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ECUADOR

CRECER PROGRAM: CREDIT FOR BUSINESS GROWTH AND RECOVERY

(EC-L1279)

LOAN PROPOSAL

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Annex II	Results Matrix
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LINKS

REQUIRED

1. Monitoring and evaluation plan
2. Summary of environmental and social review
3. Procurement plan
4. Multiyear execution plan
5. Annual work plan

OPTIONAL

1. Project economic analysis
2. Program Operating Regulations
3. Post-pandemic diagnostic assessment of MSMEs in Ecuador
4. Gaps in financing for MSMEs in Ecuador
5. Current state of Ecuador's financial system
6. FNG: Background and strengthening plan
7. Merger of CFN and BanEcuador into BFE
8. Potential financing for women business owners in Ecuador
9. Financial services and indigenous communities in Ecuador
10. Overview of climate finance in Ecuador
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ABBREVIATIONS

ASOBANCA	Asociación de Bancos del Ecuador [Ecuadorian Bank Association]
BFE	Banco de Fomento Económico del Ecuador
CFN	Corporación Financiera Nacional, Banca Pública
CONAFIPS	National Corporation for Popular Finance and Cooperative Associations [Corporación Nacional de Finanzas Populares y Solidarias]
FNG	Fondo Nacional de Garantías [National Guarantee Fund]
GDP	Gross domestic product
IFC	International Finance Corporation
IMF	International Monetary Fund
MEF	Ministry of Economy and Finance
MSMEs	Micro, small, and medium-sized enterprises
SOFR	Secured Overnight Financing Rate

PROJECT SUMMARY

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Financial Terms and Conditions				
Borrower and executing agency:			**Flexible Financing Facility[a]**	
Corporación Financiera Nacional, Banca Pública (CFN)			**Amortization period:**	25 years
Guarantor:			**Disbursement period:**	5 years
Republic of Ecuador			**Grace period:**	5.5 years[b]
Source	**Amount (US$)**	**%**	**Interest rate:**	SOFR-based
IDB Ordinary Capital:	300,000,000	100	**Credit fee:**	[c]
Total:	300,000,000	100	**Inspection and supervision fee:**	[c]
			Weighted average life:	15.25 years
			Approval currency:	U.S. dollars

Project at a Glance
Project objective/description: The general development objective of the program is to support the economic recovery of micro, small, and medium-sized enterprises (MSMEs) in Ecuador. The specific development objective is to expand access to credit for Ecuadorian MSMEs through CFN's second-tier financial instruments.
Special contractual conditions precedent to the first disbursement of the financing: As a special contractual condition precedent to the first disbursement of the financing, the borrower will submit evidence of the approval and entry into force of the program Operating Regulations under the terms previously agreed upon with the Bank. In addition, as a condition precedent to the first disbursement of resources under Component 1, the borrower will submit evidence of the approval and entry into force of the investment policy of the National Guarantee Fund (FNG), by its Trust Fund Board, in accordance with the program Operating Regulations. (paragraph 3.8).
Exceptions to Bank policies: A request is made of the Board of Executive Directors to approve a partial waiver of the Bank's Operational Policy on Guarantees Required from the Borrower (OP-303) to allow the Republic of Ecuador to guarantee only those financial obligations arising from the loan contract between the Bank and CFN (paragraph 3.9).

Strategic Alignment			
Challenges:[d]	SI ☒	PI ☒	EI ☐
Crosscutting themes:[e]	GE ☒ and DI ☐	CC ☒ and ES ☐	IC ☒

[a] Under the terms of the Flexible Financing Facility (document FN-655-1), the borrower has the option of requesting changes to the amortization schedule, as well as currency, interest rate, commodity, and catastrophe protection conversions. The Bank will take operational and risk management considerations into account when reviewing such requests.

[b] Under the flexible repayment options of the Flexible Financing Facility, changes to the grace period are permitted provided that they do not entail any extension of the original weighted average life of the loan or the last payment date as documented in the loan contract.

[c] The credit fee and inspection and supervision fee will be established periodically by the Board of Executive Directors as part of its review of the Bank's lending charges, in accordance with applicable policies.

[d] SI (Social Inclusion and Equality); PI (Productivity and Innovation); and EI (Economic Integration).

[e] GE (Gender Equality) and DI (Diversity); CC (Climate Change) and ES (Environmental Sustainability); and IC (Institutional Capacity and Rule of Law).

I. DESCRIPTION AND RESULTS MONITORING

A. Background, problem addressed, and rationale

1.1 **Ecuador shows significant signs of post-pandemic recovery.** The Central Bank of Ecuador is projecting gross domestic product (GDP) to grow 2.8% in 2022, but the International Monetary Fund (IMF) and the World Bank have more recently projected growth at 2.9% and 3.7%, respectively. In May 2022, the IMF approved the fourth and fifth reviews to the lending program it signed with Ecuador in 2020.[1] New regulations for stability and transparency in public finances, the tax reform package approved in December 2021, the gradual elimination of fuel subsidies, and the efficient management and coverage of COVID-19 vaccination efforts have contributed to Ecuador's post-pandemic economic recovery. Tax revenues rose 28% between the first quarter of 2021 and the first quarter of 2022, and the unemployment rate fell from 5.4% to 5.0%. Public debt as a percentage of GDP declined from 58.6% in December 2021 to 55% in March 2022. While the national strike led by indigenous movements in June 2022 caused substantial economic losses, the government achieved a resumption of the country's economic activities through dialogue roundtables to address the protestors' demands.[2]

1.2 **Despite the recovery, low levels of productivity persist.** Ecuador's economy has one of the lowest productivity levels in the region. Its total factor productivity in 2019 was 42% of that of the United States, one of the lowest rates in the region, trailing Brazil (50%), Colombia (68%), Paraguay (61%), and Uruguay (69%). The lack of productivity accounts for 90% of the gap in per-capita GDP between Ecuador and the United States, more than in any other country in Latin America and the Caribbean, where this figure averages 78%.[3] Low productivity is related to structural factors in production and business in Ecuador, with high transaction costs, high barriers to innovation, and low levels of financing. The productivity gap is the main limiting factor on economic growth and competitiveness in Ecuador over the medium and long terms. Ecuador's business fabric still needs support for the economic recovery, particularly for MSMEs that have suffered adverse effects in terms of employment, sales, survival,[4] and access to credit.[5]

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1 This review process noted the fiscal results of the last two quarters of 2021, and a new disbursement of US$1 billion is slated for June 2022.

2 The mobilization associated with the national strike from 13 to 30 June 2022 caused more than US$1 billion in estimated losses. The dialogue roundtables are addressing such topics as the public and private banking systems, promotion of production, energy and natural resources, collective rights, and access to healthcare. On 18 July 2022, public and private banking became the first topic on which agreements were reached.

3 Andean Development Corporation (2018): *Instituciones para la productividad: Hacia un mejor entorno empresarial*. Economic and Development Report.

4 The impact of COVID-19 on access to credit for MSMEs, as analyzed in optional link 3, was found to have contributed to low MSME survival rates.

5 The number of MSMEs gaining access to loans, since average and total loan amounts increased during the pandemic (see optional link 5).

1.3 **Businesses are fewer and find growth more challenging.** Out of 846,000 businesses in Ecuador as of late 2020,[6] 99.7% were MSMEs.[7,8] The number of businesses has dropped sharply in the past two years, from 914,000 in 2018 and 886,000 in 2019. This decline was most pronounced among small and medium-sized enterprises, whose numbers fell by 20% and 13%, respectively. While the number of microenterprises fell by only 6.4%, this translates in absolute terms to the loss of 52,400 businesses. In addition to the decline in the number of businesses, the lack of growth is a major problem. An analysis of changes in business size between 2015 and 2020 found that only 1% of microenterprises grew to exceed US$100,000 in sales. During that period, 56.8% of microenterprises shut down, and 42.3% remained at the same size. Similarly, only 3.4% of small enterprises were able to scale up, while 39% remained at the same size, 33% became microenterprises, and 24% shut down. Among medium-sized enterprises, 10% scaled up, 30% remained at the same size, 40% scaled down, and the remainder closed down (optional link 3).

1.4 **MSMEs' economic recovery is crucial for Ecuador.**[9] MSMEs account for 60% of all jobs, 45% of the wage bill, 42% of business assets, and 28% of business sales in Ecuador's economy. During the pandemic, the government implemented 16 policy measures to support MSMEs until December 2020, with a focus on four action areas: liquidity, financing, jobs, and support for production. Though the pandemic reduced the number of businesses, the government's intervention was successful in maintaining relative stability in liquidity, solvency, and management for surviving MSMEs, albeit it at lower sales figures than before the pandemic. An analysis of sales among a sampling of MSMEs between 2015 and 2020 found that the hardest-hit sectors were lodging and dining, the arts, entertainment and recreation, construction, manufacturing, mining, and quarry operations; meanwhile, MSMEs associated with the health, information, and communication sectors experienced a situational increase in sales. In the post-pandemic period, supporting and assisting MSMEs in the hardest-hit sectors will be key to creating jobs and boosting productivity.

1.5 **Credit is a factor in the recovery and development of Ecuadorian MSMEs.** Businesses with access to credit, in comparison with those that do not, have 130% the level of investment, 27% higher labor productivity, and 15% higher total factor

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6 This is the number of all businesses that reported sales to Ecuador's Internal Revenue Service, registered job positions with the Ecuadorian Social Security Institute, and/or submitted tax returns as part of the simplified tax system in 2020.

7 The regulations for the Production, Commerce, and Investment Code include the following definitions: (i) microenterprise: 1-9 employees and US$300,000 or less in annual sales or revenue; (ii) small enterprise: 10-49 employees and US$300,001 to US$1,000,000 in annual sales or revenue; and (iii) medium-sized enterprise: 50-199 employees and US$1,000,001 to US$5,000,000 in annual sales or revenue.

8 Microenterprises accounted for 93.6% of all businesses; small enterprises, 4.7%; medium-sized enterprises, 1.4%; and large enterprises, 0.3%.

9 All data in this paragraph are from optional link 3 ("Post-pandemic diagnostic assessment of MSMEs in Ecuador").

productivity.[10] Pre-pandemic analyses in Ecuador identified access to credit as the third-largest obstacle to business growth, after a lack of formal status and political instability.[11] Business size was a significant factor, as 15.4% of small enterprises and 10.6% of medium-sized enterprises identified a lack of access to credit as the greatest constraint on growth, compared with only 8.4% of large companies. These analyses also found that only 32.3% of small enterprises used bank credit; 9.7% of them had credit applications denied; and those whose applications were approved were asked to put up collateral equivalent to 211.8% of the loan amount.[12] While current data are lacking, the 2022 analysis of balance sheets of formal-sector enterprises found that only a third of all businesses in Ecuador, regardless of size, have gained access to credit or financial instruments (optional link 3). The same source indicates that smaller businesses tend to rely more on shareholder capital (47% among microenterprises, compared with 8% among large companies) and receive less financing from suppliers (19% among microenterprises, compared with 47% among large companies).

1.6 **However, banking system credit is reaching a smaller number of businesses in larger amounts.** At year-end 2021, bank-issued loans totaled US$31.24 billion for the year, up from US$28.11 billion at year-end 2020,[13] but still down from the pre-pandemic total of US$32.043 billion in 2019. Of all loans placed in 2021, 76% were for production-oriented loans; 13%, for consumer loans; 9%, for microloans; and 3%, for housing loans. The number of lending operations—on the decline since peaking in 2019 (at 2,205,523)—stood at 1,941,737 at year-end 2021. Forty-three percent of these were consumer loans; 34%, microloans; 23%, production-oriented loans; and 1%, housing loans. Although total lending to businesses (i.e., production-oriented loans and microloans) increased 12% since 2017 (from US$23.509 billion to US$26.395 billion), the number of loan operations fell by 3% (from 1,135,999 to 1,102,937). Since the average amount of lending to businesses increased even during the pandemic,[14] it may be inferred that such lending has become increasingly concentrated in fewer operations. This adds to the evidence that financial inclusion of MSMEs is lacking in Ecuador.

1.7 **Access to credit in Ecuador is more limited for MSMEs.** In 2017, only an estimated 18% of MSMEs' demand for loans was met by the Ecuadorian financial system, which equates to an estimated US$17.937 billion in unmet demand.[15] Updated post-pandemic data for 2022 show that this gap may have grown to more than US$25 billion (optional link 4). Obstacles to access for MSMEs include: (i) the high cost of generating and providing bank-required documentation, which can

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10 Ruiz-Arranz, M. et al. (2018): *Creciendo con productividad: Una agenda para la Región Andina*. IDB. Monograph.

11 International Finance Corporation (IFC) (2017a): Enterprise Survey Ecuador.

12 Idem, IFC (2017a).

13 The average loan amount increased for all loan types, which did not see declines even during the pandemic. In other words, banks are concentrating more resources in each loan operation and avoiding operations that the banking system deems risky (optional link 5).

14 Between 2017 and 2021, the average microloan increased from US$3,323 to US$4,112; the average production-oriented loan, from US$48,661 to US$53,899.

15 IFC MSME Finance Gap, 2017b.

entail a high degree of sophistication; (ii) a lack of guarantees or collateral to support their applications for financing;[16] and (iii) a lack of knowledge on available lending instruments and how lending products work, including lines of credit for MSMEs. Supply-side obstacles are related to: (i) products whose repayment timetable is not compatible with MSMEs' business cycle; (ii) high interest rates, which may be more related to internal operational inefficiencies than to the cost of overseeing small loans; (iii) a lack of data-gathering and oversight methodologies for more effective risk management; and (iv) guarantee or collateral requirements that are beyond the means of MSMEs.

1.8 **The financial system is healthy and solvent, though underdeveloped.** The lack of development of Ecuador's financial sector limits the capacity for economic reactivation. Its financial development index, calculated by the IMF, was 0.13 in 2020, down from 0.18 in 2019 due to the impact of the pandemic. Total bank lending amounted to only 36% of GDP, trailing other upper-middle-income countries in Latin America and the Caribbean. Although Ecuador has 24 private banks, more than 70% of the system's assets are concentrated in five banks.[17] As of June 2022, private banks reported US$52.679 billion in assets, US$36.121 billion in loans, US$40.929 billion in deposits, and US$5.341 billion in equity. Banks are in a strong position overall, bolstered by a strong ratio of risk coverage to nonperforming loans (3.2), technical equity ratio of 13.6% (4.6 percentage points above the minimum requirement), operational coverage of liabilities with cost (129.8%) and coverage of operating expenses (operating margin of 120.8%). The liquidity rate is 23.2%, and the rate of return on equity is 11.2%. The rate of arrears (2.2% on average) is on the decline and, in fact, is on the verge of falling below pre-pandemic levels (optional link 5).

1.9 **Bank liabilities are structured for the short term, and an interest rates regime is in effect.**[18] As of June 2022, term deposits accounted for 38% of all deposits. This means that US$6 out of every US$10 deposited are highly liquid. Moreover, 78% of term deposits mature within 180 days (only 3% of deposits have terms exceeding 360 days). This liability structure forces banks to keep resources on hand in the very short term and hinders financing with repayment periods exceeding one year. In other words, banks need funding with longer-term resources to avoid deposit mismatches (since more than 60% of current funding is payable on demand) and thereby meet the need for credit with longer tenors, such as those needed by MSMEs (optional link 5). Ecuador's financial system is also subject to caps on lending rates, as provided in Ecuador's Constitution and its Monetary and Financial Code. Since 2007, this cap is the benchmark rate plus a factor calculated by the Central Bank's board of directors. After the methodology was adjusted in 2021, the benchmark lending rate declined 11% between July 2019 and July 2022, while the benchmark borrowing rate fell 29.6%.[19] Banks

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16 Only 0.29% of all loans from the financial system are backed by local guarantee funds.

17 These banks are Banco Pichincha, Banco del Pacífico, Banco Guayaquil, Produbanco, and Banco Bolivariano.

18 All data in this paragraph are from optional link 5 ("Current state of the Ecuadorian financial system").

19 The methodology is published by the Central Bank.

say that interest rate caps hinder their ability to lend to MSMEs because the caps do not allow them to cover the high operating costs that such lending entails.

1.10 **Guarantee funds have not yet triggered lending in Ecuador.** In Latin America and the Caribbean, as in Ecuador, public guarantee funds have traditionally been aimed at supporting MSMEs, in view of finance gaps affecting this segment. Guarantee funds back up the credit applications of MSMEs that have constraints such as lack of capital or collateral, as well as those that are new to the market and lack the experience to cover their credit needs.[20] Guarantee fund products generate benefits for banks by providing partial coverage in the event of nonpayment, which contributes to: (i) diversification of credit risk; (ii) liquidity and quality of guarantees, compared with other instruments; and (iii) an associated reduction of required capital.[21] Moreover, international evidence shows that guarantee funds are an important tool.[22,23] Ecuador's financial system, however, lacks a significant guarantee fund, as the two in existence—the National Guarantee Fund (FNG) and the Guarantee Fund for the Popular and Solidarity-based Economy—guarantee loan portfolios with balances on the order of US$90 million.[24] Actors in the Ecuadorian financial system attribute this to a lack of modernization in guarantee products, a perception of operational inefficiency or slowness, a lack of clarity on the regulatory benefits of guarantees, and the high liquidity or execution risk that guarantees entail by having capital invested in credit instruments.[25]

1.11 **The FNG in the Ecuadorian banking system.** The FNG was created in late 2013 as a trust fund with contributions from Corporación Financiera Nacional (CFN), a public development bank that works to promote development in Ecuador by providing financial services targeted to MSMEs. CFN serves as the technical secretariat of the FNG and engages a fiduciary entity to manage it. The FNG's leadership body is the Trust Fund Board, consisting of the ministers of production, economic policy, and social development. CFN, as founder of the FNG, makes its technical resources available to help the FNG achieve its objectives and support its mission. Between 2017 and February 2022, nine financial institutions[26] operated as guarantee-receiving entities of the FNG, with US$227 million in guarantees (6,620 operations) benefitting 5,573 MSMEs[27] and backing a total of US$370.99 million in loans. The claim rate between 2012 and 2021 was 2.36% (US$5.17 million) of the amount guaranteed over that period. As of August 2022, the FNG was supporting a US$133.3 million portfolio balance while guaranteeing

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20 World Bank (2015). Principles for Public Credit Guarantee Schemes for SMEs. Washington, D.C.

21 Fernandini et al. (2020). *Fondos y otros mecanismos de garantía para las MIPYME en América Latina y el Caribe*.

22 Economic Commission for Latin America and the Caribbean (2014). *Algunas lecciones de la experiencia reciente de financiamiento a las PYMES: Colombia, Costa Rica y México*.

23 Bolzico and Prats (2022): *Esquemas de garantía pública para créditos bancarios en tiempos de COVID-19 en América Latina y el Caribe*.

24 Data as of May 2021 based on Bolzico and Prats (2022).

25 Findings of the survey on perceptions of the MSME financing market in Ecuador, conducted with CFN and its institutional clients in July and August 2022.

26 Eight banks and one savings and loan cooperative.

27 An estimated 11.15% of these MSMEs were first-time clients of the guarantee-receiving entities.

US$84.4 million of that amount and serving 3,869 clients. With US$50.1 million in equity, its leverage ratio is 1.68. In 2020, CFN initiated an internal diagnostic assessment using World Bank and IDB methodologies, as well as inputs from the Superintendency of Banks, and identified areas for improvement in FNG management as it pertains to portfolio distribution across guarantee-receiving entities,[28] economic sectors,[29] credit segments, and regions.[30] Compounding this is the perception of bureaucratization, slowness, and inefficiency in processes and procedures, as evidenced by the small number of guarantee-receiving entities and the lack of involvement of Ecuador's leading commercial banks. In response to the identified weaknesses, CFN and the FNG prepared an aggressive and ambitious strengthening plan,[31] which is now being executed (optional link 6).

1.12 **The FNG is being strengthened as CFN undergoes a transformation process.** Ecuador's new administration has focused on providing low-cost, long-term credit geared toward MSMEs, while ensuring operational efficiency and financial sustainability. In 2021, it ordered the merger of BanEcuador and CFN into a single entity to be called Banco de Fomento Económico del Ecuador (BFE). The BFE will provide financial services authorized by the Superintendency of Banks for MSMEs and production-oriented associative enterprises in the agribusiness, commerce, and export sectors, as well as other activities producing goods and services. The BFE will operate through first- and second-tier mechanisms (for which expertise will be provided by BanEcuador and CFN, respectively). The merger process is detailed in a roadmap and transition plan being implemented under the supervision of the Ministry of Economy and Finance (MEF) and the CFN Office of the President (optional link 7).

1.13 **Important crosscutting considerations in the Ecuadorian financial system.** Analyzing the challenges in access to credit for MSMEs calls for mainstreaming considerations regarding gender and diversity, as well as climate change, to gain a deeper understanding of potentially significant gaps:

a. **Gender equity.** According to the 2021 Global Findex report, only 14.52% of women in Ecuador reported that they had applied for a loan from a financial institution, compared with 32.18% of men.[32] According to the proposal for Ecuador's National Financial Inclusion Strategy 2020-2024, 43% of women have an account in the financial system, compared to 60% of Ecuadorian men. Available data indicate that only 14% of MSMEs are owned by women, 28% of

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[28] Banco del Pacífico accounts for 67% of the portfolio's current balance and 90% of related claims.

[29] Sixty-five percent of the portfolio's current balance is concentrated in only three sectors, with the commerce sector accounting for 39%.

[30] The Guayas (40%) and Pichincha (25%) regions account for 65% of the current balance.

[31] The plan includes the following pillars: (i) comprehensive risk management; (ii) evaluation of outcomes: creation of a system for evaluating outcomes and impact of FNG management; (iii) operational efficiency: improvements to administrative and accounting processes; (iv) ethical structure: establishment and crosscutting implementation of institutional values and the code of ethics; (v) regulatory efficiency: development, updating, and restructuring of FNG procedure manuals; (vi) people: strengthening of human resources, corporate governance, and transparency; (vii) intermediaries: strengthening and diversification of guarantee-receiving entities; and (viii) digital transformation.

[32] World Bank (2021): Global Findex.

which report experiencing financial constraints.[33] Only 6% of women had applied for a microloan as of year-end 2021.[34] The percentage of women-led businesses that have a line of credit or loan from a financial institution is lower (43%) than that of male-led enterprises (64.6%).[35] A higher percentage of these loans for woman require collateral (77.1%, compared with 54.7% for men), and women are required to put up larger amounts of collateral than men relative to the approved loan amount (253.5% for women and 197.6% for men). Moreover, women-led MSMEs are more concentrated than male-led MSMEs in the economic sectors hardest hit by the COVID-19 crisis, such as commerce (30%), services (18.7%), and manufacturing (13.1%)[36] Statistics on the portfolio for women-led MSMEs across the banking system are lacking, but CFN had US$32.3 million in such loans in its second-tier banking operations as of mid-2022. The finance gap for women-led MSMEs in Ecuador's formal sector exceeds US$9.5 billion (optional link 8).

b. **Diversity.** More than one million Ecuadorians[37] self-identify as indigenous (7% of the total population). The Central Bank estimates that indigenous people account for 18% of Ecuador's households.[38] Moreover, indigenous people make up more than 50% of the population of 16 of the country's cantons. In general, Ecuador's Amazon region (5% and 6%) and the cantons with high concentrations of indigenous people (3% and 2%) are much less covered by service locations of financial institutions (branches and affiliate locations) than other provinces in the central Sierra region. The service gap is not considered very large, particularly in terms of banking services, as savings and loan cooperatives enjoy a more physically and culturally close relationship as part of the "popular and solidarity-based" economy. As for the public banking system, institutions such as BanEcuador (first tier) and the National Corporation for Popular Finance and Cooperative Associations (CONAFIPS) (second tier) maintain channels through which they serve this population. In July 2022, the government forgave US$59 million in cumulative debt held at BanEcuador on behalf of indigenous movements, which affected the perception of risk of the country's banks and other financial institutions (optional link 9).

c. **Climate change and sustainability.** Ecuador is one of 17 megadiverse countries in the world. Though it contributes less than 1% of global greenhouse gas emissions, Ecuador is not immune from the adverse effects of climate change, which may cost it US$5.6 billion in losses by 2025. Its National Climate Finance Strategy 2020-2030 aims to coordinate with relevant actors (public, private, and international) to ensure that the financial system incorporates financing for climate change mitigation and adaptation as a crosscutting

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33 IFC (2017): MSME Finance Gap.

34 Superintendency of Banks (December 2021): *Boletín trimestral de inclusión financiera*.

35 Idem.

36 Mastercard Index of Women Entrepreneurs 2020.

37 According to the 2010 census, this figure stood at 1,018,176 people.

38 Indigenous, mulatto, Afro-Ecuadorian, and Montubio people live in both urban and rural areas, although the indigenous and Montubio populations reside primarily in rural areas (80% and 53%, respectively).

feature. In 2021, the 15 members of the Ecuadorian Bank Association (ASOBANCA) signed a commitment to combat climate change through sustainable finance initiatives. ASOBANCA reports that six banks have green products ranging from green accounts to lines of credit for specific projects. As for public development banks, CFN contributes to climate change mitigation and adaptation in its sectors geared toward MSMEs, businesses, and corporate clients by providing financing for electric transportation and forestry. Its institutional strategic plan also includes sustainability as a crosscutting feature, and the Environmental and Social Risk Management System has been in effect since 2019 (optional link 10). The placement of green, sustainable loans has trended in a positive direction in recent years,[39] although requirements for long-term liabilities continue to undermine this growth. As of mid-2022, CFN had US$7.03 million in this type of loan in its second-tier portfolio.

1.14 **Proposed intervention.** The program addresses the problem of access to credit for MSMEs in Ecuador within a context of economic recovery that can benefit from the strengthening of CFN's second-tier financial mechanisms, such as the FNG and second-tier banking operations. (i) If the FNG is financially strengthened with program-provided resources, it could support more MSMEs that have difficulties accessing credit in the banking system. While improving its risk profile from the banks' perspective, the FNG's guarantees would have the effect of mobilizing private sector resources because the guarantees require the banks to provide counterpart funding for the loans to MSMEs; and (ii) CFN's second-tier banking operations would benefit from program resources not only through financing to alleviate the lack of medium- and long-term liabilities in the banking system, which are needed to serve MSMEs' productive activity, but also by promoting the CFN's new strategy and image as a public development bank that is not competing with private banks in the first tier. The program will intervene in the market using complementary second-tier mechanisms to narrow the finance gaps affecting MSMEs in Ecuador. Not only will the FNG expand access to credit for MSMEs by serving those excluded or underserved by the banking system, but CFN's second-tier banking operations will deepen access to credit in specific segments of women-led MSMEs and/or MSMEs pursuing climate change mitigation and adaptation projects.

1.15 **Institutional and strategic framework.** The program is aligned with the Ecuadorian government's Opportunity Creation Plan 2021-2025, specifically in the key areas of productivity and competitiveness, a suitable business environment conducive to attracting investment, ecological transition, and gender inclusion. The program is also aligned with the Law on Economic Development and Fiscal Sustainability after the COVID-19 Pandemic, of November 2021, which provides a framework for financial institutions to issue loans to the country's productive sectors and includes provisions on initial procedures to merge CFN with BanEcuador into the BFE. In Executive Order 406 of 25 April 2022, the government announced the merger of CFN with BanEcuador and the resultant formation of the

[39] For example, Banco Pichincha went from 547 operations in 2019 to 4,551 as of October 2021. ProCredit issued over 300 loans in 2021, twice as many as in 2019.

BFE as a strengthened development instrument within the financial system that specializes in financing and services for MSMEs (paragraph 3.2). During the merger process, both entities will ensure the continuity of their respective contractual, administrative, and other processes that are already in progress. Preparations for the merger are under way, and the BFE is slated to begin operations by the first half of 2024 (optional link 7).

1.16 **The Bank's experience and lessons learned.** The Bank has a long track record of working with the region's public development banks on similar loan and guarantee programs. Fifteen programs supporting guarantee funds were approved between 2012 and 2021, four of them (5205/OC-BA, 5024/OC-EC, 5082/BL-HO, 5058/OC-UR) in response to the COVID-19 crisis. The proposed program incorporates the lessons from these programs, especially the technical lessons related to good practices for strengthening financial and institutional capacities in guarantee funds (paragraph 1.23), maximizing the mobilization of private sector credit (paragraph 1.26), and measuring economic and social outcomes. The program also benefits from the Bank's experience on operations for financing MSMEs in times of crisis to enable them to continue operating, specifically on the Global Credit Program for Safeguarding the Productive Fabric and Employment (5024/OC-EC), which strengthened second-tier instruments of CONAFIPS that are similar to those of this program (paragraphs 1.17, 1.21, and 1.22). That program is in its closing phase, and lessons learned are being assembled. Preliminarily, the experience of the program affirms the need for long-term financing for working capital loans, especially in times of crisis when MSMEs can only make small payments on loans. Also incorporated is CFN's experience as the Bank's executing agency on the Multisectoral Global Credit Program (650/OC-EC) and the Microenterprise Support Program (851/SF-EC). Although these two programs are from 30 years ago, in both cases the evaluations pointed up CFN's pioneering role in providing financing to MSMEs in Ecuador through special products that did not require collateral, as well as its role in establishing a second tier as a pilot platform for the country's financial system.

1.17 **Complementarity with other IDB Group operations.** Complementarity with IDB Invest is key to achieving active dialogue with private banks and fostering a crowding-in effect through the program. In particular, IDB Invest operations to finance working and/or investment capital for MSMEs with crosscutting sustainability and gender components are expected to promote financing for this sector in a manner that complements the efforts of CFN and the program. Moreover, the joint dialogue of IDB and IDB Invest with the banking sector will help gain an understanding of challenges in the FNG's structure, operations, and risk profile. For the Bank, the program is complementary with the Global Credit Program for Safeguarding the Productive Fabric and Employment (5024/OC-EC), approved in 2020 and now 100% disbursed, whose objective is to support the sustainability of microenterprises and small businesses as employment providers in Ecuador amid the COVID-19 crisis; and (ii) the Program for Development and Economic Recovery in Ecuador (5421/OC-EC), approved in 2021 as a policy-based loan and now pending the signing of the contract, whose objective is to promote the sustainable, inclusive reactivation of Ecuador's economy.

1.18 **Coordination with other donors.** The proposed program is being coordinated with the World Bank project to promote access to production-oriented financing

for MSMEs, approved in 2020 for US$260 million to help CFN support MSMEs during the pandemic. This program is directly complementary, as it will provide US$40 million to the FNG and will finance the FNG's institutional strengthening plan. Weekly meetings will be held to coordinate actions between the IDB, World Bank, and CFN teams and ensure synergy between the two programs.

1.19 **Strategic alignment.** The program is aligned with the Update to the Institutional Strategy 2020-2023 (document AB-3190-2) through the development challenges of: (i) productivity and innovation, as it will expand access to financing for MSMEs by strengthening the FNG and CFN's second-tier lines of finance; and (ii) social inclusion and equality, as it will help provide financing to MSMEs where financial inclusion gaps are pronounced. The program is also aligned with the crosscutting areas of: (i) gender equality and diversity, as 30% of its resources will go to women-led MSMEs (paragraph 1.20); (ii) institutional capacity and rule of law, as it includes actions to modernize and strengthen CFN and FNG operations; and (iii) climate change, as resources will be used to finance MSMEs' initiatives that will have an impact on climate change (equivalent to US$30 million). In accordance with the multilateral development banks' joint methodologies for tracking climate finance, 10% of the operation's resources will be invested in climate change mitigation and adaptation activities (paragraph 1.21). The program will contribute to the Corporate Results Framework 2020-2023 (document GN-2727-12) through the following indicators: (i) women beneficiaries of economic empowerment initiatives; (ii) micro, small, medium-sized enterprises financed; and (iii) agencies with strengthened digital technology and managerial capacity. The program is also consistent with the Support to SMEs and Financial Access/Supervision Sector Framework Document (document GN-2768-7), as part of the focus on improving the efficiency and scope of bank credit intermediation for the productive sector. The program is aligned with the IDB Group Country Strategy with Ecuador 2022-2025 (document GN-3103-1), specifically with the priority area of developing the productive sector as a driver of sustainable growth and the strategic objective of improving access to finance. The program is included in the updated Annex III of the 2022 Operational Program Report (document GN-3087-2).

1.20 **Gender and diversity considerations.** The program includes actions to address gender gaps, as US$90 million under Component 2 will go toward loans to women-led MSMEs (equivalent to 30% of program resources). This will scale up CFN's current portfolio (US$32.3 million) to US$122.3 million by the end of the program's execution period. The program will also use resources from operation ATN/OC-18918-RG to help develop CFN and FNG capacities to assist women-led MSMEs by developing a gender action plan that will: (i) formalize the use of definitions of women-led MSMEs; (ii) implement the disaggregation of data by gender in portfolio reports; and (iii) establish a system of indicators for monitoring the portfolio of women-led MSMEs. In the case of indigenous communities, although this market niche is perceived as high risk among banks, and where physical coverage is still low (paragraph 1.13(b)), the program will take advantage of the plan to include a survey mapping the scope of CFN and FNG operations in geographical areas where indigenous populations are present and start measuring their contribution to the depth of financial penetration in those areas, with a view to future actions with banks that may be interested in penetrating

those markets. Resources from operation ATN/OC-19100-RG will be used to support CFN in this regard.

1.21 **Climate change considerations.** The program will promote MSMEs' investments in climate change mitigation and adaptation, as 10% of its resources will be used to finance this type of loan (equivalent to US$30 million under Component 2); this will be a groundbreaking approach to promoting CFN's penetration in green finance. Resources from operation ATN/AC-18933 will support the use of a tool in CFN to identify and classify MSMEs' investments in climate change mitigation and adaptation.

B. Objectives, components, and cost

1.22 **Objectives.** The general development objective of the program is to support the economic recovery of micro, small, and medium-sized enterprises (MSMEs) in Ecuador. The specific development objective is to expand access to credit for Ecuadorian MSMEs through CFN's second-tier financial instruments.

1.23 **Component 1. Financial strengthening of the FNG (US$100 million).** CFN will provide the resources for this component as a contribution to the FNG, and these resources will in turn be invested in accordance with an investment policy designed to improve the FNG's risk profile and liquidity vis-à-vis commercial banks. This will build confidence and incentivize the use of guarantees generated from these resources for loans to MSMEs. This component will focus on the issuance of partial guarantees by the FNG to generate loans for eligible MSMEs that have strong risk ratings (A or B),[40] production-oriented initiatives, and a need for financing for working capital and/or fixed assets but which lack the capital or collateral needed to gain access to bank credit. MSMEs will not be subject to restrictions on the basis of economic sector or geographic area, but priority will be given to MSMEs that are gaining access to credit for the first time or were left out of the formal financial system during the pandemic. The FNG's guarantees will initially cover up to 50% of the amount of the issued loan. A typical amount for a loan promoted through this component will be around US$25,000. Although the ceiling was set at US$2 million, 90% of loans are expected to be under US$1 million, and amounts above US$1 million and up to US$2 million will only be permitted for medium-sized enterprises with financing proposals for fixed assets for climate change mitigation and adaptation (paragraph 3.6). In addition, the amount of any single guarantee that may be issued for bank-issued loans will be capped at US$500,000. The FNG will not be permitted to issue security interests to public banks. Banks will be responsible for assessing MSMEs' repayment capacity in accordance with their own risk policies, as well as for setting final terms and conditions in accordance with the criteria and guidelines set out in the program Operating Regulations.

1.24 **Component 2. CFN's second-tier banking operations (US$199.3 million).** CFN will use its second-tier banking operations to direct program resources to eligible banks, which will use the resources for this component to place loans to MSMEs. This component will target MSMEs with production-oriented initiatives and a need for primarily medium- and long-term financing for working capital

[40] These are definitions used by CFN: risk level A (0-30 days in arrears) and risk level B (31-90 days in arrears).

and/or fixed assets. MSMEs will not be subject to restrictions on the basis of economic sector or geographic area, but priority will be given to MSMEs that are gaining access to credit for the first time or were left out of the formal financial system during the pandemic. This component will give priority to women-led MSMEs and MSMEs pursuing climate change mitigation and adaptation projects, in order to address crosscutting considerations in Ecuador's financing gaps (paragraph 1.13), with at least US$90 million going to loans for women-led MSMEs (paragraph 1.20) and US$30 million going to MSME investments climate change mitigation and adaptation (paragraph 1.21). A typical amount for a loan promoted through this component will be around US$25,000. Although the ceiling was set at US$2 million, 90% of loans are expected to be under US$1 million, and amounts above US$1 million and up to US$2 million will only be permitted for medium-sized enterprises with financing proposals for fixed assets for climate change mitigation and adaptation (paragraph 3.6). Banks will be responsible for assessing MSMEs' repayment capacity in accordance with their own risk policies, as well as for setting final terms and conditions in accordance with the criteria and guidelines set out in the program Operating Regulations. Moreover, the Operating Regulations will include definitions and annexes for classifying and disaggregating data on the initiatives of women-led MSMEs and MSMEs pursuing climate change mitigation and adaptation projects.

1.25 **Component 3. Technical modernization (US$500,000).** The program includes strengthening activities that will contribute to the objective of expanding access to credit for Ecuadorian MSMEs through CFN's second-tier financial instruments. To facilitate execution of Component 1, consulting services will be engaged in line with the FNG strengthening plan (paragraph 1.11), specifically to update the FNG operations manual and develop an information technology solution to streamline FNG operations with banks. For Component 2, a consulting engagement will be financed to monitor the CFN-to-BFE institutional transition plan (paragraph 1.12), with emphasis on the transition of second-tier banking operations.

1.26 **Audit and monitoring (US$200,000).** The program will allocate resources to cover auditing and reporting costs, particularly for the monitoring of Components 1 and 2.

1.27 **Beneficiaries.** The beneficiaries of Components 1 and 2 will be an estimated 33,671 MSMEs in all economic sectors and geographic areas of Ecuador, including some 15,487 women-led MSMEs. The beneficiaries of Component 3 will be CFN and the FNG, as the consulting services to be procured will aim to strengthen their institutional capacities.

1.28 **Resource mobilization.** The guarantees issued to MSMEs through the FNG will help mobilize the resources of banks that work with the FNG. Current laws and regulations on guarantees in Ecuador allow a leveraging ratio of up to 10; however, using conservative leveraging ratios of 3.35 to 5.03 and an average leveraging ratio of 3.5, the financial strengthening of the FNG—with the help of an additional US$100 million provided by the IDB—should generate a portfolio estimated at some US$1.613 billion (optional link 1). In addition, the US$199.3 million allocated for CFN's second-tier financial products, together with the US$79.7 million of private banks' own resources, could generate a portfolio of US$279 million for MSMEs in Ecuador.

C. Key results indicators

1.29 **Expected results.** The general development objective will be measured by: (i) the number of registered jobs at MSMEs as a percentage of all registered jobs in Ecuador; and (ii) reported sales by MSMEs as a percentage of total reported sales in Ecuador. The specific development objectives will be measured by the following indicators: (i) leveraging of the FNG; (ii) balance of the FNG's current portfolio covered by guarantees; (iii) number of beneficiary MSMEs served for the first time with credit from FNG client banks; (iv) relative rate of arrears over 90 days in the program-supported portfolio for MSME access to credit, compared with the rate of arrears on banking system loans to MSMEs; (v) amount allocated to MSMEs for climate change mitigation and adaptation projects; (vi) amount allocated to loans for women-led MSMEs; and (vii) average tenor of loans using CFN resources.

1.30 **Economic viability.** The economic evaluation identified the flows of program-generated benefits and costs. A 12% discount rate yields US$109.08 million in benefits and a 19.46% internal rate of return. The sensitivity analysis found that the program is resilient to external shocks (optional link 1).

II. Finance Structure and Main Risks

A. Financing instruments

2.1 The total amount of the proposed program is US$300 million in Ordinary Capital resources. The program will be implemented through an investment loan using the global credit modality, due to its nature as a financial intermediation operation for beneficiary MSMEs.

Table 1. Estimated program costs (US$)

Component/Project type	IDB (Ordinary Capital)	%
Component 1. Financial strengthening of the FNG	100,000,000	33.33
Component 2. CFN's second-tier banking operations	199,300,000	66.43
Component 3. Technical modernization[41]	500,000	0.17
Audit and monitoring	200,000	0.07
Total	**300,000,000**	**100.00**

2.2 According to preliminary estimates, program resources will be committed and disbursed over a five-year period starting on the effective date of the loan contract, as shown in Table 2.

[41] See paragraph **Error! Reference source not found.** and the procurement plan for detailed information on the consulting contracts.

Table 2. Projected disbursement timetable

	Year 1	Year 2	Year 3	Year 4	Year 5
Component 1	20.00	20.00	20.00	20.00	20.00
Component 2	40.00	60.00	60.00	39.30	0
Component 3	0,25	0,25	0	0	0
Audit and monitoring	0.04	0.04	0.04	0.04	0.04
Cumulative (US$)	60.29	140.58	220.62	279.96	300.00
Cumulative percentage	20.10%	46.86%	73.54%	93.32%	100.00%

B. Environmental and social risks

2.3 In accordance with the Environmental and Social Policy Framework (document GN-2965-23), this operation is classified as a financial intermediation operation with moderate environmental and social risk. The operation's disaster and climate change risk is rated as moderate. While MSMEs will not be subject to restrictions based on economic sector, the sectors that may receive financing include commerce, services, manufacturing, and, to a lesser extent, agriculture. The environmental and social due diligence review indicates that most program-financed subprojects will have a low social and environmental risk, while some potential subprojects may have a moderate risk. It is anticipated that the average amount of financing per subproject will be around US$9,000 for microenterprises, US$175,000 for small businesses, and US$246,000 for medium-sized businesses. A maximum amount of US$2 million per loan has been set, and financing in amounts above US$1 million up to US$2 million may only go to medium-sized businesses for projects to finance fixed assets for climate change mitigation and adaptation. The program will not finance subprojects with a social and environmental risk of category A or higher. The potential environmental and social impacts associated with the program will be managed through the program's environmental and social management system, which will be based on, among other things, the exclusion list set forth in the Bank's Environmental and Social Policy Framework, local laws, and additional exclusion and eligibility criteria. Pursuant to the IDB Group Measures to Address Risk of Forced Labor in the Supply Chain of Silicon-based Solar Modules (document GN-3062-1), for subprojects that require financing for solar panels, the maximum loan amount will be US$1 million, and measures have been established to prevent and mitigate the risk of forced labor, in compliance with local laws and international agreements, and have been integrated into the program's environmental and social management system. These environmental and social requirements will constitute the program's environmental and social management system and will be included in the program Operating Regulations.

2.4 **Fiduciary risks.** The institutional capacity assessment, conducted in the second quarter of 2022, found that CFN has a high degree of institutional and crosscutting capacity to carry out operational, financial, procurement, and administrative management activities, indicating a low level of fiduciary risk. The most significant area identified as an opportunity for improvement is the strengthening of CFN's monitoring capacities, particularly to supervise the CFN-to-BFE institutional transition plan. Component 3 (technical modernization) was included in the

program to assist in this regard, as well as to improve CFN's and the FNG's technical capacity and ensure fulfillment of the program's development objectives.

C. Other key issues and risks

2.5 **Medium-high risks.** Three medium-high risks were identified: (i) social environment: in the event of social protests demanding that the government and banks forgive MSMEs' debts in the financial system, or if loans are provided to MSMEs at subsidized interest rates, CFN may be identified as an entity associated with interventions that undermine the willingness to pay and create an uneven playing field; this risk will be mitigated by supporting CFN in its transition to a public development bank that provides only second-tier services, which would eliminate any direct negotiation or interaction with end borrowers, while raising awareness of this restriction among relevant constituencies so that they can exclude CFN from consideration; (ii) organizational structure: if the FNG does not satisfactorily implement its strengthening plan within the projected timeline, banks interested in its products may withdraw from participation or take conservative positions, which would have an adverse effect on the desired growth of the guarantee portfolio and program results; this risk will be mitigated through detailed oversight of progress on activities, including the existence of adequate sources of self-financing and financing from multilateral organizations (e.g. the World Bank), and by helping CFN identify firms or individual consultants that can assume responsibility for tasks through the Bank's contact networks, as well as by ensuring the availability of resources under Component 3 to finance an information technology solution that will streamline the FNG's operations with banks; and (iii) organizational structure: If resources aimed at enhancing the FNG's equity are invested only in Ecuadorian public issuers, private banks will not want to participate in the program due to the country risk perception; this risk will be mitigated by asking CFN and the FNG to approve an investment policy in accordance with principles of balanced diversification of contributors' resources across instruments of local private issuers and foreign issuers, to ensure optimal levels of returns and liquidity so that backups in the structure of contributions to the FNG can generate greater confidence (paragraph 3.8).

2.6 **Key issue.** The process of merging CFN and BanEcuador into the BFE will be monitored during the program's execution period, as it could have repercussions on the execution mechanism. The merger is an opportunity for the program's intervention to gain visibility and become more sustainable, but if the merger does not include an orderly plan for CFN's institutional transition, program execution and the fulfillment of targets may be adversely affected. This low-moderate risk will be mitigated by the IDB and its counterparts in Ecuador, including the MEF, CFN, and BanEcuador, by monitoring the progress and fulfillment of CFN's institutional transition plan (paragraph 1.12) and, specifically, the transfer of CFN's program-supported second-tier mechanisms (second-tier banking and the FNG) to the BFE in terms of team roles and duties, information systems, and legal compliance vis-à-vis creditors.

2.7 **Sustainability.** CFN will execute the resources of program components by applying financial terms and conditions that ensure an adequate financial return to cover costs and generate earnings. CFN can thereby reinvest revenues generated by the FNG and funds recovered from the second-tier lines of finance for further

transactions of this type. The program will be executed amid the transformation of CFN into the BFE, which poses an opportunity to ensure the intervention's medium- and long-term sustainability and scaling, since the BFE will adopt the second-tier mechanisms supported by the program.

III. Implementation and Management Plan

A. Summary of implementation arrangements

3.1 **Borrower, executing agency, and guarantor.** CFN will be the borrower, and the Republic of Ecuador will be the executing agency and guarantor. Founded in 1964, CFN is Ecuador's largest and oldest public development bank. In accordance with Executive Order 868 of 30 December 2015, CFN was reorganized as a public-law entity of the financial public sector with administrative, financial, legal, and budgetary autonomy. CFN's operations, activities, and business dealings are governed and covered by the Monetary and Financial Code; the Code on Monetary, Financial, Securities, and Insurance Resolutions; the Regulations Code of the Superintendency of Banks; the decisions of the Monetary and Financial Policy and Regulation Board; and the decisions of the Board of Directors of the Central Bank of Ecuador. As of June 2022, CFN had US$3,080,400,000 in assets, US$1,177,570,000 in equity, US$15,110,000 in net earnings, a 28.54% solvency rate, and a 40.65% liquidity rate. In March 2022, BankWatch Ratings S.A. gave CFN a risk rating of "A" with a stable outlook and "under observation" status.[42] CFN is eligible to be a public-sector borrower of the IDB, in accordance with the policy on eligible borrowers (operational policy OP-301); in addition to its institutional and legal authority and its financial capacity, CFN has experience as a borrower and executing agency of the IDB on similar programs, where it demonstrated operational capacity (paragraph 1.16). CFN is currently executing programs with multilateral and bilateral organizations, such as the World Bank, the Andean Development Corporation, and the German development bank KfW.

3.2 The Decree-Law on Economic Development and Fiscal Sustainability, in force since 29 November 2021, calls for the initiation of procedures for the merger of CFN and BanEcuador into a single entity, the BFE. The objective of the merger is to attain technical and capital parameters for the issuance of loans to the agricultural and productive sectors. The merger process is moving forward; both CFN and BanEcuador are cleaning up their financial statements through the portfolio review, loan restructuring, and portfolio recovery. For CFN, a provision of US$651.6 million was made in late 2021 for unrecoverable loans as a result of an appraisal of assets by an external audit firm. While this decision resulted in US$239.52 million in losses in that fiscal period, CFN's solvency and liquidity levels remained strong. As part of the merger process, liabilities will be transferred from CFN to the BFE, as will trust funds such as the FNG, under the same terms originally agreed upon with the creditors and contributors. Once the merger process is complete, both entities' national and international legal rights and obligations will be transferred to the BFE. This transfer should have no effect

[42] "Under observation" status is typically designated in the event of a specific merger process, such as that of CFN for the formation of the BFE.

whatsoever on the FNG's operations or the flow of repayments on liabilities. The government periodically updates the merger timetable in view of progress in financial stabilization; governance; operational capacity and processes; and market, business, technology, and infrastructure management. While the BFE was initially slated to being operating in the second quarter of 2023, the latest updates to the merger timetable indicate a potential start of operations in the first quarter of 2024 (optional link 7).

3.3 **Execution mechanism.** CFN will have fiduciary responsibility for the loan proceeds, manage program execution, and oversee compliance with the loan contract and the program Operating Regulations. The program will use CFN's existing structure, through the Products and Services Development Division, which will lead the relationship with the Bank and overall program execution and will coordinate with other designated units: (i) the Products and Services Development Analysis Office, which will execute activities for Components 1 and 2; (ii) the Credit Guarantees Office, responsible for technical and operational oversight of the FNG and program monitoring; (iii) the Procurement Office, responsible for procurement management; and (iv) the Fundraising Office, responsible for accounting records, program financial management, and procurement of Bank-required external audits and related oversight. CFN may designate additional support units in view of program needs previously described in the Operating Regulations.

3.4 **Interagency coordination mechanism.** As the merger of CFN and BanEcuador involves actions by multiple parts of the Ecuadorian government, an interagency coordination mechanism will be established; this mechanism will be led by the MEF's designated delegate and will consist of representatives of the Superintendency of Banks, the IMF, the World Bank, and other multilateral institutions monitoring the merger. This mechanism will hold regular meetings with CFN and BanEcuador and will prepare minutes that reflect decisions aimed at mitigating any deviation from the merger roadmap. CFN will report to the IDB on progress in the merger and the aforementioned decisions in accordance with the program Operating Regulations.

3.5 **Eligibility of first-tier banks and MSMEs.** Loan proceeds will be channeled to banks through the FNG (Component 1) and CFN's second-tier lines of finance (Component 2), two mechanisms that have internal policies based on risk management principles and bank evaluation systems. In view of these policies and program needs, the eligibility criteria for banks to use quotas for the issuance of guarantee certificates (Component 1) and quotas for second-tier lines of finance (Component 2) will be as follows: (i) banks regulated by the Superintendency of Banks; (ii) risk rating above BB+; (iii) rate of arrears below 10%; (iv) positive operating margin; and (v) solvency rate above 10%. As for eligibility of MSMEs, while the client banks of CFN and the FNG will be responsible for selecting MSMEs in accordance with their own risk policies, the program is aimed at MSMEs that meet the following criteria: (i) qualify as an MSME in accordance with Ecuador's official definitions; (ii) engage in production-oriented activities not included in the program's exclusion lists; (iii) be pursuing an initiative for investment in working capital or fixed assets; and (iv) pass the banks' credit evaluation. MSMEs will not be subject to restrictions on the basis of economic sector or geographic area. The program Operating Regulations will provide more detailed information on the eligibility criteria agreed upon by CFN and the IDB.

3.6 **Financing amount and limit.** The loans promoted under Components 1 and 2 are expected to be concentrated around the amount of US$25,000 (paragraphs 1.23 and 1.24), averaging US$9,000 for microenterprises, US$175,000 for small businesses, and US$246,000 for medium-sized enterprises. The final structure in terms of number of loans supported by the program is expected to be strongly concentrated in microenterprises (80%), with smaller positions, in terms of number of loans, in small businesses (15%) and medium-sized businesses (5%).[43] Although a program limit of US$2 million per loan has been set, 90% of loans are expected to be for amounts less than US$1 million, with financing for amounts above US$1 million and up to US$2 million permitted only for medium-sized enterprises seeking fixed asset financing for climate change adaptation and mitigation projects. A limit of US$500,000 was set on the guarantees that the FNG can provide for bank-issued loans. These limits were set in view of data on historical and projected guarantees and loans in the second-tier banking portfolios of CFN and the FNG, respectively. The program Operating Regulations will also include guidelines to eliminate the risk of loan concentration in any particular segment, with a view toward distributing program resources in small amounts.

3.7 **Operating Regulations.** The program will be governed by the loan contract and the Operating Regulations, the latter of which will detail program execution and will include, at a minimum: (i) the program coordination mechanism; (ii) specific procedures, conditions, and requirements related to the use of resources and financial management of the program; (iii) selection criteria and eligibility requirements; (iv) programming, monitoring, and evaluation; (v) external audit; (vi) environmental and social considerations; (vii) mechanisms to implement the Bank's provisions on prohibited practices; and (viii) the FNG's investment policy.

3.8 **Special contractual conditions precedent to the first disbursement of the financing. As a special contractual condition precedent to the first disbursement of the financing, the borrower will submit evidence of the approval and entry into force of the program Operating Regulations under the terms previously agreed upon with the Bank.** This condition is needed to ensure effective program execution, as the Bank's experience in the region indicates that approval of the Operating Regulations before the first disbursement will contribute to the executing agency's internal organization for successful program execution. **In addition, as a condition precedent to the first disbursement of resources under Component 1, the borrower will submit evidence of the approval and entry into force of the investment policy of the FNG, by its Trust Fund Board, in accordance with the program Operating Regulations.** This condition is needed to ensure a low-risk, short-term diversified investment portfolio that will give the market confidence while ensuring adequate liquidity levels.

3.9 **Exceptions to Bank policies.** A request is made of the Board of Executive Directors to approve a partial waiver of the Bank's Operational Policy on Guarantees Required from the Borrower (OP-303) to allow the Republic of Ecuador to guarantee only those financial obligations arising from the loan contract

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[43] The market prospective puts the number of potential medium-sized enterprises for the proposed program at 40 to 60.

between the Bank and CFN, including interest and fees. The request is justified and supported by CFN's financial and legal soundness (paragraphs 3.1 and 3.2). In accordance with the Public Finance and Planning Code and with rules creating it, CFN is a public agency of the State, and in its capacity as the entity contracting the debt, it is responsible for executing the projects financed with those resources, and it has the necessary legal stability that will allow it to guarantee long-term legal certainty in its operations, maintaining its administrative, financial, economic, and operational autonomy and complying with the Constitution of the Republic and other laws. As precedent for the request, there are other operations with similar execution mechanisms in Ecuador (5024/OC-EC and 4759/OC-EC) and in the region (5169/TC-CO, 4939/OC-CO, 5083/OC-ES, 4567/GN-ES, 3271/OC-ES, and others).

3.10 **Disbursements.** Program resources will be disbursed from the IDB to CFN using the modalities set forth in the Financial Management Guidelines for IDB-financed Projects (document OP-273-12) or current IDB policies. Disbursements will be verified on an ex post basis and will be subject to onsite reviews of subloans or guarantees. Disbursement requests will be accompanied by the information described in the program Operating Regulations.

3.11 **Procurement.** For Components 1 and 2, since this is a demand-based financial intermediation program, execution is not expected to require the procurement of works, goods, or consulting or nonconsulting services. Component 3 requires the procurement of consulting services, as set forth in the procurement plan; such procurement will be carried out in accordance with the Policies for the Selection and Contracting of Consultants Financed by the Inter-American Development Bank (document GN-2350-15) or any subsequent updates to these policies. See the Fiduciary Agreements and Requirements (Annex III) for more details.

3.12 **Financial statements and audit.** CFN will submit the program's audited special-purpose annual financial statements within 120 days after the end of the fiscal year (31 December) or the date of the last disbursement. Such financial statements will be audited by a Bank-eligible independent audit firm in accordance with the procedures set forth in document OP-273-12 and applicable instructions. The audit will be commissioned within 120 days after the end of the effective period or the date of the last disbursement. In addition, CFN's and the FNG's audited financial statements will be submitted to the Bank, for purposes of consolidated monitoring, within 180 days after the end of each fiscal period.

B. Summary of arrangements for monitoring results

3.13 **Monitoring.** Program activities will be monitored through progress monitoring reports to be submitted by CFN within 60 days after the close of each six-month period. The reports will consider the nature of all program components and will be based on the reporting commitments included in the Results Matrix and the fulfillment of the eligibility criteria set forth in the program Operating Regulations.

3.14 **Information for program monitoring and evaluation.** CFN will be responsible for maintaining systems for compiling data and monitoring the program. CFN agrees to maintain a system for monitoring and evaluation of all components, which it will use to prepare the reports and data for submittal to the Bank. For evaluation purposes, CFN will compile, store, and safeguard all information,

indicators, and parameters, including annual plans, as well as the final evaluation as needed to prepare the project completion report. Any additional information needed for the evaluation will be drawn from secondary national or international sources of statistical data and, potentially, reports from relevant organizations.

3.15 **Evaluation.** The following approaches will be used as part of the strategy for evaluating program results: (i) a reflexive evaluation, before and after the program, to determine the extent of outcomes and impacts; and (ii) a qualitative analysis discussing the lessons learned during program execution. The evaluation strategy is described in the monitoring and evaluation plan.

Development Effectiveness Matrix		
Summary	EC-L1279	
I. Corporate and Country Priorities		
Section 1. IDB Group Strategic Priorities and CRF Indicators		
Development Challenges & Cross-cutting Issues	-Social Inclusion and Equality -Productivity and Innovation -Gender Equality and Diversity -Climate Change -Institutional Capacity and the Rule of Law	
CRF Level 2 Indicators: IDB Group Contributions to Development Results	-Micro / small / medium enterprises financed (#) -Women beneficiaries of economic empowerment initiatives (#) -Agencies with strengthened digital technology and managerial capacity (#)	
2. Country Development Objectives		
Country Strategy Results Matrix	GN-3103-1	Improve access to financing.
Country Program Results Matrix	GN-3087-2	The intervention is included in the 2022 Operational Program.
Relevance of this project to country development challenges (If not aligned to country strategy or country program)		
II. Development Outcomes - Evaluability		Evaluable
3. Evidence-based Assessment & Solution	7.7	
3.1 Program Diagnosis	0.8	
3.2 Proposed Interventions or Solutions	3.2	
3.3 Results Matrix Quality	3.8	
4. Ex ante Economic Analysis	7.5	
4.1 Program has an ERR/NPV, or key outcomes identified for CEA	1.5	
4.2 Identified and Quantified Benefits and Costs	3.0	
4.3 Reasonable Assumptions	0.0	
4.4 Sensitivity Analysis	2.0	
4.5 Consistency with results matrix	1.0	
5. Monitoring and Evaluation	8.3	
5.1 Monitoring Mechanisms	4.0	
5.2 Evaluation Plan	4.3	
III. Risks & Mitigation Monitoring Matrix		
Overall risks rate = magnitude of risks*likelihood	Medium Low	
Environmental & social risk classification	FI	
IV. IDB´s Role - Additionality		
The project relies on the use of country systems		
Fiduciary (VPC/FMP Criteria)		
Non-Fiduciary		
The IDB's involvement promotes additional improvements of the intended beneficiaries and/or public sector entity in the following dimensions:		
Additional (to project preparation) technical assistance was provided to the public sector entity prior to approval to increase the likelihood of success of the project		

Evaluability Assessment Note: The CRECER Program (Credit for Enterprise Recovery and Growth, EC-L1279) has as a general development objective to support economic recovery among Ecuadorean MSMEs. The Program proposes to contribute to that objective through the specific development objective of expanding access to financing among MSMEs through second-tier financial instruments at the Corporación Financiera Nacional (CFN). These instruments will offer credits and guarantees to MSMEs, with a focus on environmentally sustainable projects and enterprises led by women. The operation's diagnosis indicates a necessity for support of the economic recovery of MSMEs, which were affected during the pandemic in terms of employment, sales, and access to credit. The absence of up-to-date information makes it difficult to verify demand levels, as well as whether the restrictions that affected MSMEs during the pandemic are still as pressing during the recovery period.

The results matrix has SMART indicators that help measure the scope of objectives. Additional funds incorporated to Component 2 increase targets for indicators associated with relative NPL ratio, amounts for mitigation and adaptation to climate change, and those destined for MSMEs led by women. Targets associated with indicators related to loan term and beneficiary MSMEs that receive credit for the first time do not register changes with the additional funds.

The economic analysis quantifies benefits in terms of sales and employment and generates an IRR of 19.46%. The analysis is based on evidence linked to credits, although half of the current program is used for guarantees.

The monitoring and evaluation plan proposes three evaluation strategies: (i) a before and after evaluation to capture achievements in results and impacts; (ii) a qualitative analysis with lessons learned from the Program; and (iii) an ex post cost-benefit analysis.

RESULTS MATRIX

Project objective:	The specific development objective is to expand access to credit for Ecuadorian micro, small, and medium-sized enterprises (MSMEs) through CFN's second-tier financial instruments. The general development objective of the program is to support the economic recovery of MSMEs in Ecuador.

GENERAL DEVELOPMENT OBJECTIVE

Indicators	Unit of measure	Baseline value 2022	Final target	Means of verification	Comments
General development objective: To support the economic recovery of MSMEs in Ecuador.					
Indicator 1: Registered jobs at MSMEs as a percentage of all registered jobs in Ecuador.	%	60.51	64.81	CFN's information management system and six-monthly reports	See monitoring and evaluation plan.
Indicator 2: MSMEs' reported sales as a percentage of total reported sales in Ecuador.	%	27.64	30.02		See monitoring and evaluation plan.

SPECIFIC DEVELOPMENT OBJECTIVES

Indicators	Unit of measure	Baseline 2022	Final target	Means of verification	Comments
Specific development objective: To expand access to credit for Ecuadorian MSMEs through CFN's second-tier financial instruments					
Indicator 1: Leveraging of the FNG.	Ratio	1.68	3.5	CFN's information management system and six-monthly reports	See monitoring and evaluation plan.
Indicator 2: Balance of the FNG's current portfolio covered by guarantees.	US$ million	84.4	525.3		See monitoring and evaluation plan.
Indicator 3: Number of beneficiary MSMEs served for the first time with credit from FNG client banks.	Number	431	1,279		See monitoring and evaluation plan.
Indicator 4: Relative rate of arrears over 90 days in the program-supported portfolio for MSME access to credit, compared with the rate of arrears on banking system loans to MSMEs.	%	16.63	16.63		See monitoring and evaluation plan.
Indicator 5: Amount allocated to MSMEs for climate change mitigation and adaptation projects.	US$ million	7.03	37.03		See monitoring and evaluation plan.
Indicator 6: Amount allocated to loans for women-led MSMEs.	US$ million	32.3	122.3		See monitoring and evaluation plan.
Indicator 7: Average tenor of loans using CFN resources.	Months	46	48		See monitoring and evaluation plan.

OUTPUTS

Outputs	Unit of measure	Baseline 2022	Year 1	Year 2	Year 3	Year 4	Year 5	Final target	Means of verification	Comments
Component 1: Financial strengthening of the FNG (US$100 million)										
Output 1: Amount issued for the financial strengthening of the FNG	US$ million	0	20	20	20	20	20	100	CFN's information management system and six-monthly reports	See monitoring and evaluation plan.
Component 2: CFN's second-tier banking operations (US$199.3 million)										
Output 2: Amount issued for second-tier lines of financing	US$ million	0	40	60	60	39.3	0	199.3	CFN's information management system and six-monthly reports	See monitoring and evaluation plan.
Milestone 1: Amount issued for women-led MSMEs with program support	US$ million	0	18	18	18	18	18	90		See monitoring and evaluation plan. Pro-Gender indicator.
Component 3: Technical modernization (US$500,000)										
Output 3: Amount issued for technical assistance for CFN and the FNG	US$ million	0	0.25	0.25	0	0	0	0.5	CFN's information management system and six-monthly reports	See monitoring and evaluation plan.

Country: Ecuador **Division:** IFD/CMF **Project number:** EC-L1279 **Year:** 2022

FIDUCIARY AGREEMENTS AND REQUIREMENTS

Executing agency: Corporación Financiera Nacional, Banca Pública (CFN)

Project name: CRECER Program: Credit for Business Growth and Recovery

I. FIDUCIARY CONTEXT OF THE EXECUTING AGENCY

1. Use of country systems in program

☒ Budget	☒ Reports	☐ Information system	☐ National competitive bidding (NCB)
☒ Treasury	☒ Internal audit	☐ Shopping	☐ Other
☒ Accounting	☐ External control	☐ Individual consultants	

2. Fiduciary execution mechanism

☒	Features of fiduciary execution	The borrower and executing agency of this operation is CFN. The loan is aimed at strengthening the National Guarantee Fund (FNG) so that CFN may issue guarantees through major private banks and lines of credit to local second-tier financial institutions for the benefit of micro, small, and medium-sized enterprises (MSMEs).

3. Fiduciary capacity

Fiduciary capacity of the executing agency	The assessment found that the executing agency has a high fiduciary capacity. The tool, used as part of the institutional capacity assessment, found that CFN has an adequate organizational structure to complete all fiduciary processes and financial reports required by the Bank for effective execution. The assessment also found that CFN is the executing agency for a similar loan with the World Bank and a credit operation with the German development bank KfW, thus confirming CFN's capacity.

4. Fiduciary risks and risk response

Area (Financial management / procurement)	Risk	Level of risk	Risk response
Internal processes	If CFN's own resources are used to commission the external audit, it would entail the use of local processes and regulations, which could lead to delays.	Low	The loan contract and program Operating Regulations will require the external audit to be commissioned using the Bank's methodology and Bank-eligible firms.
Organizational structure	The process of merging CFN and BanEcuador into the BFE by 2023 could have an adverse effect on fiduciary capacities for program execution.	Low	The program envisages a strengthening component to support CFN's transition to the new entity (BFE).

5. Policies and guidelines applicable to the program: document GN-2350-15; document GN-2729-4, paragraph 3.37.
6. Exceptions to Policies and Guidelines: None.

II. Considerations for the Special Provisions of the Loan Contract

Exchange rate: For the purposes of Article 4.10 of the General Conditions, the parties agree that the exchange rate will be as specified in paragraph (b)(i) of Article 4.10. To determine the equivalence of expenditures incurred in local currency as a charge against the local contribution or of the reimbursement of expenditures as a charge against the loan, the agreed exchange rate will be the rate at the time of the payment in which the borrower, the executing agency, or any other person or entity authorized to make expenditures makes the applicable payments to the contractor, provider, or beneficiary.
Type of audit: The program's audited special-purpose annual financial statements and the FNG's financial statements will be submitted within 120 days after the end of each fiscal period (31 December) or the date of the last disbursement. In addition, the entity's individual and consolidated financial statements will be submitted within 180 days after the close of the fiscal period. Program resources will be used to commission the program audit, and CFN's own resources will be used to commission the audits of the guarantee fund and the entity. All audits will be conducted by a Bank-eligible firm.

III. AGREEMENTS AND REQUIREMENTS FOR PROCUREMENT EXECUTION

<table>
<tr><td>☒</td><td>Bidding documents</td><td>The selection and procurement of consulting services envisaged under Component 3 and in the procurement plan for the operation will be carried out in accordance with the policies governing the selection of consultants (document GN-2350-15), using the standard request for proposals issued by the Bank or agreed upon between the executing agency and the Bank.</td></tr>
<tr><td>☒</td><td>Projects with financial intermediaries</td><td>As this loan is for global credit programs and other operations in which resources are provided to financial intermediaries that will in turn issue subloans or resources via other onlending modalities, it will be stipulated that the Bank's prohibited practices clauses are to be included in the agreements between the executing agency, its financial intermediaries, and the end beneficiaries. Alternatively, if the effective inclusion of these clauses in the aforementioned contracts is not possible or practical in view of the program's circumstances, the project team may examine other mechanisms to adopt acceptable controls and duly bind the relevant third parties to the Sanctions Procedures. The design of such mechanisms will be coordinated with the Office of Institutional Integrity, with support from the Legal Department, and described in the program Operating Regulations.</td></tr>
<tr><td>☒</td><td>Procurement supervision</td><td>Ex post supervision will be used, except where ex ante review is warranted. The (i) ex ante or (ii) ex post supervision method will be specified for each selection process. Ex post reviews will be conducted every 12 months in accordance with the project supervision plan, subject to changes during execution. The threshold amounts for ex post review are as follows:
<table>
<tr><th>Executing agency</th><th>Works</th><th>Goods / Services</th><th>Consulting services</th></tr>
<tr><td>CFN</td><td>N/A</td><td>N/A</td><td>US$100,000 for firms
US$30,000 for individuals</td></tr>
</table></td></tr>
<tr><td>☒</td><td>Records and files</td><td>For ex ante or ex post supervision by the Bank, CFN will keep digital copies in formats that can be subsequently consulted or requested by the Bank.</td></tr>
</table>

Main procurement items

Description	Selection method	Estimated date	Estimated amount (US$)
Consulting services for the CFN-to-BFE institutional transition plan	Quality- and cost-based selection (QCBS)	Q1 2023	60,000
Consulting services to update the FNG's operations manual	QCBS	Q1 2023	100,000
Consulting services to develop an information technology solution to streamline FNG operations	QCBS	Q1 2023	340,000
Audits	QCBS	Q3 2023	160,000
Consulting services to monitor the FNG	Selection of individual consultant (3CV)	Q2 2023	40,000

IV. Financial Management Agreements and Requirements

☒	Programming and budget	The Public Finance and Planning Code (COPLAFIP) is applicable to Bank-financed programs and is implemented in the Integrated Public Finance Management System (SINAFIP). The executing agency will manage budget allocations through the lead ministry, which in turn will manage them with the Ministry of Economy and Finance. Although CFN is administratively and financially autonomous, it must comply with the provisions of COPLAFIP. CFN's board of directors will approve budget allocations and will not need to obtain authorization from the central government.
☒	Treasury and disbursement management	As CFN is a public financial institution with administrative and financial autonomy, loan disbursements and program payments will be made through CFN's accounts and are barred from using the treasury single account. The program will have an exclusive account at the Central Bank of Ecuador, from which the proceeds of the financing will be disbursed. Disbursements may be processed through the online disbursement platform or manually. The U.S. dollar will be used for program management and is the currency in circulation in Ecuador. The Bank will make loan disbursements to provide capital to the FNG through direct payments to third parties for Component 1 and through advances of funds for the second-tier lines of credit for Component 2, in accordance with actual liquidity needs and the financial plan, for a period of up to 12 months. In view of the nature of the market, administrative and disbursement process, and the timetable for

		justification between CFN and participating financial institutions, and for the sake of smooth execution, the percentage for substantiating disbursements for this operation will be 70%. This reduced percentage for Component 2 is in accordance with—not an exception to—the guidelines set forth in document OP-273-12. A subsequent disbursement may be made after at least 70% of the balance on previous advances of funds has been substantiated.
☒	Accounting, information systems, and reporting	CFN's system will be used for the operation's accounting records, and all program commitments and payments will be recorded in that system. In addition to the reports to be issued, detailed nonaccounting records will be kept as appropriate.
☒	Internal control and internal audit	The Superintendency of Banks requires financial institutions to have two types of internal auditors: a bank auditor and a government auditor. The bank auditor reviews all financial operations, while the government auditor enforces laws and reviews procurement processes in accordance with Ecuadorian law. The internal bank auditor, whose annual work plan includes oversight of CFN's loans with multilateral banks, may collaborate on this program.
☒	External control and financial reports	CFN will use the loan proceeds to select and contract external audit services for the program in accordance with the terms and conditions previously agreed upon with the Bank. The program's external audit will be conducted by independent auditors acceptable to the IDB in accordance with document OP-273-12, which will set forth the type of review, timing, and scope. The selection of the external auditor and the auditing standards to be used will be acceptable to the Bank. In addition to the program's financial statements, the executing agency will be required to submit to the Bank the financial statements for the guarantee fund, which will be submitted to the Bank along with the special-purpose financial statement within 120 days after the end of each fiscal period (31 December) or the date of the last disbursement. In addition to these two audits, CFN will be asked to submit its individual and consolidated financial statements to the Bank, so that its financial performance and continuity as an ongoing business may be monitored.
☒	Project financial supervision	The focus will be on cash flow programming and disbursement execution, portfolio reviews and oversight visits (virtual or in-person); analysis of financial statements, the program, the guarantee fund, and the entity; and reports on internal control findings issued by the external auditors and the internal bank auditor.

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE-__/22

Ecuador. Loan ____/OC-EC to the Corporación Financiera Nacional Banca Pública
CRECER Program – Credit for Business Growth and Recovery

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with the Corporación Financiera Nacional Banca Pública, as borrower, and with the Republic of Ecuador, as guarantor, for the purpose of granting the former a financing aimed at cooperating in the execution of the CRECER Program – Credit for Business Growth and Recovery. Such financing will be for the amount of up to US$300,000,000, from the resources of the Bank's Ordinary Capital, and will be subject to the Financial Terms and Conditions and the Special Contractual Conditions of the Project Summary of the Loan Proposal.

(Adopted on _____ 2022)

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