

MULTI-SECTOR CREDIT PROGRAM: STAGE II

(PE-0191)

EXECUTIVE SUMMARY

BORROWER AND GUARANTOR:	Republic of Peru	
EXECUTING AGENCY:	Corporación Financiera de Desarrollo S.A. (COFIDE)	
AMOUNT AND SOURCE:	IDB:	US\$ 200.0 million (OC)
	Counterpart funding:	US\$ 134.3 million
	Total:	US\$ 334.3 million
FINANCIAL TERMS AND CONDITIONS:	Amortization period:	20 years
	Disbursement period:	3 years
	Grace period:	5 years from date of contract
	Interest rate:	Variable (6 month LIBOR based)
	Inspection and supervision:	1 %
	Commitment fee:	0.75 %
	Currency:	US Dollars from the Dollar Window Program
OBJECTIVES:	<p>Private-sector investment has contributed significantly to economic growth in Peru. Recently the country has been affected by the twin shocks of the <i>El Niño</i> phenomenon and the Asian financial crisis. The Program will reduce the financial constraints resulting from these crises and enable firms of all sizes to continue to invest and grow at rates consistent with demand for their products.</p> <p>The Program will place special emphasis on small enterprise development. Benefits will be economy wide, as small enterprise uses relatively labor- intensive techniques and is capable of rapidly adapting its productive activities to a more competitive and dynamic business environment.</p>	
DESCRIPTION:	<p>The Program consists of one lending operation with two components. The first component will supply credit to firms of all sizes. This will be accomplished by providing US\$130 million in resources for a second stage of the Bank-supported Multi-sector Credit Program (loan 852/OC-PE), which is fully disbursed. The second component will supply</p>	

US\$70 million in resources for increasing the access of small businesses to medium- and long-term financing. This will enable the banks to develop new lending programs for this market segment and/or to consolidate their existing programs.

The program will also include US\$ 320,000 for technical assistance activities to be funded with counterpart resources. These activities will benefit the small-business component of the program in the areas of (i) implementation of environmental safeguards, (ii) preparation and distribution of an informational folder describing business development services available for sub-borrowers from COFIDE and other sources, (iii) development of COFIDE's capacity for an eventual increased participation in the domestic financial markets, and (iv) evaluation of the efficiency and impact of the program.

**RELATIONSHIP OF
THE PROJECT WITH
THE BANK'S
COUNTRY AND
SECTOR STRATEGY:**

The economic and social strategies of the Government of Peru are designed to a) deepen structural reform, b) achieve macroeconomic stabilization, c) reduce extreme poverty by 50% by the year 2000 by: i) promoting private investment, ii) completing the peace process, and iii) increasing the provision of services as well as the volume and quality of social spending, with emphasis on the poorest regions.

The Bank's Strategy for the period 1998-2000 is to (a) help the country in the critical tasks that will enable it to make progress in economic modernization, assigning special priority to the private sector and to the second stage of the process of structural reform of the economy, (b) provide support for (i) private sector job creation, (ii) increased coverage and improved quality of social services, and (iii) efforts in poverty reduction, and (c) assist in modernization of the State.

The Bank will provide direct support for private-sector efforts to increase factor productivity and thus improve the international competitiveness of domestic production. Among the Bank's initiatives identified to achieve these objectives is support for small businesses and for micro-enterprise to improve their productivity. The recently approved loan for a second micro-enterprise global credit program (PE-0189) is one element of this support. The small-enterprise component of the proposed Multi-sector Credit Program is the other element of this support. These two elements respond directly to the private-investment promotion objective of the Government and to the first two objectives of the Bank's strategy.

The funding from the proposed Multi-sector Credit Program for

use by firms of any size will support conditions for continued private sector development and job creation in the face of unsettled international financial markets.

**ENVIRONMENTAL
AND SOCIAL
IMPACT:**

The small-enterprise stratum of the economy is inherently diverse from an environmental perspective. It ranges from quite small businesses little different from, and only slightly larger than, micro-enterprise to the larger well-established firm. Given that the proposed operation will finance investment activity in virtually all economic sectors and geographic regions, the environmental effects, and therefore the mitigation requirements, may vary substantially. The small enterprise component of the program will utilize a simplified procedure for screening out projects having a deleterious environmental impact or else will require that specific remedial measures be taken before the financing can be approved.

The retail financial intermediaries (IFIs) will distribute an informational folder to all prospective small enterprise clients explaining these procedures and providing guidance on how to comply with the regulations. The clients will also be assisted in contracting specialized consulting services to assist in this compliance.

Women have an increasingly important role in the economy and in the ownership and operation of small enterprise in Peru. Therefore the informational folder will emphasize equal access to credit and will contain information on organizations that specialize in gender issues. Similarly, taking into consideration the large native Peruvian population and its increasing economic importance, the informational folder will also provide information related to indigenous issues.

The second stage of the multisectoral credit component of the Program will build on the successful implementation of environmental safeguards that were put in place during the first stage. For further guidance on environmental and social impact issues these borrowers will also have access to the informational folder.

BENEFITS:

The Program will help to forestall the effects of a contraction in the availability of long-term investment resources as a result of the Asian financial crisis and the aftermath of the *El Niño* phenomenon. The Program will enable firms of all sizes to continue their growth and modernization. The special emphasis on small enterprise will support the better integration of the small business community into the Peruvian economy.

Related benefits of the small-enterprise component of the Program will be: i) increase in the productivity and competitiveness of small enterprises as they become more specialized and gain access to technology, ii) greater economic and business interaction between small, medium and large enterprises, and iii) identification of market niches for small enterprises in local and international markets.

In terms of financial market development, this program will help to assure liquidity of long-term resources for the banking system, enabling continued lending to the larger business customers while encouraging the IFIs to further develop their installed capacity to lend for small-enterprise projects.

RISKS:

At the level of overall program implementation, the greatest risks are deterioration in the portfolios of the participating intermediaries and/or the reduced ability of subborrowers to service their dollar-denominated debt. Regarding the former, high foreign currency reserves and increased provisioning requirements as well as ample capital adequacy ratios suggest that the banking system as a whole is in a good position to weather a rise in arrearages. Furthermore, requirements for IFIs to participate in the program not only call for full compliance with all Banking Superintendency norms, but also with additional prudential criteria imposed by COFIDE. Regarding the currency risk, it must be kept in mind that the economy is highly dollarized, and almost half of the subborrowers of the existing Bank-supported program are directly or indirectly involved in export related activities.

A risk to the small-enterprise component of the program is the IFIs' perception of relatively low profitability in lending to this sector. However the program will be attractive as it is designed to respond to the multiple requirements of IFIs and their small business clients. Both fixed and permanent working capital credit products will be offered, and they will be made available by means of automatic discount of individual loans or through a line of credit.

As regards the environmental technical assistance activity, there is a risk that the new small-enterprise program will not fully implement these norms. However a consulting firm has developed guidelines for compliance with the Bank's environment requirements. Training will be provided to consultants to assure adequate provision of these services and so that their recommendations do not complicate production processes and

make small enterprises incur in higher production costs.

Finally there is the risk that the business development services to be provided by COFIDE in conjunction with the small-enterprise program may not meet the demands of its future clients. However COFIDE has a budget sufficient to deliver these services, and the unit responsible is scheduled to undergo major restructuring and modernization. Furthermore this unit acts as a broker and will not be required to maintain the specialized technical skills in-house, nor to incur the high costs to deliver such quality services.

**SPECIAL
CONTRACTUAL
CONDITIONS:**

Prior to first disbursement, the following measures will have been taken:

1. The Ministry of Economics and Finance will have entered into an agreement with COFIDE regarding the transfer of loan proceeds.
2. COFIDE will have instituted the Credit Regulations governing both components of the program, in accordance with terms agreed with the IDB.
3. At least 3 eligible IFIs will have entered into agreements with COFIDE regarding their participation in the Program and channeling of program resources to them.
4. Regarding the technical assistance activities for the small enterprise component of the program:
 - The environmental requirements must be established.
 - The participating IFIs must have received initial training on environmental issues and requirement of the program.
 - The informational folder should be prepared and distributed to the IFIs participating in the program.

**POVERTY
TARGETING AND
SOCIAL SECTOR
CLASSIFICATION:**

The program does not qualify as a Poverty Targeted Investment.

**EXCEPTIONS TO
BANK POLICY:**

On September 25, 1996 the Board of Executive Directors approved a two year extension of the US Dollar Window Program (DEA/96/34) as recommended by Management (FN-483-5). The extension expired on September 25, 1998. In order to fund the proposed multi-sectoral credit program with resources from the U.S. Dollar Window, a waiver of this expiration date is requested. (At the time of submission of this loan proposal for the Board's consideration, management is preparing a short paper containing a recommendation to extend the Dollar Window Facility.)

PROCUREMENT: The normal Bank procurement regulations will be observed.

REVOLVING FUND: Provision will be made to advance up to 20% of the Bank financing into the revolving fund.

I. FRAME OF REFERENCE

A. Structural adjustment and private enterprise.

- 1.1 **Macroeconomic stabilization.** After decades of recurrent economic crisis, Peru initiated a program of profound economic stabilization and structural reform in the early 1990's. The "second wave" of reforms is still in progress. Macroeconomic results have been dramatic with inflation falling from more than 7,000% in 1990 to single digits in 1997, while GDP growth has gone from negative rates during the crisis years to an annual rate of 7.3% between 1993 and 1997.
- 1.2 More recently the economy has confronted two major external shocks: the *El Niño* phenomenon and the Asian financial crisis. Economic growth in Peru has been cut by more than half, to 3.1% (as of June 1998); exports have declined; and the perception of country risk in the international financial markets has increased. The latter is reflected in the widening interest rate differential between Peruvian Brady bonds and US Treasuries, which has risen from 309 basis points in October 1997 to 925 points on September 2, 1998. This situation is also reflected on the Lima securities exchange, which has seen a decline in the general stock price index of 35 percent from September 1997 to September 1998.
- 1.3 In the face of these events, the authorities have reemphasized their economic policy of assuring internal stability and minimizing the impact of external economic turbulence. This policy is based on fiscal discipline, with the specific target of achieving a budget surplus of 1.7% of GDP in 1998. Meanwhile monetary policy has been set to discourage short-term foreign indebtedness by commercial banks. The flexible exchange rate regime has been continued, which is an appropriate market mechanism to absorb some of the effects of international market instability.
- 1.4 Since the early 1990s reductions in tariff barriers as well as a stable domestic macro-economic environment have encouraged more competition throughout the economy. Many state-owned enterprises have been privatized, and the legal system has been overhauled to improve transparency and treat foreign investors more equally. These and related underlying structural reforms have generally established a favorable business environment. Small business in particular has the potential for taking advantage of this new environment with its relatively labor-intensive techniques and capacity for rapidly adjusting its productive activities to changing market circumstances. However it is constrained from responding to these opportunities by inadequate access to term financing and a better understanding of potential marketing opportunities.

- 1.5 Counteracting these favorable structural reforms, recent economic events have reduced the availability of term financing for business of all sizes as private capital flows are restricted by the perception of an increased country risk. Initiatives to counteract this trend can benefit private enterprise in general and if properly structured can assure that small firms will not suffer unduly from these capital shortages.
- 1.6 **Characteristics of the private sector and its reliance on term financing.** Mining has been and remains the premiere sector in Peru, accounting for more than 40% of total exports and 10% of GDP. The government encourages foreign direct investment in mining as it does in all sectors, and this has led to sizeable projects which are typically financed directly. Some smaller mining projects and related activities, such as heavy transport vehicles, have been financed domestically, and Bank resources through the PROBID operation currently in execution (see below) have partially financed these investments. The energy sector also receives large direct infusions of equity and debt capital directly from consortium members in privatization or green-field deals, although there is an isolated case of the PROBID program providing partial financing for a small hydroelectric project. As privatization of the energy sector progresses, opportunities for such special situations and financing of related investments may become more frequent.
- 1.7 Industry, including intermediate and consumer goods manufacture, initially was hard hit by the economic liberalization programs instituted in the early 1990s but has since recovered and grown unevenly at around 3 to 6% per year since 1993. This sector is the single biggest user of PROBID resources, accounting for about 23 percent of the total. Growth in the sector increased to 6.5% in 1997, and in 1998 manufacturing is expected to perform well, "encouraged by the fact that the negative effects of bad weather and the fall in international commodity prices should not negatively impact on the sector...Textiles are projected to grow very fast as will other sectors such as iron, plastics and glass, spurred by rapid growth in the construction sector... It is encouraging that in 1997 and 1998 manufacturing growth resulted from the country's own dynamics rather than from fiscal or monetary stimulus..."¹
- 1.8 Tourism is another sector which has accounted for an important share of PROBID financing (19% of total placements). The inherent attractiveness of Peru as a tourist destination and Government's success against terrorism have led to rapid growth in arrivals, from 600,000 in 1996 to an expected 800,000 in 1998 and an expected 1 million in year 2000. Tourist earnings have gone up to US\$1 billion in 1997 from \$900 million in the previous year.² This is a sector which is relatively unaffected by recent turmoil in international financial markets and presumably should benefit from any reduction in the value of the sol which may result.

¹ PERU 1998: *Annual Report on Government, Economy, the Business Environment, Capital Markets and Industry, with Forecasts through end-2000* Business Monitor International Ltd: London, June 1998.

² *ibid.*

- 1.9 Firms in the service sector have also been important clients of the PROBID program, accounting for about 20% of the total placements. Notable among the specific projects financed are a number of private health clinics and educational facilities as well as a broad range of automobile repair shops, fast food establishments, office equipment, fleet rental vehicles, etc. While the service sector would be affected by a downturn in the economy, the individual activities in which investments are made are widely diversified and the average size is relatively small, around US\$700,000 per project.
- 1.10 Finally it is useful to review the utilization of the PROBID resources from the point of view of those activities which are directly or indirectly export related. Close to 47% of the resources were lent to firms in the tourism, fishing, mining, and agricultural sectors, all of which produce goods, or services, which earn foreign exchange or substitute for imports. This does not even take into account those investments in manufacturing sector projects, which do now or potentially could produce goods for export. These investment activities have been undertaken in the environment of a small open economy, and by concentrating in those activities in which Peru has a comparative advantage they are relative capable of withstanding market fluctuations.
- 1.11 **Characteristics of small enterprise.** Small enterprise has been identified as crucial to the economic and social development of Latin America and the Caribbean. The Third National Census in Peru (1993) estimated that small and micro enterprises constitute 98% of existing businesses in Peru, make up for 75% of the economically active population (PEA) and 42% of the gross domestic product (GDP). The percentage of these establishments that are small heavily depends on the criteria used to define small enterprises, whether they are the number of employees, the value of assets, or sales per year or some combination. A benchmark used widely throughout the region and proposed in legislation currently before the Peruvian Congress is in terms of employment. Firms with fifty or fewer employees are considered to be small. The lower limit (between small and micro) may also be defined in terms of numbers of employees, taking as a benchmark the parameter of 10 employees used in the Bank-sponsored micro global credit program currently in execution (Loan 958/OC-PE).
- 1.12 A recent study by the Instituto Peruano de Economía found that most small enterprises in Peru are located in urban settings. Almost half (43.6%) of them are located in the main two cities of Peru, Lima (35.8%) and Arequipa (7.8%). Two thirds are dedicated to commerce, followed by a 10.8% of manufacturing activities and a 9.55% of hotel and restaurant related activities. This study also revealed that within the micro and small enterprise universe, the small enterprises had the highest productivity, and survival rates.

B. The financial system and capital markets

- 1.13 The financial system has grown dramatically since the late 1980's. From 1990 to 1996 the ratio of broad money (M3) to GDP grew from 3.4% to 23.5%, and by the latter year the outstanding credit of the banking system's represented 16.5% of GDP. In 1997 credit further expanded to almost 20% of GDP, of which almost three-quarters (73%) was denominated in foreign exchange. Although this growth is substantial, the level of broad money is still below the 35 to 40% of GDP characteristic of countries at a similar stage of development and in Peru before the crisis.
- 1.14 **Spreads.** The average lending rate in dollar terms (TAMEX) has declined from around 20% in the early 1990s to about 14% now. Over the same period the average rate paid on savings deposits fell from 7-8.5% to 5.5-6.2%. The spreads are attributable to high but declining operating costs (24% of productive assets in 1992, reduced to 8% in March 1998) and a high reserve requirement (45% on dollar deposits). Competition is driving down the former and a recent reduction of the latter to 35% should also contribute to lowered spreads.
- 1.15 These tendencies are counteracted by a progressive increase in provisioning requirements in both domestic and foreign currency set by the Superintendency of Banks and Insurance (SBS) to meet legislatively mandated targets for mid 2000.³ System-wide profits are not excessive, diminishing from 2.2% of productive assets in 1992 to 1.3% (annualized) as of March 1998. In the immediate future spreads may widen as the banks comply with the authorities' more stringent provisioning requirements and strengthen their capital adequacy ratios in order to counteract the potential impact of the Asian crisis.
- 1.16 In a study of spreads in six countries, Peru was found to have lower margins than Argentina, have comparable margins to Colombia, and higher than those in Chile, Mexico, and Bolivia in 1993 (4th quarter). The study concluded that narrow spreads in developing countries do not necessarily imply efficient banking systems, but may instead reflect an unwarranted risk-prone attitude by banks, such as occurred during the Mexican banking crisis. By the same token, the study notes that wide spreads can be an appropriate instrument for protecting a bank's capitalization.⁴

³ The major increase in provisioning requirements is for normal category loans, which accounted for approximately 94 percent of the total as of March 1998. The new banking law (1996) raises the requirements progressively from 0.0% to 0.3% by March 1998, 0.6% by December 1998, and finally to 1.0% by June 2000. Provisions for loans with potential problems are also set to rise from 2 to 5%.

⁴ Phillip Brock & Liliana Rojas-Suarez *Understanding the Behavior of Bank Spreads in Latin America*. Fourth Annual Bank Conference on Development in Latin America and the Caribbean. San Salvador June 1998.

- 1.17 **Banking system structure.** In the last few years, the fastest growing area has been consumer banking. Since 1995 banks have been designing and promoting financial services and products for individuals, and in the last two years personal banking has increased 70% (to US\$ 2,3 billion), of which half represent personal credits (including those for small enterprise), followed by mortgage credits and consumer loans.
- 1.18 Structural reforms in the system led to the liberalization of interest rates and capital accounts, the establishment of equal treatment of foreign and domestic investors, the promulgation of a liberal legal framework and prudential supervision of the financial system, and the closure of all state-owned first-tier (retail) development banks. At present only two state-owned institutions, the *Banco de la Nación* (BN) and the *Corporación Financiera de Desarrollo* (COFIDE) remain. They function respectively as the financial agent of the central government, and the conduit for foreign development assistance loans. (see chapter IV.) The Superintendency of Banks and Insurance (SBS) has created a public credit bureau (central de riesgo), and more recently private credit rating agencies have been established.
- 1.19 These reforms have resulted in an influx of new private financial intermediaries and have stimulated greater competition in the system. As of July 1998 the system had grown to 79 institutions, of which 33 are commercial banks, finance companies or consumer lending agencies and 10 are leasing companies. Of these 43 institutions, 28 have significant foreign ownership or have foreign strategic partners. The remaining 36 institutions consist of municipal S&Ls, (*Cajas Municipales*) rural S&Ls (*Cajas Rurales*) and small, newly created banks (EDPYMES) all of which are owned by Peruvian interests. Despite the new entrants, the system is relatively concentrated, with the top five commercial banks accounting for 73 percent of the systems assets, significantly above the Latin American average of 58%.
- 1.20 **Capital markets.** In recent years the primary and secondary securities markets have grown substantially. In 1997 the primary market registered transactions of US\$2.4 billion which represented a 68% increase over the year before, while volume on the secondary market grew to \$ 12.7 billion i.e. 36% above the year before. In relative terms the secondary market grew from 2% of GDP in 1992 to 19.4% in 1997. The large, well-established firms for their funding requirements are increasingly tapping the bond market. Domestic primary issues of corporate bonds rose from US\$18 million in 1993 to \$391 million in 1997, while total issues, including leasing and subordinated debentures, totaled US\$688 million in the latter year. Pension and mutual funds have become major consumers of these products. Recent financial market instability may temporarily slow down this disintermediation process, however the impact should be mitigated with good macroeconomic policy management and the provision of a stable supply of long-term funding from COFIDE.

- 1.21 Over the past several years, the banking system has also contributed directly to the development of the capital market. For example, the spot market for foreign exchange has become more liquid and competition has reduced spreads. Forward operations have doubled between 1995 and 1997 from US\$1.3 billion to \$2.6 billion. The SBS is preparing new regulations that will better protect banks from the market risks of such hedging operations. This will enable the prudential expansion of this service to clients who prefer not to absorb the foreign exchange risk directly.⁵
- 1.22 **Implications for small and medium enterprise financing.** In the increasingly competitive market, large corporations are not only able to negotiate low borrowing rates, thus reducing banks' profitability in this segment of the market, but may be able to bypass the banking system altogether by raising funds directly. In response to the greater competition in corporate lending, the existing commercial banks (IFIs) have until recently been looking "down market" to small- and micro-enterprise. Innovations in loan origination and related administrative procedures, often introduced by the new foreign-owned banks, as well as the availability of credit bureau services are reducing transactions cost and risk of smaller loans. As commercial banks have gained experience in lending to the small enterprise segment of the market many have established specialized units for this purpose. The units are valuable to the banks as well as their borrowers because while they provide technical assistance to the borrowers, they also provide the banks with an excellent source of intelligence on how to better serve their existing clients and where potential new clients might be found.
- 1.23 **Implications of recent developments for private enterprise financing in general.** Due to "flight to quality" brought about by the Asian financial crisis, foreign "money center" banks have recently become more reluctant to renew existing or extend new lines of credit to their affiliates in developing countries, including Peru. All Peruvian banks are affected but the smaller ones, which don't have strong foreign affiliations, are affected more. Also the larger and export-oriented firms which were beginning to get financing directly from foreign and domestic capital markets will find it harder to issue new bonds. These developments could have the effect of slowing the movement "down market" as commercial banks concentrate their reduced supply of medium and long-term liquidity on loans to their traditional large corporate clients. In this environment the availability of an stable source of long-term financing for firms of all sizes takes on even greater importance, as it will help to assure that the process of deepening and broadening commercial banking sector continues.

⁵ As this market matures, it will offer the IFIs and their borrowers participating in the program a means to hedge the foreign exchange risk associated with dollar indebtedness. COFIDE is studying ways to offer an FX hedging service directly to its smaller IFI clients (i.e. *Cajas Municipales and Cajas Rurales*) which may not be able to participate in the formal forwards markets.

C. Financial products sought by small business.

- 1.24 **Fixed capital.** Small business needs fixed and working capital. The more progressive (and competitive) firms invest in plant, equipment, and machinery, which may be quite sophisticated and costly. For example computer assisted manufacturing, while not widespread, is making inroads in such areas as embroidering, and engraving. Small businesses are also increasingly relying on personal computers for performing their record keeping and other accounting functions. More traditional capital goods are of course in relatively greater demand. It is precisely this ability to combine sophisticated capital-intensive production techniques for some aspects of the production process with labor-intensive techniques relying on relatively less and simpler capital for the other activities that enables the small entrepreneur to survive and prosper in the competitive marketplace.
- 1.25 **Permanent working capital.** As just suggested, one of the strengths of small business is its capacity to grow and change in response to new market circumstances. By the same token its working capital needs are constantly changing both in size and composition. Typically a firm will start out as a micro or extremely small enterprise and will grow. Its credits may be limited to small loans from friends and family, minimal bank overdrafts, letters of credit and various suppliers' and purchasers' credits. These are most likely to be very short-term, from 30 to 90 days, and very small. As the firm grows from a micro- to a small-business, the number and composition of these loans changes from a few simple operations to a complex web of overlapping but fragmented transactions. Management of these debts can become a major preoccupation of the owner/operator as he/she seeks to assure a positive net cash flow after debt service and other expenses. Although tied to specific input purchases, product sales or other activities, these loan funds are fungible and essentially become the permanent working capital of the firm.
- 1.26 While nominal interest rates of these many small loans may be at market levels, their full cost can be substantially higher. Fees and commissions for renewal of those credits which can not be fully liquidated on the due dates can be substantial. (e.g. extension or rescheduling of a 30 day letter of credit may cost 2 - 4 percent of face value of loan, i.e. \pm 36% per year in addition to nominal rate) The paperwork and associated transactions cost for both the small business-person and his/her creditors also add to the effective cost. Finally the capacity of small enterprise to negotiate input and product prices is greatly limited when these items are respectively bought and sold on credit. If one considers the foregone discounts as part of the cost of the loans, the effective "all-in" interest rate is even higher. These firms would benefit substantially from the availability of a line of permanent working capital credit to finance these expenditures.

- 1.27 Firms faced with increased demand but which have excess capacity will not immediately need to invest in more plant or equipment. However they would need to buy additional inputs and carry greater inventory. These firms could either increase their reliance on short-term suppliers credits etc. with all the attendant costs and inefficiencies, or they could establish (or expand) a line of permanent working capital with a financial intermediary.

D. Financial Products Sought by Medium and Larger Enterprise

- 1.28 These enterprises require short-term working capital as well as long-term fixed capital credit. Relative to small business, they are capable of obtaining the former from the domestic and even international financial markets on reasonable market terms. As mentioned, the advent of the Asian crisis has not only reduced the availability of all credit but has also shortened the term for which private financial agents are willing to lend. Thus long-term credit is being constrained even more tightly than short-term funding. This suggests that the larger enterprises are primarily interested in an assured supply of long-term credit for fixed-capital investments.

E. Credit Demand

- 1.29 Estimates of demand for credit are notoriously difficult to make especially when the size and characteristics of the market segment to be served have no inherently unique definition, and the resources of the credit program are priced so as to avoid substituting for other sources, and thereby achieve additionality.
- 1.30 Short of a complete estimate of demand *per se*, the next best approach is to look at actual and prospective levels of credit placed by other sources with firms which could potentially participate in the program. For example the SBS reports an outstanding balance of US\$2.1 billion in short-term credit from the financial system to enterprises with annual sales between US\$278 and \$555 thousand, as noted in the following table. (Data on arrearages are also presented to demonstrate that these are overwhelmingly performing loans thus suggesting that banks have an incentive to continue lending to this sector in the future.)

Credit to Small Enterprise (March 1998)

Source of credit	Outstanding balance (US\$ millions)	Arrearages (percent)
Commercial banks (IFIs)	2,023.3	5.7
Finance companies (Financieras)	17.8	10.1
Leasing companies	129.7	1.7
Total	2,170.8	5.5

Source: SBS

- 1.31 Separately the Instituto Peruano de Economía (IPE) in a June 1996 study estimated annual demand for credit from firms with 20 employees or less over the next several years as US\$277 million for working capital and \$525 million for fixed capital.⁶ Finally the demand for credit from the current PROBID operation rose sharply in the third quarter of 1998, and placements were more than US\$ 70 million.
- 1.32 The data from these sources are not comparable; the first are stocks and the latter two are flows, and their universes neither coincide with each other nor with the universe of the businesses in the proposed program. The SBS data pertain to a subset and the IPE data include micro-enterprises but exclude the larger firms, which the program will include. Nonetheless these data do suggest that in terms of rough orders of magnitude, the US\$200 million in funding for the proposed credit program should have little difficulty in being placed over the expected execution period of three years.

F. Government's Strategy

- 1.33 The central theme of the government's strategy for the period from 1996 to the year 2000 is to "reinvigorate the reforms of the State and the economy". The major elements of the government's strategy are: (i) a commitment to continuing with a macroeconomic policy based on fiscal austerity and monetary discipline, geared towards increasing domestic savings; (ii) poverty alleviation through social spending and education, health, and justice, and investment in social infrastructure to contribute towards physical linkage and trade integration of the country; and (iii) the need to consolidate the peace process and public security.

⁶ Carlos Otero Bonicelli and Hugo Wiener Fresco *Financiamiento de la Pequeña y Microempresa: Una Propuesta Alternativa* Instituto Peruano de Economía. Lima, June 1996.

- 1.34 Specifically, the economic and social strategies of the Government of Peru aim at: a) deepening structural reform, b) achieving macroeconomic stabilization, c) reducing extreme poverty by 50% by the year 2000 by: i) promoting private investment, ii) completing the peace process, and iii) increasing the provision of services as well as the volume and quality of social spending, with emphasis on the poorest regions.

G. Bank's Strategy

- 1.35 The Bank's Strategy for the period 1998-2000 is to (a) help the country in the critical tasks that will enable it to make progress in economic modernization, assigning special priority to the private sector and the second stage of the process of structural reform of the economy, (b) support (i) private sector job creation and (ii) increased coverage and improved quality of social services as well as (iii) efforts in poverty reduction, and (c) assist in modernization of the State.
- 1.36 The Bank will provide direct support for private-sector efforts to increase factor productivity and thus improve the international competitiveness of domestic production. Among the Bank's initiatives identified to achieve these objectives are support for small and medium-scale businesses and for micro-enterprise to improve their productivity. The US\$30 million loan for a second micro-enterprise global credit program (PE-0189) is one element of this support. The small-enterprise component, to be financed with an allocation of US\$70 million from the proposed Multi-sectoral Credit program, is the other element of this support. These elements will respond directly to the private investment promotion objective of the Government and to the first two objectives of the Bank's strategy.
- 1.37 The US\$130 million funding from the proposed Multi-sector Credit Program for use by firms of any size will support conditions for continued private sector development and job creation in the face of unsettled international financial markets.

H. The project's relationship to related IDB and other donor programs

- 1.38 **The Bank** has closely supported the reforms of the financial sector, first with the Financial Sector Adjustment Program (loan 677/OC-PE) and parallel technical cooperation program (loan 678/OC-PE) which were carried out between 1992 and 1996 and more recently with the Investment Sector Reform Program (ISRP -- loan 985/OC-PE) which was initiated in early 1997 and is still in execution. Conditionality of the former operation included reduction of government participation in commercial banking, rationalization of development banking, reorganization of the Central Bank and the Superintendency of Banks, and privatization of the pension system. The more recent operation is focussed on further strengthening of the SBS, strengthening the capital structure of COFIDE, and increasing the accessibility of the securities markets and assuring proper oversight capability by the National Securities Commission (CONASEV).

- 1.39 The Bank has also been actively involved in providing long-term resources to the domestic banking system through COFIDE. Two operations are in execution and two more, including the present proposal, are in preparation. The Multi-sector Credit Program, known as PROBID, was approved in 1994 (loan 852/OC-PE) in the amount of US\$100 million and was subsequently co-financed with a loan of equal value from the Japan Export-Import Bank (JEXIM). The funds are lent through the IFIs to firms of any size. As of September 30, 1998, a total of 232 sub-loans had been made ranging from US\$20,000 to \$10 million, with an average size of slightly over US\$1,000,000 financing projects worth approximately \$1.7 million each. The original Bank and JEXIM loans have been fully committed and disbursed. Also recoveries from the early subloans have been relent. As a result a total of US\$ 238.5 million of Bank and JEXIM resources have been placed with subborrowers to date.
- 1.40 PROBID funds have been lent to the IFIs at or above a floor rate of interest that is not below the domestic savings rate adjusted for the effect of the reserve requirement (see below). The IFIs and sub-borrowers may freely negotiate the "retail" rate of interest. Sub-borrowers are responsible for obtaining environmental approval of their proposed projects from the respective line ministry. The paperwork associated with this process has been a deterrent to applicants for smaller projects.
- 1.41 **An evaluation of PROBID** done by an outside consultant⁷ found that (a) the program provides an attractive source of medium and long-term financing for smaller firms given their limited negotiating capacity with the banks and their lack of direct access to the domestic capital markets; (b) the mechanism for setting the wholesale interest rate works well but as the domestic bond market matures consideration should be given to tying the rate more closely to the latter; (c) the requirements for sub-loans of less than US\$500 thousand should be simplified with greater reliance on *ex post* inspection; (d) lines of credit for leasing operations should be offered; and (e) take out financing for new construction should be offered.
- 1.42 In general the evaluation found that PROBID had been very beneficial to the IFIs and their subborrowers, enabling them to carry out longer term investment projects and count on financing with terms to match. For example, during the first three years of the program the average term of subloans increased by almost 40 percent, from 4.9 to 6.8 years. The small and medium size firms particularly benefitted from the program, because as noted above they are at a disadvantage in terms of access to long-term financing compared to large enterprise. Finally the concentration of PROBID resources in export-oriented sectors noted previously deserves mention as a benefit of the program, as this contributes to the international competitiveness of the economy.

⁷ Felipe Portocarrero M. *El programa Global de Credito Multisectorial: Desarrollo y Perspectivas* Lima, Agosto 1997.

- 1.43 The Bank also funded a global micro-enterprise credit program, known as MICROGLOBAL, which was approved in 1995 (loan 958/OC-PE) in the amount of US\$25 million. Funds are channeled through private first-tier intermediaries that specialize in serving micro-enterprise. The same floor rate as used in the PROBID operation applies to the “wholesale” rate COFIDE charges the intermediaries, and the retail rate is freely determined. Environmental eligibility is handled on a streamlined, pre-qualification basis. The Bank is currently preparing a second stage of this “micro-global” credit line (PE-0189).
- 1.44 *The Corporación Andina de Fomento* (CAF) has sponsored several programs with COFIDE, most notably two stages of the PROPEM program that will serve as the departure point for the development of the proposed operation. The second CAF financing of approximately US\$45 million was disbursed between 1994 and 1996. Recoveries and a small contribution from COFIDE’s own resources enabled disbursements of \$2.4 million in 1997. This CAF program did not have any particular environmental requirements. Sub-lending was widely distributed both geographically and by sector with over two thirds of the loans being made outside of Lima and with the agricultural, industrial, service and commercial sectors each receiving substantial funding. Sub-loans were relatively small and numerous, with an average size of \$42,800 (well below the maximum of \$140,000) and a total of 1,058 being made. Thus the experience with the CAF program suggests that the proposed operation will be widely diversified both geographically and by economic sector.
- 1.45 In conclusion, when IFIs have adequate funding for their traditional clients, they have an incentive to increase lending to small enterprise because a) increased competition for traditional corporate lending have reduced profit margins in this market segment, b) transactions costs on smaller loans are coming down as banks gain experience and apply new technology, and c) effective demand from small enterprise is growing due to favorable economic conditions. The proposed Bank program is consistent with the country’s and Bank’s strategy. It will provide a stable source of long-term resources to the financial system thereby enabling IFIs to continue to serve their traditional larger enterprise clientele while at the same time encouraging them to further develop their installed capacity to analyze and lend for small-enterprise projects.

II. THE PROGRAM

A. Program Objectives

- 2.1 The program will help to sustain profitable, private-sector investment activity in Peru in the face of external shocks to financial sector. In so doing the program will enable medium and larger enterprise to continue to grow at rates consistent with demand for their products. At the same time the program will encourage the development of small enterprise in Peru. This will benefit the economy as a whole because small enterprise uses relatively labor intensive techniques and is capable of rapidly adapting its productive activities to the more competitive and dynamic business.
- 2.2 The program will maintain a steady supply of credit to medium and large enterprise while increasing the access of small businesses to medium- and long-term financing. It will supply a stable source of long-term funding to retail financial intermediaries for on-lending to the small-business strata. This will enable the banks to develop new lending programs for this market segment or to consolidate their existing programs.

B. Program Description

- 2.3 **Lending operations.** The Program consists of one operation with two components. They take into account several of the recommendations from the evaluation mentioned in chapter I including the proposal to modify the methodology for determining the wholesale rate of interest as the domestic bond market matures. This is explained more fully in chapter III. (para. 3.18 – 3.22) The two components of the Program are referred to by their respective acronyms: (i) PROBID II and (ii) PROPEM, as explained below.
- 2.4 **PROBID II.** As noted in chapter I, the Bank has provided partial financing for a multisectoral credit program (loan 852/OC-PE). The program is widely known in Peru as PROBID and has been administered by the *Corporacion Financiera de Desarrollo S.A.* (COFIDE). The first component of the proposed new operation will be a second stage of PROBID and will likely be known as PROBID II. As did the first stage, PROBID II will provide financing for medium- and long-term loans to investors for the establishment, expansion, and improvement of private-sector productive activities through (i) the purchase of fixed assets, including permanent working capital associated with the project, (ii) investment-related technical and administrative support services, (iii) financing of exports of capital goods, consumer durables, and engineering and installation services as well as the sale of capital goods in the local market. To be eligible for financing, a project must comply with current environmental legislation in Peru and with the environmental requirements of the program. The methodology for establishing environmental compliance, taking remedial measures when necessary and certifying compliance with government-approved standards will be continued from the first PROBID program. Similarly the credit regulations, as approved by the Bank and currently in force, will be carried over to the new PROBID II program. These are discussed more fully in Chapter III.

- 2.5 **PROPEM.** The second component of the proposed new operation will set aside funds for medium- and long-term loans to small investors for the financing of (i) establishment, expansion and improvement of plant and equipment and related design costs and support services, and (ii) permanent working capital. The latter will be limited in scope and will be structured so as to be a resource of last resort. (See discussion of credit regulations). The program will build on the existing CAF-sponsored *Programa de Financiamiento Multisectorial para la Pequeña Empresa* which is administered by COFIDE. The design of the new PROPEM program takes into account several of the recommendations from the evaluation mentioned in chapter I (para. 1.41) including making special provision for small enterprise which lacks direct access to the capital markets, simplifying requirements for loans under US\$ 500,000, and establishing lines of credit for leasing operations. Chapter III contains more details on the parameters for small-enterprise lending. (para. 3.8 – 3.17)
- 2.6 **Technical Assistance for PROPEM.** In addition to the lending operations, a small amount (US\$ 320,000) of counterpart resources will be set aside in the PROPEM program for technical assistance in four areas. The funds will be used primarily to pay for consultant services. These activities are discussed more fully in chapter IV. Their main features and estimated costs are as follows:
- a. **Implementation of Environmental Safeguards.** -\$40,000- Prior to first disbursement the environmental requirements of the program must be established. CENTRO COFIDE has agreed to provide the IFIs with initial training on the environmental issues and requirements of this program.
 - b. **Business Development Services (BDS).** -\$150,000- COFIDE's technical information center, known as CENTRO COFIDE, will prepare an informational folder on BDS in Peru to be distributed by the IFIs to small enterprise entrepreneur clients.⁸ This informational folder will be frequently updated with information on new BDS providers, their services and new market opportunities for small enterprises. CENTRO COFIDE will also provide initial training to the IFIs on BDS and the use of the informational folder.
 - c. **Study of Domestic Financial Markets.** -\$50,000- A feasibility study of how COFIDE can best raise and place medium and long term resources in the domestic financial markets will deal with issues of debt structure, risk and impact on COFIDE's credit rating, among other topics. This study will be combined with an analysis of how the floor interest rate on COFIDE's loans to the IFIs can be more closely linked to the medium and long-term rates in the bond market. The conclusions of this study will be equally applicable to the PROBID II program as to the PROPEM operation.

⁸ Three MIF programs are in execution to provide non-financial advisory services to small enterprise. (TC-94-09-12, TC-95-02-16-4, and TC-95-04-22-7) in the areas of technology transfer, business services, and export promotion. These have the potential to complement the proposed credit program; however the respective executing agencies responsible for administering these programs have been slow to deliver the services effectively. As these programs become operational, the availability of their services will be incorporated into the publications distributed by COFIDE.

- d. **Impact Evaluation of PROPEM.** -\$80,000- An evaluation will be carried out of (i) current and potential small business demand for long-term credit according to the size of loans made, (ii) transaction costs of the various types and size loans made, (iii) obstacles to small business access to credit, (iv) the impact of the program of IFI credit delivery efficiency, and (v) compliance with environmental protection requirements.

C. Program Size and Financing Plan

- 2.7 The total program size will be US\$334.3 million, allocated as follows:

Program Component	Bank	Counterpart	Total	%
Credit lines				
PROBID II	128.70	87.30	216.00	64.6
PROPEM	69.30	46.68	115.98	34.7
Technical Assistance	-	0.32	0.32	0.1
Inspection and Supervision	2.0	-	2.0	0.6
Total	200.00	134.30	334.30	100.0

- 2.8 **Terms and conditions of the loan.** The Bank will finance up to US\$200 million in the form of a reimbursable financing in US dollars charged to the US Dollar Window Program of the Bank. US\$ 70 million will be reserved for on-lending to small enterprise, and the balance of US\$130 million will be available for on-lending to firms of any size. The interest rate for the entire financing will be a six month LIBOR-based variable rate reset semiannually; the grace period will be five years beginning on the date of the loan contract; the final maturity date will be 20 years after contract signature. COFIDE, the IFIs, and the sub-borrowers will finance the counterpart contribution of US\$134.3 million. The contribution from the latter will be limited to recognition of up to 15% of the program cost
- 2.9 The program satisfies the eligibility criteria for the Extended Dollar Window program as proposed by Management (FN-483-5) and approved by the Board of Executive Directors (DEA/96/34). The program is a multi-sector global credit program; all subborrowers are to be private-sector individuals or institutions; and the borrower is a borrowing member country which plans to on-lend the resources to the private sector. As noted in the executive summary, a waiver of the expiration date of the U.S. Dollar Window Program is requested in order to

permit funding the proposed multisectoral credit program.⁹

- 2.10 All COFIDE transactions are dollar denominated. The Government of Peru at COFIDE's request has elected financing from the Dollar Window Program rather than the Single Currency Facility for the following reasons. (i) Although LIBOR is more volatile than the SCF rate, the corresponding risk to COFIDE is virtually eliminated because its on-lending rate is LIBOR based, plus a spread as noted in Chapter III. (See para. 3.19 ff.) In fact COFIDE is concerned that a mis-match of interest rates between its assets and such a large liability might affect its credit rating unfavorably. (ii) LIBOR is currently substantially below the SCF rate and may well fall further in the near term. (iii) The Dollar Window offers a five-year grace period. This is attractive, as COFIDE believes the resources will be fully disbursed well before the fifth year after contract signature, and could come as soon as the year 2000. In 2001 a number of COFIDE's other obligations either fall due or their grace period will have expired.
- 2.11 **Revolving fund.** Based on the experience with the PROBID and MICROGLOBAL operations currently in execution, COFIDE expects to place significant amounts of program resources with its borrowers (the IFIs) at the initiation of the program. The PROBID operation had a first disbursement of 30% of Bank resources, which was fully committed within two months. In the case of the MICROGLOBAL program, the initial 20% advance was committed within five months, and during the most recent twelve month period (May 97 - June 98) the utilization rate has been about 6 percent per month.
- 2.12 Given the similarities between these two programs and the proposed new operation, it is likely that the pace of resource placements will also be similar. Also the current situation of a shortage of long-term resources in Peru is likely to result demand for rapid disbursements. If advances to COFIDE were limited to 5% of the Bank's resources (the norm established by OA-345), disbursement requests would have to be processed once per month or more often, and COFIDE could have difficulty meeting its commitment to provide funds on demand to IFIs with qualified projects, as established in the automatic rediscount facility. To avoid these funding problems and given that Dollar Window disbursements may be made only once per quarter on pre-established dates, advances of up to 20% of program resources (i.e. US\$ 40 million) should be authorized. The Country Office has proposed a revolving fund of at least 15% of program resources.

⁹ In parallel with the processing of this loan, the Bank's Regional Support Services Subdepartment is preparing a request to the Board of Executive Directors for an extension of the Dollar Window Program, to avoid the need for such exceptions in the future.

III. PROJECT EXECUTION

A. Borrower and Executing Agency

- 3.1 The borrower and guarantor of the program will be the Republic of Peru as represented by the Ministry of Economics and Finance (MEF). COFIDE will be the executing agency. Prior to first disbursement, the borrower and COFIDE will enter into an agreement whereby the former will transfer program resources to the latter on similar conditions to those of the loan contract with the Bank. Funds will be on-lent according to credit regulations that will specify the terms under which COFIDE will channel the resources to the IFIs. The latter will lend to the sub-borrowers at freely determined rates and will assume the full credit risk.

B. Credit Regulations of the Program

- 3.2 **IFIs Eligibility.** COFIDE will be responsible for identifying and selecting the IFIs eligible to participate in the program. These selection criteria will be the same for both the multisectoral and small enterprise credit components of the program. All IFIs must (i) be supervised by and be in good standing with the Superintendency of Banks (SBS), (ii) be in compliance with applicable legal reserve requirements, (iii) have no pending legal action against COFIDE, (iv) have debts to COFIDE which are less than 30% of their total liabilities, and (v) have positive net profits in real terms. In addition the IFIs must satisfy one of three following sets of criteria:

The IFI must have loan arrearages within acceptable limits (defined as less than the smaller of 10% or 1.3 times the average for the private banking system), or

The IFI as an entity must have been rated “A” or “B” and in no case lower than “B” by one or more private rating agencies which have been registered with, and are utilizing methodology approved by, the SBS, or

If the IFI has not received a rating as an entity, but has issued long-term (more than one year) debentures, these instruments must be rated I or II (the top two categories) and in no case lower than II by the Investment Classification Commission appointed by the Superintendency of Pension Fund Administrators (SAFP) and/or by private rating agencies authorized by CONASEV.

- 3.3 **Sector eligibility.** All economic sectors and activities will be eligible for financing by either component of the program except those which may be deleterious to the environment, public health or safety, unless remedial measures are undertaken. Also excluded are purchases of goods or services not from Bank member countries, the purchase of equity or debt of other enterprises, land purchases, general and administrative expenses, personal use vehicles and other

personal consumption credit. There are also limits on the kind of debt that can be financed, which are treated below.

- 3.4 **Subborrower eligibility for PROBID II.** Resources of the multi-sectoral credit component of the program (PROBID II) will be available to firms regardless of size, owned by natural or juridical persons, which seek financing from eligible IFIs for the following project related expenditures: (a) fixed assets, (b) structural (permanent) working capital associated with the project, (c) payments for technical or management services related to project (such as consulting services), (d) financing of export of capital-goods, durable consumer goods, engineering and installation services, as well as capital goods for sale in the local market, (e) investments in projects initiated within twelve (12) months previous to the loan application to the IFI. Furthermore the subborrower must prepare an environmental brief (*ficha ambiental*) and obtain the approval from the pertinent authorities that the project complies with all the applicable current environmental requirements.
- 3.5 **Subborrower eligibility for PROPEM.** Resources from the small enterprise component of the program (PROPEM) will be available to firms, owned by natural or juridical persons, with annual sales of US\$1.5 million or less. The eligible project-related expenditures are the same as those for the multisectoral credit program, although the procedures for meeting environmental approval requirements are simplified, as described below.
- 3.6 This **definition of small enterprise** is based on the following logic: As noted earlier, an accepted definition for small enterprise is in terms of those having fifty or fewer employees.¹⁰ However it is operationally difficult for loan officers to verify employment levels when determining borrower eligibility, especially when credit decisions must be made expeditiously. An exhaustive study recently completed at the University of Lima has established that a level of US\$1.5 million in annual sales includes most firms with employment levels of 50 workers or less.¹¹
- 3.7 The limit of US\$1.5 million in sales will apply to the group as a whole in the case of firms which are subsidiaries of or otherwise associated with other businesses such that they may be considered to be a "common risk", as defined by the new banking law.¹²

¹⁰ The Bank-funded MICROGLOBAL credit line is available to those business establishments with less than 10 employees and US\$20,000 in assets (excluding real estate). These parameters establish the *de facto* lower limits for the small enterprise credit program; however there will be no restriction on smaller firms from applying for loans from the small enterprise program. These loan can not be used for consumption credit purposes.

¹¹ Jaime García Díaz, et. al. *PYMES en el Peru: Conceptos y Cifras*. Lima, August 1998 A research project of the "Programa ULPYME" (Universidad de Lima; Pequeña y Micro Empresa) supported by the Ministry of Industry, Tourism, Integration and International Commercial Negotiations (MITINCI) and foreign sources.

¹² Article 203 of Law No. 26702 *Ley General del Sistema Financiero del Sistema de Seguros y Organica de la Superintendencia de Banca y Seguros*. Common risk is understood to exist when one entity exercises direct or indirect control over the other, there is an explicit or implied joint liability for debt service, loan resources obtained by one party may be used for the benefit of the other(s), and the various parties act as one economic interest.

- 3.8 **Loan products and lending modalities for PROPEM.** The small enterprise component of the program will offer essentially two products.¹³ The first is credit for fixed capital investments and associated structural working capital. The second product is credit for stand-alone permanent (medium-term) working capital. COFIDE will lend the resources to the IFIs and be repaid in the same currency (US dollars). As with the multisectoral credit program, the IFIs are at liberty to on-lend the resources in the same or different currencies. Thus the IFIs or the subborrowers will assume the exchange risk.
- 3.9 **Modality.** IFIs that satisfy all eligibility requirements may access either small-enterprise credit product in one of two ways: (i) automatic rediscount of each sub-loan or (ii) establishment of a line of credit with COFIDE.
- (i) **Automatic rediscount.** COFIDE uses this facility to disburse funds to the IFIs rapidly and with a minimum of paperwork. If the IFI cannot provide adequate justification for the loan *ex post*, the funds revert to COFIDE's account. To avoid the IFIs using the funds for liquidity purposes, the IFI must pass on the resources to the sub-borrower within 5 days of receiving a disbursement from COFIDE. The term of the loan from COFIDE to the IFI is matched to the term of the sub-loan from the IFI to the sub-borrower.
- (ii) **Credit line.** COFIDE may establish a line of credit with an IFI, which in turn will have no more than 90 days to on-lend the resources. Funds not lent out will be returned to COFIDE. The repayment period will depend on which of the two loan products will be financed as described below.
- 3.10 **Terms and conditions of fixed capital loans made with PROPEM resources.** These loans will be made to the IFIs (commercial banks and leasing companies) for on-lending to the sub-borrowers to finance any investment activity and associated structural working capital not explicitly precluded by the credit regulations (see above). The wholesale interest rate COFIDE charges the IFI will be at or above the floor rate described below. The retail rate, which the IFI charges the final sub-borrower, will be freely determined by the two parties.
- 3.11 In keeping with the current practice of the PROBID operation, the investment activity must have been initiated no more than twelve (12) months prior to the date of the sub-loan rediscount request from the IFI to COFIDE. Similarly in the case of leasing operations, sub-borrowers will be eligible to apply for sale-leaseback arrangements, only if the original purchase of the equipment occurred no more than 12 months prior to the leasing company's application for financing from COFIDE.

¹³ The multisectoral credit program will provide resources solely through the rediscount mechanism and will finance only that permanent working capital which is directly related with the project.

- 3.12 The minimum term of COFIDE's financings to the IFIs will be one year and the maximum term of loans made under the automatic rediscount facility will be determined by COFIDE on the basis of the useful life of the financed capital goods in consultation with the IFI. In the case of fixed capital loans financed with the credit line facility, the maximum term of that line will be set based on an analysis by COFIDE and the IFI of the nature of investments to be financed and the sub-loans expected and the probable terms of the sub-loans which will be granted. As part of the monitoring and evaluation activities, the terms of these subloans will also be reviewed *ex post* to assure the appropriate match funding of subsequent credit lines.
- 3.13 Sub-loans will be a maximum of US\$300,000. In the case of mature sub-borrowers with well-established sales records such a limit may be redundant. Arguably, first-tier banks, which are assuming the entire credit risk, have a built in incentive to limit the size of their sub-loans according to prudential considerations regarding overall exposure to the client in question. However in the case of newly formed enterprises with no sales record, sub-loan size limitation is necessary to achieve the goal of restricting use of the funds to small enterprises.
- 3.14 **Terms and conditions of stand-alone permanent working capital credits made with PROPEM resources.** The objective of this loan product is to provide banks with match funding for assisting credit-worthy borrowers to establish and/or expand their permanent working capital at an "all-in" cost substantially less than the customers currently incur as discussed in Frame of Reference (see paragraphs 1.25-1.27). Many of the firms which are expected to take advantage of this facility are those which have grown too large to qualify for the MICROGLOBAL credit program offered by COFIDE with Bank financing, which does allow for financing working capital. In this sense the facility can be seen as intended for the "*micro mas uno*" stratum of the business community.
- 3.15 This stratum can be characterized in general terms as those enterprises that have between 10 and 20 employees. The García Díaz (*Programa ULPYME*) study previously cited establishes that sales of this group average about US\$ 500 thousand per year. Based on their experience COFIDE and its client IFIs have developed two very rough rules of thumb: (a) sub-borrowers' productive cycles are approximately three months and (b) about 55% of sales represent direct costs which need to be financed. Thus this stratum of the business community would need US\$68,750 in working capital on average to cover its production cycle. Given crude nature of these estimates this figure can be rounded off to US\$70,000 as an appropriate upper limit for the size of these loans.
- 3.16 Because the intention of the product is to address the permanent working capital requirements of small-enterprise sub-borrowers and because financial markets are relatively illiquid at terms greater than one year, a minimum one-year term would

be placed on the sub-loans. If the sub-loans are to be financed using the automatic rediscount facility the term of the loan from COFIDE to the IFI would be matched to the sub-loan term. If the line-of-credit facility is used, the term of the sub-loans will be very difficult to determine *a priori*; however they should rarely exceed three years. Therefore the maximum term of three years will be set in the case of credit lines destined for stand-alone permanent working capital. As part of the monitoring and evaluation activities, the terms of these subloans will be analyzed *ex post* to assure the appropriate match funding of subsequent credit lines.

- 3.17 The interest rate charged by COFIDE to the IFIs for the stand-alone permanent working capital product will be the floor rate as defined for the fixed capital credit product (see below) plus a surcharge of not less than 25 basis points. The IFIs would freely negotiate the term and retail rate with the sub-borrowers based on IFI assessment of credit risk. The purpose of the surcharge is to assure that the IFIs view the program as a resource of last resort, thereby further assuring that the funds are complementary to and not a substitute for the IFIs own internal resources.
- 3.18 **Uniform wholesale interest rate for both components.** The rate COFIDE charges the IFIs for both the multisectoral (PROBID II) and small enterprise (PROPEM) credit components will be set so as not to distort the market for domestic savings mobilization, but rather to complement it. The proposed methodology sets the rate according to the domestic long-term savings rate (i.e. one year or more) adjusted for the reserve requirement (TLP). The base rate is the higher of TLP or COFIDE's funding cost plus an intermediation spread. The formula for TLP has been applied to the PROBID operation and refined to better capture the reality of the Peruvian market for domestic resource mobilization. Originally the reference savings rate was a simple average of the long-term rate paid by all banks in Peru. Subsequently the computation was modified to include only those IFIs eligible for the PROBID (or MICROGLOBAL) program. The average was weighted to take into account the respective deposit balances of these eligible IFIs. A further adjustment was made to account for the fact that not all resources mobilized are subject to the same reserve requirement. (In late June 1998 the Central Bank announced a reduction in the reserve requirement from 45 to 35 percent which will tend to reduce the value of the floor rate.)
- 3.19 Once the floor rate is determined, COFIDE sets its actual wholesale rate differentially above this rate according to the term of the sub-loan (1-4 yrs, 4-7 yrs, 7-10 yrs, and 10+ yrs) and the relative riskiness of the IFI in question. In the new operation, COFIDE may also use an auction mechanism to set the rate above the floor for one of the products to be offered. Based on experience with another product they offer officials at COFIDE believe that the credit lines for stand-alone permanent working capital may be amenable to pricing by auction.

- 3.20 **Alternative reference rates.** A potentially complementary source of pricing information is the bond market, which has grown substantially in the past several years as noted in chapter I above. There are five major types of bonds, three of which have significant trading activity and balances outstanding, while the other two do not. The five bond types are (i) leasing, (ii) corporate, (iii) subordinated, (iv) securitized, and (v) government. There is very little activity in the last two, because of the relative novelty and sophistication of the former and the scarcity of the latter due to government's policy of not incurring any domestic debt.
- 3.21 Leasing and corporate bonds have terms of 3 to 5 years, while subordinated bonds typically have a term of 10 years as they are issued by banks primarily for the purpose of strengthening their (tier II) capital position. The secondary market in these bonds is quite active with volume on the Lima Securities Exchange (BVL) in 1996 and 1997 ranging from 1.4 to 3.7 times the volume in the primary market. Much of this activity in the leasing bond market is essentially of a very short-term "repo" nature, with the sellers agreeing to repurchase the instruments within 90 to 180 days at prices which implicitly reflect the short term interest rather than a rate consistent with the 3-5 year term of the underlying instruments. Corporate bonds are another source of rate data; however recently they have been increasingly issued in *soles* (approximately half the total in 1997). Thus the market in dollar denominated instruments is correspondingly thinner and the associated interest rates correspondingly questionable. Interest rates on subordinated bonds are not directly comparable to those of leasing and corporate bonds due to the former's quasi-equity status. The effects of the Asian financial crisis, as discussed in chapter I, are likely to retard the further deepening and maturation of the bond markets in Peru, thus postponing the date when these could provide reliable price signals for setting COFIDE's floor rate.
- 3.22 **Strategy for establishing the floor rate.** In the immediate future COFIDE will continue to set its floor lending rate according to the TLP deposit rate methodology following the current practice. COFIDE will also price differentially above this rate taking term and risk considerations into account or utilizing an auction mechanism when appropriate. As soon as the effects of the Asian financial crisis have subsided and the domestic bond markets have stabilized, COFIDE will initiate a detailed analysis of the bond market to assess the depth of its various heterogeneous segments, the reliability of the respective price signals, and their definitional relevance to the program. While a starting date cannot be established at this time, the study should take approximately three months to complete. COFIDE will present the conclusions to the Bank and recommend modifications to the algorithm for determining the floor interest rate. Based on these discussions, the appropriate changes will be made to the credit regulations of all Bank-sponsored credit operations currently in execution with COFIDE at that time.
- 3.23 The benefits of this transitional approach are that it takes advantage of a proven method while an alternative approach is fully analyzed and tested. The risks are

that the floor rate used during the transition may not fully reflect all relevant market conditions. This risk is mitigated to the extent that COFIDE differentially prices above the floor rate according to risk and term considerations or by using an auction mechanism where feasible.

C. Business Development Services for PROPEM

- 3.24 Business development services (BDS), traditionally known as non-financial services, play a crucial role in the development of small enterprise around the world. Given that the overall objective of the small enterprise component of the program is to help this sector's development, a BDS component is included to support and complement the main financial objectives of this component.
- 3.25 COFIDE has acted as a broker of business development services to micro and small enterprises since 1994 through a unit called CENTRO COFIDE. An evaluation of the performance of this center and other similar facilities in Peru, demonstrated that the services of the CENTRO could greatly benefit and complement the program as a whole. Based on its experience in BDS and on COFIDE's collaborative relationship with the IFIs, the CENTRO will produce an informational folder that will be distributed by the IFIs to all small enterprises that apply for credit under the program. The folder will have information on all of the business development services that COFIDE provides throughout Peru, as well as key information on other specialized, government and non-government BDS providers. Additionally, the folder will include information relevant to issues of environment, gender and indigenous peoples. Specifically the folder, as well as other information the IFIs supply about the program, will promote equal access regardless of gender or ethnic origin.

D. Use of program recoveries

- 3.26 The proceeds of repayments of credits granted from both components of the program funds which are in excess of the amounts necessary to service the IDB loan may be used only to make new loans to IFIs that substantially conform to the rules set forth in the loan contract and the corresponding credit regulations. Five years after the date of last disbursement the IDB and the borrower may agree on some other use of the recoveries without departing from the basic objective of the financing, or they may decide to reduce the effective term of this condition.

E. Environmental Considerations for the Small Enterprise Component

- 3.27 The small enterprise component of the program will adopt the MICROGLOBAL environmental classification model which is based on four environmental categories to grade the impact of micro-enterprises on the environment:

CATEGORY I: Beneficial to the environment
CATEGORY II: Without a significant impact on the environment

- CATEGORY III: Moderately negative environmental impact that could be easily minimized or prevented.
- CATEGORY IV: Significantly negative environmental impacts.

- 3.28 In the case of the MICROGLOBAL program all micro-enterprises classified under category IV were not be eligible for credit, while micro-enterprises in category III had to sign a "letter of intent" stating that they would modify their production techniques to mitigate and prevent environmental damage. These enterprises have to prove that they had adopted new production techniques before being eligible for a second credit.
- 3.29 For the proposed small enterprise component of the program all firms will be eligible to receive credit, regardless of their environmental category. Category III enterprises, however, would still have to sign a "letter of intent" and follow the same requirements of the MICROGLOBAL model, while Category IV enterprises would have to put in place environmentally safe production procedures before receiving the first disbursement.
- 3.30 A consulting firm was retained to analyze the environmental issues related to small enterprise. It prepared a list of typical small enterprise activities and their environmental classification based on the same principles as the MICROGLOBAL list of activities, and taking into account the Bank's *Guías para Mejorar la Calidad Ambiental de las Operaciones de Crédito para Microempresas*. A table classifying these typical activities according to each of the respective four environmental categories has been prepared.
- 3.31 At the time of loan application, a small enterprise would be asked by the IFI to sign a *Declaración Jurada de Efecto Ambiental*, of its business activity, and with the help of the IFI and according to the classification table, the category the activity falls into would be identified. Environmental consultants would be available through CENTRO COFIDE, to help both the IFI and the small enterprise with this requirement. In the event the activity falls into Category III or IV, CENTRO COFIDE would also be prepared to provide information on where the firm, and the IFI, can seek additional support and environmental guidance.

F. Impact Evaluation of the Program.

- 3.32 Proper evaluation of the program should be on-going and not only *ex post*. If adequate follow-up mechanisms of the impact of the program are set in to place, lessons learned could be applied to the program while it is still in execution. COFIDE has agreed to contract a consultant who will design on-going impact evaluation mechanisms to i) review current and potential small business demand for long-term credit according to size of firm, ii) quantify transactions costs of the various types and size of loans made, iii) identify obstacles to small business

access to credit, iv) evaluate the impact of the credit program on the IFIs and the sub-borrowers in terms of improved credit delivery mechanisms for the former and changes in the manner and cost of financing investment activities for the latter, and v) evaluate compliance with the environmental protection requirements.

- 3.33 COFIDE has agreed to contract independent consultants to carry out an *ex post* evaluation of both components of the program. The *ex post* evaluation will benefit from this on-going impact evaluation mechanism and will include the following topics: i) the effectiveness of the discount mechanism and lines of credit as resource allocation device, ii) the operational effectiveness of the IFIs participating in the program, iii) the quality of the service provided to small enterprises, and iv) the compliance of the small enterprises with the environmental requirements.
- 3.34 The execution of both components of the program will also be evaluated according to the normal procedures of the Bank, including the executing agency's interim progress reports and a final Project Completion Report prepared jointly by the executing agency and the Country Office.

IV. THE EXECUTING AGENCY

- 4.1 The *Corporación Financiera de Desarrollo* (COFIDE), a public financial enterprise established under private law, is owned primarily by the Peruvian Government (97%). The *Corporación Andina de Fomento* (CAF) owns the remaining 3% of the capital stock. COFIDE is organized as a *Sociedad Anónima* and has administrative, organizational, and financial autonomy. Its net worth, as of December 1997, was US\$ 258 million; it had net assets of \$1.18 billion, and a portfolio of outstanding loans of US\$792 million, of which 64% were medium and long-term operations. The rest corresponds to short-term financing with working capital credit lines accounting for 25% of the total portfolio, and foreign trade lines, including contingent loans, the remaining 11%.
- 4.2 **Mission and objectives.** COFIDE's mission is to support the country's economic and social development by promoting and furnishing investment resources. A central part of this mission is to foster micro and small business growth, by providing not only financial services, but also a variety of business development services through *CENTRO COFIDE*.
- 4.3 **Organizational Structure.** COFIDE is governed by an assembly of shareholders which names a Board of Directors. The General Manager and the Audit Unit report directly to the Board. The General Manager's office is responsible for five central departments and two support departments. These central departments are: i) Credit Department, in charge of the placement of COFIDE's resources in the financial system; ii) Development Department, in charge of selecting and qualifying the financial intermediaries as well as executing COFIDE's non- financial activities; iii) Finance Department, in charge of corporate financial policy decisions, funding and internal control of revenues and costs centers ; iv) Risk Department, responsible for administering the risks associated with the placement of funds, as well as the market risks and v) Trust Department, in charge of supervising the trusts and commissions (e.g. Citizens' Participation Project). The support departments are the Legal Assistance Department and the Department of Information and Administration, which provides administrative support and formulates policies with regard to personnel and acquisition of goods and services.
- 4.4 **Sources of funding and major operations.** COFIDE manages a total of six programs or lines of credit which are made available to qualified financial intermediaries in the Peruvian financial sector: i) the Multi-sector Investment Program, composed of the MICROGLOBAL, PROPEM and PROBID operations. These are distinguished according to the size of the beneficiary enterprise; ii) the Multi-sector Working Capital Lines, designed for enterprises that demand short and medium term loans; iii) Support Programs for the Rural Sector; iv) International Trade Programs; v) Multi-sector Privatization Credit Program, and vi) Credit Line

for Non-Traditional Financial Intermediaries, designed exclusively for financial intermediaries with a social capital of up to US\$300,000 approximately.

- 4.5 In 1997 COFIDE approved US\$1,189 million in credits, representing an increase of 51% over 1996 and a 100% increase over 1995. As a result, at the end of 1997, the current portfolio of COFIDE stood at US\$792 million, an increase of 26% over the previous year. Medium and long term operations were US\$509 million, representing 64% of the total portfolio. The remaining assets corresponded to short-term loans, where lines of working capital represented 25% and the international trade lines the remaining 11%. In regard to the medium and long-term operations the PROBID program approved 67 investment projects in 1997 for a total of US\$39 million, and as of June 1998 the combined IDB and JEXIM disbursements totaled US\$152.6 million. During 1997 the Microglobal approved US\$15 million, which lead to a total of US\$29 million disbursed for this line of credit.
- 4.6 **Main financial indicators.** The growth of the loan placements revealed a substantial increase in the productivity of human resources, passing from US\$ 4 million per employee to US\$6 million in 1997. Furthermore this growth was accompanied by an improvement in the quality of the portfolio, as reflected in the relationship between the portfolio in default and legal recovery as compared to total of placements, which went from 1,3% in 1996 to 1,0% at the end of the last year.

COFIDE: Principal Financial Indicators
(in US\$ millions)

INDICATORS	Dec. 31, 1997	Dec. 31, 1996
Total Assets	1180	810
Loan balances	792	630
Liabilities	922	643
Net Worth	258	167
Net profits	13	12
Gross Loans/Employees	6	4
<u>In percentage terms</u>		
Average return on capital	5.3	7.1
Average return on assets		
Bad debts/Gross loans	1.4	1.5
Operating Expenses/ Total Assets	1.0	1.3
Risk-weighted	1.1	1.3
Assets/Equity	4.0	5.7

V. PROGRAM FEASIBILITY, BENEFITS AND RISKS

A. Socioeconomic Feasibility

- 5.1 Peru enjoys an economic policy environment which stimulates competition and promotes efficient allocation of resources. The consensus throughout the country in favor of this policy is widespread, although recently the pace of reform may have slowed compared to the early and mid 1990s. Nonetheless the consolidation of the institutional and legal reforms already made throughout the economy and particularly in the financial sector provides an impetus for a continuing auspicious macro-economic and sectoral environment. With its capability to adjust its productive activities to changing market circumstances, small business can thrive in this environment and in turn make an important contribution to overall employment and income generation. Larger enterprises can also thrive in this environment, but they must be assured of a reliable supply of term financing for their essential investment activities.
- 5.2 Recently the country has been subject to the twin external shocks of the *El Niño* phenomenon and the Asian financial crisis. This has led to a “flight to quality” by international funding sources and a reduced supply of term financing even for the best financial intermediaries and their best large-enterprise clients. Smaller banks and smaller enterprises, whose access to private international capital was less well-established, have been hurt proportionately more. Meanwhile Peru continues to offer opportunities for profitable private sector investment. Economic growth while down is still expected to be in the range of 3.5% in 1998 and for next year is expected to recover to a rate of 4.1% (according to some private estimates).
- 5.3 Investment demand may be lower than it would have been in the absence of the Asian crisis and *El Niño*, however it is still greater than the substantially reduced supply of long term funds. The most direct evidence of this is the recent sharp rise in demand for the PROBID credit line, which is one of the few sources of financing not affected by the “flight to quality”. In the third quarter of 1998, with rising interest rates, the program funds were placed more than three times as fast as had they had been during the previous year.
- 5.4 While the program is designed to assure a continued supply of funds for private enterprise of all sizes during the current unsettled economic conditions, it also has been structured to both take advantage of and contribute to the further development of financial services available to small business. First it will build on the capacity that many IFIs have already established in lending to this strata. Second it will take advantage of the competitive incentives IFIs have to look “down market” to small enterprise for business as profit margins in corporate finance are squeezed. Third by providing a reliable source of funding it will encourage IFIs to further develop their capacity to lend to this segment of the market and thereby increase the efficiency and profitability of this lending.

B. Institutional Feasibility

- 5.5 The viability of the apex institution, COFIDE, is assured by its successful transformation to an exclusively wholesale (second tier) financial intermediary with increasing levels of lending activity and profitability. Its administration of similar programs, such as the Bank-funded PROBID and MICROGLOBAL as well as the CAF-sponsored PROPEM programs, provide it with an ample knowledge base for carrying out the proposed small enterprise credit operation.
- 5.6 At the first-tier level, viability is assured by the IFI selection criteria which permit only those which are financially sound to participate. Since May 1995 when the first sub-loan was granted, 18 IFIs have participated in the first stage of the PROBID program, although some did not immediately qualify. Those which are currently in good standing will be eligible for continued participation in the PROBID II operation. Regarding the new PROPEM program, several of these same IFIs already have considerable experience with the small-business stratum of the business community, and they will be able to take full advantage of this component of the program right from the outset (the special contractual conditions call for at least three IFIs to agree to participate in the program prior to first disbursement). Meanwhile those IFIs which do not immediately meet the eligibility criteria or which have had relatively little experience with small business will be able to enter the program as they strengthen their balance sheets and/or determine whether small business is consistent with their strategic plans.

C. Financial Viability

- 5.7 The design of the small-enterprise component of the program is based on appropriate elements from both the Bank-sponsored PROBID and MICROGLOBAL programs as well as the earlier CAF-sponsored PROPEM program, all three of which have proven to be fully financially viable operations. In particular, the methodology for setting the wholesale interest rate has been fully tested and adjustments have been made as needed, consistent with the underlying principle of pricing the resources so as not to discourage domestic resource mobilization. Further adjustments are contemplated as the bond markets mature and their price signals are better understood.
- 5.8 Financial viability at the IFI level is almost a tautology, as only those, which are viable, will be allowed to participate. If due to unforeseen circumstances one or more IFIs drop below the threshold, they will be excluded from the program; however others will still be eligible, and the program as a whole will continue. Meanwhile the risks to IFIs which are eligible to participate in the program are reduced by (a) the availability of credit bureau services from the SBS and several private providers, and (b) the IFIs' increasing capacity to evaluate project risk at the small-enterprise level.

D. Benefits

- 5.9 At the level of the country as a whole, the PROBID II program will help to insure that profitable private-sector investment will continue to be carried out in a timely manner and will not be cancelled or postponed due to lack of long-term financing. At the level of the individual IFIs and subborrowers, the program will assure that these funds are distributed broadly among all eligible financial intermediaries and in turn are on-lent to a broad range of private subborrowers, because COFIDE will permit all qualified intermediaries equal access, subject to impartial prudential criteria. In the absence of the program whatever limited funds were available would likely be controlled by the biggest banks which in turn would likely lend only to their best "blue chip" clients. Thus the program will counteract tendencies to return to a more concentrated Peruvian banking system and in the long run will help assure greater competition in the sector.
- 5.10 The PROPEM component of the program will contribute to the strengthening and better integration of small business into the Peruvian economy not only by providing a stable source of long-term credit but perhaps even more importantly by doing so with financial products and related Business Development Services which are better attuned to the needs of this stratum of the business community.
- 5.11 Related benefits from the PROPEM component are expected to be: i) greater incentives for small enterprises to become formalized, ii) identification of market niches for small enterprises in local and international markets, iii) increased productivity and competitiveness of small enterprises as they become more specialized, gain access to technology and develop long-term business plans, iv) greater economic and business interaction between small, medium and large enterprises, v) tailored financial services from the IFIs that better meet the needs of small enterprise, vi) greater environmental impact awareness, and vii) information disseminated on business development providers to small enterprise.

E. Risks

- 5.12 At the macroeconomic level the main risk to the program as a whole is a recurrence of instability and financial market repression. This would distort incentives and likely reduce lending to small enterprise. As noted, the Government's firm commitment to continuation of the current sound economic policies, particularly in the face of the shocks associated with the Asian financial crisis, has strong support throughout the country. Having successfully completed several IMF stabilization programs, no further formal programs are contemplated; however it is expected that the Government will continue to abide by the guideposts provided by the Fund.
- 5.13 At the level of overall program implementation, the greatest risks are deterioration in the portfolios of the participating intermediaries and/or the reduced ability of subborrowers to service their dollar denominated debt.

Regarding the former, high foreign currency reserves and increased provisioning requirements as well as capital adequacy ratios exceeding the Basle norms suggest that the banking system as a whole is in a good position to weather a rise in arrearages. Furthermore, requirements for IFIs to participate in the program not only call for full compliance with all Banking Superintendency norms, but also with additional prudential criteria. (see para. 3.2) These are designated to screen out marginal banks before they become a threat to the program, or more broadly to COFIDE itself.

- 5.14 Regarding the currency risk, it must be kept in mind that the economy is highly dollarized (see para. 1.13). Also almost half of the subborrowers of the existing PROBID program are directly or indirectly involved in export related activities (para. 1.10) and should be able to invoice in dollars or dollar equivalents. Even those subborrowers who are not engaged in export related activities will have no difficulty obtaining dollars due to Peru's policy of free convertibility. However a major reduction in the floating dollar/*sol* exchange rate would obviously raise the *sol* cost of debt service. In recent years the *sol* has been quite stable due to well-designed and well-administered macro-economic policy and to substantial foreign investment due in part to the favorable policy environment in Peru. Thus to the extent the government continues these policies, the risk of major devaluation is mitigated. However, exogenous factors leading to sharp drops in foreign investment still represent a major risk to the stability of the exchange rate. Individual sub-borrowers may be able to obtain some protection by locking in an exchange rate in the forward market (see para. 1.21), but this would only address their most immediate debt service obligations and not the effects of devaluation over the entire life of the typical 5 – 7 year loan.
- 5.15 A risk to the small-enterprise component of the program (PROPEM) is the loss of incentive for the IFIs to continue participating due to a perception of relatively low profitability. This risk is mitigated by the availability of funds from the companion PROBID II component of the program. In the face of reduced funding from other sources induced by the Asian financial crisis, program funds will enable the IFIs to continue to serve their larger clients thereby helping to maintain the relatively competitive environment in the IFIs' traditional markets. In turn they will have an incentive to continue their expansion into new markets such as small enterprise. Also the PROPEM program is attractive as it is designed to respond to the multiple requirements of IFIs and their small business clients for both fixed and permanent working capital credit products to be made available on either an individual automatic rediscount basis or as a credit line.
- 5.16 As regards the environmental technical assistance activity, there is a risk that these norms will not be adequately implemented in the new PROPEM program. However a consulting firm has developed guidelines for compliance with the Bank's environment requirements. This firm is also studying ways in which CENTRO COFIDE can help both entrepreneurs and credit officials, address these environmental requirements. Training will be provided to assure that the

consultants will be adequately qualified to provide these services, so that their recommendations do not complicate production processes and make small enterprises incur in higher production costs.

- 5.17 Finally there is the risk that the business development services to be provided by CENTRO COFIDE in conjunction with the PROPEM program may not meet the demands of its future clients. This risk of this eventuality, however, is minimal, considering that CENTRO COFIDE has an adequate budget to deliver its services and is scheduled to undergo profound restructuring which will modernize the center and make it as sustainable and competitive as possible. Also, given that CENTRO COFIDE will be more of a broker of services than a direct provider, it will not be required to maintain the specialized technical skills in-house, nor to incur the high costs to deliver such quality services.

PERU
MULTI-SECTOR CREDIT PROGRAM: STAGE II
PE-0191

LOGICAL FRAMEWORK

NARRATIVE SUMMARY	OBJECTIVELY VERIFIABLE INDICATORS	MEANS OF VERIFICATION	ASSUMPTIONS
<p>able enterprises in Peru to ine to grow at rates consistent the demand for their products at the same time encourage lopment of small enterprise.</p>	<p>-Investment as a percentage of GDP holds steady or improves.</p> <p>-Small enterprise's share of GDP increases.</p> <p>-The number of formal small enterprises increases.</p>	<p>-INEI statistics.</p> <p>-SUNAT data on new small enterprises recorded.</p>	<p>-The policy of macroeconomic stability remains intact.</p> <p>-INEI produces the required statistics.</p> <p>-SUNAT provides the required information.</p>

NARRATIVE SUMMARY	OBJECTIVELY VERIFIABLE INDICATORS	MEANS OF VERIFICATION	ASSUMPTIONS
<p><u>pose</u></p> <p>provide a steady supply of medium- and long-term financing to enable them to meet the investment needs of enterprise in rural and to develop their skilled capacity to better serve the strata and allow adequate management of funds.</p>	<ul style="list-style-type: none"> -Increase financing for investment projects. -Increase financing for IFI clients to on-lend to SE. -Specialized units within the IFIs that facilitate lending to SE. 	<ul style="list-style-type: none"> -SBS figures on term deposits. -COFIDE intelligence (lending, organization of the IFI to support investment projects and the SE). 	<ul style="list-style-type: none"> -Laws which encourage efficient and competitive functioning of IFIs. -The public has confidence in the financial system. -The following either hold steady and/or improve. <ul style="list-style-type: none"> a) IFI interest in supporting investment projects and moving into the SE sector. b) Availability of SBS credit bureau's data bases on SE.

NARRATIVE SUMMARY	OBJECTIVELY VERIFIABLE INDICATORS	MEANS OF VERIFICATION	ASSUMPTIONS
<p>Components</p> <p>3 financing to make possible COFIDE credit program with IFIs, with two components:</p> <p>Multi-sector credit for enterprises of all sizes.</p> <p>Credit for small enterprise.</p> <p>Technical assistance to COFIDE to develop financial products and to the domestic market.</p> <p>Environmental technical assistance.</p> <p>Publication of information on CENTRO COFIDE and other suppliers of business development services in Peru.</p>	<p>-Lending of program resources within the time frame stipulated in the IDB-COFIDE loan contract.</p> <p>-Completion of the training courses and environmental consulting services.</p> <p>-Data on the programs of CENTRO COFIDE and other suppliers of business development services in Peru.</p>	<p>-COFIDE reports to the IDB</p> <p>-Reports on attendance at training courses and demand for consulting services.</p> <p>-Reports on the programs of CENTRO COFIDE and other suppliers of business development services.</p>	<p>-IFIs continue to have access to COFIDE funds.</p> <p>-The training courses and consulting services function properly.</p> <p>-The programs of CENTRO COFIDE and other suppliers of business development services in Peru function adequately.</p>

NARRATIVE SUMMARY	OBJECTIVELY VERIFIABLE INDICATORS	MEANS OF VERIFICATION	ASSUMPTIONS
<p>Activities (Tasks) - COFIDE</p> <p>flexibility in dealings with IFIs (interest rates, payment periods, etc.).</p> <p>Responsive mechanisms established for credit lines to IFIs or discounts of their sub-</p> <p>Monitoring to ensure that the</p> <p>Training provided to IFIs on environmental management issues business development services. CENTRO COFIDE's informational folders on business development services are</p> <p>TC component to build up COFIDE's capacity to operate on domestic market carried out.</p>	<p>-Rapid response (within the time period stipulated in the regulations) to significant changes in the condition of the IFIs.</p> <p>-Timely provision (within the time period stipulated in the regulations) of funds to IFIs.</p> <p>-Penalization (rectification) (within the time period stipulated in the regulations) of IFIs that fail to comply.</p> <p>-Instruct IFIs' loan officers in matters related to environmental management and in the business development services that CENTRO COFIDE provides.</p> <p>-Train 10 COFIDE officers in local currency operations on the domestic market.</p>	<p>-Audit reports.</p> <p>-Audit reports (surveys of IFIs).</p> <p>-Audit reports.</p> <p>-Reports from environmental consultants and CENTRO COFIDE.</p>	<p>-COFIDE management maintains its professional efficiency.</p> <p>-Proper mechanisms for prompt on-lending are maintained.</p> <p>-Environmental standards are properly implemented.</p> <p>-(COFIDE) financing is available for instruction in environmental management by IFIs and the informational folder is delivered.</p>

NARRATIVE SUMMARY	OBJECTIVELY VERIFIABLE INDICATORS	MEANS OF VERIFICATION	ASSUMPTIONS
<p> timely lending and recovery of program proceeds, both those of multi-sector credit component and those of the small enterprise credit component</p>	<p>-Data on execution of sub-loans (time of loan, arrearage, etc.).</p>	<p>-IFIs' reports to COFIDE.</p>	<p>-IFIs are financially stable.</p>
<p> growth of the client base.</p>	<p>-Data on the number of clients.</p>	<p>-COFIDE's follow-up surveys on the services offered.</p>	<p>-IFIs do not drop below the eligibility threshold. -Corporate policies to make inroads into the SE market remain unchanged.</p>
<p> fulfillment of the environmental requirements.</p>	<p>-Sample of environmental briefs.</p>	<p>-IFSs' reports to COFIDE -IFIs' reports on fulfillment of environmental requirements.</p>	<p>-The IFIs incorporate the environmental guidelines.</p>
<p> circulation of information on CENTRO COFIDE's business development services.</p>	<p>-Number of PROPEM clients that uses the published information.</p>	<p>-CENTRO COFIDE's reports on business development services available to SE.</p>	<p>-CENTRO COFIDE's programs continue in the medium and long term.</p>

PROPOSED RESOLUTION

PERU. LOAN ___/OC-PE TO THE REPUBLIC OF PERU

(Multisector Credit Program – Stage II)

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 Republic of Peru, as Borrower, for the purpose of granting it a loan to cooperate in the execution of a mutisector credit program. Such loan will be for the amount of up to two hundred million United States of America dollars (US\$200,000,000) from the U.S. Dollar Window resources of the ordinary capital of the Bank, and will be subject to the "Special Contractual Conditions" and the "Terms and Financial Conditions" set forth in the Executive Summary of the Loan Proposal as well as in Document FN-483-5, approved September 25, 1996 (setting forth terms and financial conditions for U.S. Dollar Window Program loans).