Program resources.
 - (vii) Keep separate statistics on loans granted with Program resources.
 - (viii) Perform such other functions and obligations as are required of eligible IFI participants in the Program.

ARTICLE 8 Transfer of Program funds

- a. COFIDE will channel and transfer the Program resources to eligible IFIs, through the approval of loans.

- b. The time limit for using the proceeds of approved loans will be one year. COFIDE will charge a commitment fee on approved undisbursed loan balances, at a rate of not less than 0.75% per annum.
- c. Loans that COFIDE approves for an IFI will be disbursed by means of advances of funds to be agreed upon between the parties.
- d. The IFI will have 90 days, from the date of each disbursement, in which to demonstrate the onlending of the disbursed loan funds.
- e. Within five days after the end of the aforesaid 90-day period, the IFI will return any difference between the amount disbursed from each loan and the amounts for which supporting information was furnished to demonstrate that the funds were onlent.

ARTICLE 9 Terms and conditions of loans to IFIs

- a. The minimum interest rate that COFIDE will charge on loans to eligible IFIs will be the average rate payable on term deposits of over 360 days in foreign currency, adjusted for purposes of the statutory reserve requirement.
- b. The minimum interest rate charged by COFIDE to IFIs will be reviewed and adjusted quarterly.
- c. COFIDE will denominate its loans to eligible IFIs in dollars of the United States of America (hereinafter "U.S. dollars"), and disbursements of the resources and repayments thereof will be made in that currency.
- d. The maximum term of COFIDE's loans to eligible IFIs will be four years, with a grace period not to exceed one year, during which the eligible IFIs will pay quarterly interest on the debt.

ARTICLE 10 Nonperformance by IFIs

- a. An IFI will cease to be eligible for the Program if COFIDE determines that it no longer meets the program's eligibility requirements. The IFI will be excluded from the Program as long as it fails to satisfy those requirements.
- b. An eligible IFI may be excluded from the Program if COFIDE determines ex post, as it monitors IFI microenterprise loan portfolios and environmental assessments, that the Program funds have not been onlent in accordance with (i) Subborrower eligibility criteria or (ii) the Program's environmental requirements.
- c. The penalties that COFIDE may levy on an eligible IFI that is not performing its obligations may range from a warning to temporary or

definitive suspension from the Program. In the event of definitive suspension, the outstanding balance of loans made to an IFI with Program funds will become immediately due and payable.

ARTICLE 11 Terms and conditions of subloans

- a. Denomination: Subloans from IFIs to Subborrowers will be denominated in dollars or in new soles equivalents in dollars or in new soles. Subloan disbursements and amortization payments will be made as agreed between the IFI and the Subborrower.
- b. Terms: The repayment term of subloans will be set by the IFIs on the basis of the Subborrower's estimated repayment capacity. The IFI and the Subborrower will freely agree on the amortization schedule for the subloan.
- c. Intermediation margins and interest to be paid by Subborrowers: The IFIs will freely set the interest rates they consider appropriate for each subloan.

ARTICLE 12 Amounts of subloans

- a. The average amount of an IFI's total portfolio of subloans to Subborrowers financed with Program funds may not exceed US\$5,000 equivalent.
- b. The amount of an IFI subloan to a Subborrower financed with Program funds may not exceed US\$10,000 equivalent.

ARTICLE 13 Obligations of Subborrowers

- a. Subborrowers shall allow COFIDE, the Bank and the respective IFI to examine their property, facilities and work.
- b. Subborrowers shall provide such information as COFIDE, the IFI or the Bank may request in connection with their microentrepreneurial activities.
- c. In the case of microenterprises classified in environmental category III (moderate potential adverse environmental impacts) being financed, the Subborrowers shall agree to adopt the measures recommended by the IFI to prevent and mitigate any environmental impact, in order to qualify for a second loan.

ARTICLE 14 Restrictions on use of Program funds

Program funds may not be used to finance the following Subborrowers:

- a. Individuals whose primary source of income is not a microentrepreneurial activity but paid employment.
- b. Juridical persons (enterprises) that are part of an economic unit that is not eligible in accordance with the rules on Subborrower eligibility.
- c. Persons whose normal microentrepreneurial activities are classified by the IFI in environmental category IV (having significant potential adverse environmental impacts).
- d. Persons whose aggregate outstanding debt to the financial system exceeds the equivalent of US\$10,000 financed with program resources.

ARTICLE 15 Use of the differential and recoveries

- a. Funds corresponding to the difference between the amount obtained by COFIDE from the spread between the "COFIDE cost" – defined as the sum of the effective annual rate of interest charged by the Bank on the Loan proceeds, plus points equivalent to the annual COFIDE administrative margin – and interest income received by COFIDE on its loans to IFIs, are to be used to fund new loans of the same nature as those provided for in these Regulations.
- b. Funds repaid by IFIs for loans made with Program resources that are in excess of the sums needed to service the Loan may be used only to finance new loans for the same kind of activities provided for in these Regulations.
- c. The proceeds of the spread and loan recoveries referred to in the subparagraphs a. and b. above will be used as provided therein, unless seven years after the date of the last disbursement of the Financing the Bank and the Borrower, through COFIDE, agree to another use for the differential or recoveries, which must conform to the original basic objectives of the Financing, or agree to shorten the period of validity of this obligation.

ARTICLE 16 Environmental provisions

- a. COFIDE and the participating IFIs shall verify compliance with the environmental requirements of the Program, with respect to the obligations of Subborrowers classified in environmental category III, and to restrictions on the use of funds for Subborrowers classified in category IV.
- b. For the purposes of the preceding paragraph, COFIDE shall, upon signing the Subsidiary Participation Agreements with eligible IFIs, deliver to them the environmental materials necessary for ensuring

that, from the outset of the Program, the IFIs have available to them environmental instruments for use in the credit analysis process.

ARTICLE 17 Amendment of the Regulations

COFIDE may suggest amendments to these Regulations, to adapt them to new circumstances or conditions that might arise in the course of execution of the Program. Any such amendment shall enter into effect once the Bank has stated that it has no objection thereto.

PROPOSED RESOLUTION

PERU. LOAN ____/SF-PE TO THE REPUBLICA DEL PERU
(Global Credit Program for Microenterprises)

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf the Bank, to enter into such contract or contracts as may be necessary with the República del Perú, as Borrower, for the purpose of granting the former a financing to cooperate in the execution of a Global Credit Program for Microenterprises. Such financing will be up to the equivalent of US\$25,000,000, in nuevos soles, which are part of the resources of the Fund for Special Operations, and it will be subject to the "Special Contractual Conditions" and the "Terms and Financial Conditions" of the Executive Summary of the Loan Proposal.