

STRENGTHENING OF THE RURAL AND MUNICIPAL SAVINGS AND LOAN INSTITUTIONS**(TC-99-05-05-4)****EXECUTIVE SUMMARY**

Executing agency:	Corporación Financiera de Desarrollo, S.A. (COFIDE)		
Project number:	TC-99-05-05-4		
Beneficiaries:	Peruvian micro and small enterprises		
Financing:	Nonreimbursable (III-A)		
	MIF:	US\$1.5 million	
	Local:	US\$1.0 million	
	Total:	US\$2.5 million	
Objectives:	<p>The general objective of the project is to improve access to financial services for the low-income population. The specific objectives are a) to strengthen the administration of rural savings and loan institutions, and b) to support the privatization of municipal savings and loan institutions. The project will make it possible for private capital a) to take part in rural financial intermediation, b) to recognize the savings capacity of the rural population, c) to include rural nonfarm activities in loans made by savings and loan institutions, and d) to give attention to small and micro entrepreneurs.</p>		
Description:	<p>The project would channel technical assistance to rural savings and loan institutions to strengthen and improve their management, particularly in the areas of strategic planning, attracting depositors, strengthening internal controls and audits, developing financial products, credit technology, portfolio management, and financial and risk management. This technical assistance package could substantially improve the productivity and efficiency of savings and loan institutions and thereby facilitate reform of their asset structure through improved institutional governance, preparation for a more significant role, and access to capital markets as sources of funds. The project would also support privatization of the municipal savings and loan institutions, complementing measures already well under way. Stronger</p>		

management and structural reform will enable the savings and loan institution system to admit strategic private partners, tighten the dispersal of shareholdings, sharpen the distinction between shareholder and borrower, and correct the agency and moral risk problems associated with a diffuse ownership structure.

Execution timetable:

Execution period: 36 months
Disbursement period: 42 months

Risks:

The following risks have been identified: (i) failure to achieve sustainable development of the management and ownership structure of the rural savings and loan institutions, privately-owned autonomous entities whose owners will have to agree with the project and be willing to accomplish its purposes; and (ii) failure by the executing agency (COFIDE) and the Superintendencia de Banca y Seguros (SBS) to cooperate closely and exchange information on savings and loan institutions performance and progress. These risks will be mitigated by COFIDE, which has extensive experience in the administration of complex projects of this kind and has been in full and ongoing communication with the SBS on technical assistance projects in this area. These risks will also be mitigated by the fact that the performance indicators of the CRACs previously established and agreed-upon by COFIDE and MIF will be evaluated annually.

Special conditions:

Before the first disbursement of resources from the contribution to be used for the execution of components I and II, COFIDE must present, to the MIF's satisfaction: (i) evidence that it has designated the operating unit to be responsible for administering the project; (ii) the general timetable for use of the contribution and the counterpart resources; and (iii) evidence that the consultancy to be responsible for initiating implementation of the project has been selected in accordance with the terms of reference and procedures agreed upon with the MIF.

The MIF reserves the right to change the consulting firm or even cancel the operation if, following the annual evaluations, the MIF determines that the CRACs' performance indicators are unsatisfactory.

Exceptions to IDB policy:

None.

I. BACKGROUND

A. Eligibility

- 1.1 The project is compatible with MIF guideline III-A, section 4 of the establishing agreement stating that grants for technical cooperation may be made to financial intermediaries to increase the volume and extend the scope of the services provided to micro and small enterprises. Peru was declared eligible for all MIF facilities on December 14, 1993.

B. Frame of reference

- 1.2 The growth of the Peruvian economy in the nineties, control of inflation, and financial reform have generated conditions favorable to the development of microcredit. In addition, public-sector support has been forthcoming in the form of proper regulations and financial support to intermediaries. However, this extension of the range of the formal financial system is still quite far from covering the great potential demand for financing from microenterprises, particularly in the countryside.
- 1.3 The traditional model of rural financing in the country was typically one of heavy government intervention through publicly owned and managed agricultural banks, whose primary function was the making of soft loans. The reform of the financial sector includes liberalization of the financial market and liquidation of the development banks to foster competition among financial institutions, modernize operations, intensify financial intermediation, and strengthen the institutions of inspection and supervision.
- 1.4 The rural credit unions (CRACs) and municipal credit unions (CMACs) are new entities created specifically to serve microenterprises. In 1998 the CRACs and CMACs together commanded US\$225 million in total assets.
- 1.5 The CRACs were established in 1992 as privately owned financial enterprises that receive resources from the public and place them preferentially in rural small and microenterprises, with the expectation of filling the vacuum left by the passing of the Banco Agrario. The CRACs have grown rapidly, their assets increasing from US\$44.2 million in 1995 to US\$78.7 million in 1997. The average loan amount is US\$1,826.
- 1.6 However, the financial sustainability of the CRACs is not yet assured, with 17.5% of their portfolio in arrears, which has generated losses of 1.9% of their net worth in 1998 and the liquidation of 6 of them by decision of the Superintendency of Banks and Insurance (SBS). There are at present 14 CRACs, some of them in near-bankruptcy.

- 1.7 The principal constraints on the CRACs include: (i) the requirement of insufficient minimum capital – particularly for the purposes of taking savings deposits – which encourages a proliferation of entities with insufficient net worth and unable to achieve economies of scale;¹ (ii) the promotion of a diffuse ownership structure, the original legislation restricting the equity of any single shareholder to not more than 5% and requiring at least 20 local shareholders; (iii) this in turn hampered diversification of the regional and sectoral risks.² This limit on equity resulted in an extensive fragmentation of stock capital, which led to the formation of boards of directors unrepresentative of the interests of the majority of the stockholders, some of which even interfered in the decisions of the managers. This interference by board members is one of the crucial problems.
- 1.8 In the eighties, however, support was given to the establishment of municipal credit unions (CMACs) as part of the public sector efforts to broaden the supply of finance to low-income sectors and promote decentralization. In the first stage the institutional design of the CMACs included adequate growth incentives and a governing structure to maintain a balance of forces and control the influence of municipal government, thus permitting them to be managed on criteria of technical soundness and profitability.
- 1.9 The CMACs have made remarkable gains in coverage and sustainability. Indeed, they display a clear focus on their target group and are the most important source of microcredit, with a current portfolio of US\$70 million in 85,000 loans outstanding and an average balance of US\$827 per customer. They have also kept acceptable the quality of their portfolio, of which 5.9% is in arrears, with a return on net worth of 19.19% in 1998.
- 1.10 However, this comparison gives the CMACs no cause for complacency, for it can jeopardize the gains made in the middle and long run and hinder any large-scale expansion of their operations unless they develop a proper administrative framework. With the successful effort at privatization made in the nineties, the time is now propitious for the CMACs to start taking on new shareholders.

II. THE PROJECT

A. Objectives

- 2.1 The general objective of the project is to give the low-income population improved access to financial services. The primary beneficiaries will be low-income earning

¹ This matter will be discussed further in the context of a parallel MIF project with the SBS (see paragraph 4.3).

² In December 1995 these limits were removed by the present law on the financial system. The shareholder can operate anywhere in the country. The minimum number of shareholders is two. No shareholder in one rural credit union may be a shareholder in another except for purposes of merger.

individuals and microenterprises. It will make it possible for the rural and municipal credit unions to sustainably meet the rising demand for credit of microentrepreneurs, granting them credit on market terms and permanently reducing their transaction costs.

B. Project description

- 2.2 Consistent with this overall objective, the following specific aims have been defined: (i) the institutional strengthening and improvement of rural credit unions, and (ii) support for the privatization of municipal credit unions. The project will make it possible for private capital to participate in rural financial intermediation, for the capacity for saving of the rural population to be recognized, for nonfarm rural activities to be included among the purposes for which credit union loans are made, and for proper attention to be given to the needs of small microentrepreneurs. Once management of the CRACs has been strengthened and their structures reformed, a private strategic partner can be brought in.
- 2.3 In the design of this project, consideration was given to the institutional strengthening activities executed under the microglobal technical cooperation component (MIC I), financed by the Bank in 1998. Microglobal I included terms of reference for a consulting firm to be hired to conduct a diagnostic assessment of commercial bank performance and methodology in the field of microfinance. The objective of the consultancy was to design strategies through which an initiative by the commercial banks and other financial intermediary institutions to expand their customer base and provide financial services to the microenterprise sector could be supported. However, because of the financial crisis in recent years, the commercial banks set this initiative aside and the consultancy had to change its initial activities and focus on the diagnostic assessment and strengthening of four CRACs and three EDPYMES³. The present operation is designed to complete the work of the consortium. This project, aside from completing those technical cooperation activities, covers a much greater number of CRACs and includes additional activities essential to the long-term sustainability of these institutions⁴.
- 2.4 In addition, and for greater consistency in the execution of this project, it was agreed that COFIDE would coordinate the activities of the consortium and the MIF operation: "Strengthening of the Supervision of the Superintendency of Banks and Insurance for Microcredit Institutions" (TC-99-05-05-3) with those under this

³ In the design of this project, consideration was given to the MIC line of activity program, designed and executed by the Bank's microenterprise unit, which is working to strengthen two EDPYMES in addition to the three under MIC I.

⁴ MIC I is working with four CRACs, whereas this project would work with eight to ten CRACs. The activities of this project are based on recent studies which took into account the technical cooperation activities under MIC I and which were performed specifically for the design of this project.

project. Moreover, this MIF project will be based on data studied by the consortium and on activities already conducted for this program.

1. Component I: Program for Institutional Strengthening of Rural Credit Unions (US\$2,100,000. MIF: US\$1,300,000, Counterpart: US\$800,000)

2.5 In fact, in the design of this project, it was decided that the institutional strengthening activities described below would be initiated only once the results of the SBS inspection visits program had been taken into account (see paragraph 4.3).

2.6 This component has two subcomponents: (i) improvement of the management of CRACs, and (ii) support to reform of the net worth structure. The two subcomponents are closely interrelated and are intended to speed up the improvement of productivity and the financial soundness of the CRACs.

(i) Improvement of the management of CRACs

2.7 Investments in rural activities are associated with high risk and transaction costs owing to the small scale of these operations, the geographic dispersal of the borrowers, the high uncertainty of farm income, and the high seasonality of farming. It is hence important to provide for the structural factors and reduce the cost of credit by encouraging the entry of private partners in the long term.

2.8 This subcomponent will make itself felt primarily in the areas of: strategic planning; promotion of the attraction of deposits or development of new and redefinition of existing financial products; the strengthening of internal controls and auditing; development of the technology of lending to rural microenterprises; and the development of policies on portfolio management and financial operations with assets and liabilities.

(ii) Reform of net worth structure

2.9 Many CRACS face the problem of a dispersed and fragmented shareholder base and a consequently diffuse equity structure. Only four CRACs report the formation of a clear majority of private shareholders who can exercise clear and stable control over their intermediaries. The predominant pattern in the rest is one of unstable investments of groups that gain seats on the boards of directors by dint of active canvassing campaigns and promises made to a majority of the shareholders. The idea of promoting regional private investment is important, but, as it happens, most shareholders and directors of rural credit unions lack experience in financial services, which in some degree is an original weakness of the institution which few credit unions try to overcome despite having been operating for several years.

- 2.10 This second subcomponent will support increasing participation by the private sector by cleaning up their portfolios and improving the indicators of their profitability and productivity, and promoting the mergers that are already taking place and the need to offer shares to microinvestors to supplement the very limited investment capacity of the present CRAC shareholders.

2. Component II: Support to the Privatization of Municipal Credit Unions (US\$270,000. MIF: US\$150,000, Counterpart: US\$120,000)

- 2.11 The purpose of this component is to complement measures in progress and which are significantly advanced. Discussions have already been held in the CMAC system on the privatization of these intermediaries.
- 2.12 On the score of possible alternatives, two important criteria have been framed on the CMACs: (i) ensuring a majority of private shareholders, and (ii) ensuring that the new investors stay focused on the microentrepreneurial sector. Regarding this latter criterion, there is consensus that there is need of a kind of “shareholders’ agreement” stipulating that the majority shareholders will not swerve away from the original purpose of the CMACs.
- 2.13 It is proposed that this component of the technical assistance program will finance several national and regional events for the directors and managers of CMACs; these events, together with the financial information obtained from investment banks, will enable them to frame a definitive strategy for their privatization.
- 2.14 The team of experts will coordinate with the investment banks in this policy-making stage. One purpose of this dialogue is to weigh the advantages and disadvantages of a consolidation of the CMACs when considering privatizing them, as a strategy for maximizing their present net worths.

III. COST AND FINANCING

- 3.1 The project provides for MIF financing in a grant of US\$1.5 million. Most of these MIF resources will finance consulting services. These services will take the form of specialized consultancies and training for technical personnel. Equipment purchases must not exceed 15% of the MIF resources applied to the projects. The counterpart will be US\$1 million, at least half of it in cash.
- 3.2 The estimated budget is summarized in the following table:

COMPONENT I (CRACs)	MIF (US\$)	Counterpart (US\$)	TOTAL (US\$)
Consulting services	1,200,000	400,000	1,600,000
Travel & subsistence (approx.)	50,000	150,000	200,000
Operating costs (approx.)	50,000	250,000	300,000
Subtotal	1,300,000	800,000	2,100,000
COMPONENT II (CMACs)			
Consulting services	120,000	80,000	200,000
Travel & subsistence (approx.)	10,000	10,000	20,000
Administrative expenses	20,000	30,000	50,000
Subtotal	150,000	120,000	270,000
Program evaluation and audits	40,000	50,000	90,000
Contingencies	10,000	30,000	40,000
TOTALS	1,500,000	1,000,000	2,500,000

IV. PROJECT EXECUTION

A. The executing agency

- 4.1 The project will be executed by the Development Finance Corporation (Corporación Financiera de Desarrollo, S.A., or COFIDE) acting through an executing unit to be set up in COFIDE. COFIDE is a second-floor agency that has carried out several IDB projects including Microglobal I and II. Its purpose is to support economic and social development with emphasis on promoting the growth of micro and small enterprises. In December 1997, the net worth of COFIDE came to US\$258 million, and it held assets of US\$1,180 million and a portfolio of US\$792 million.
- 4.2 COFIDE is the principal creditor of the CRACs, accounting for US\$35.8 million, or 86%, of their total debt and 43% of their total assets. This indebtedness is 2.7 times their net worth, which places COFIDE's exposure at high risk. COFIDE is also the principal creditor of the CMACs, which owe it US\$27.5 million, but the risk of its exposure is lower because this figure comes to 57% of their indebtedness, 19% of their total assets, and 1.2 times their net worth.

B. Special aspects of execution

- 4.3 These activities have been designed for concurrent execution depending on the results of the external audit and evaluation, which will be financed by an MIF

operation: Strengthening the Capacity of the Superintendency of Banks and Insurance to Supervise the Microfinancial Intermediaries (TC-99-05-05-3).

C. Acquisition of goods and services

- 4.4 In keeping with the Bank's policies, services and equipment may be purchased with resources assigned to the project only in MIF-eligible countries subject to the principles of economy and efficiency and following competitive and open methods.

D. Status of implementation and conditions for disbursements

- 4.5 Before the first disbursement of resources from the contribution to be used for the execution of components I and II, COFIDE must present, to the MIF's satisfaction: (a) evidence that it has designated the operating unit to be responsible for administering the project; (ii) the general timetable for use of the contribution and the counterpart resources; and (iii) evidence that the consultancy to be responsible for initiating implementation of the project has been selected in accordance with the terms of reference and procedures agreed upon with the MIF.
- 4.6 The MIF reserves the right to change the consulting firm or even cancel the operation if, following the annual evaluations, the MIF determines that the CRACs' performance indicators are unsatisfactory.

V. MONITORING AND EVALUATION

- 5.1 The performance indicators for the CRACs agreed upon by the MIF and COFIDE will be evaluated annually. In addition, a more exhaustive midterm evaluation, to include the findings of the annual evaluations, will be conducted when at least half of the MIF contribution has been disbursed. This will entail a thorough analysis of the impact on communities, and the plan of execution will be adjusted as necessary. A final evaluation will be done on completion of the project.
- 5.2 The methodology for evaluating and monitoring the impact of the projects will be set out in the business plan and Operating Regulations. A revolving fund will be set up as an advance in an amount of up to 10% of the MIF contribution.
- 5.3 In addition, at the outset COFIDE will adopt an organized system for periodic information feedback and an annual action plan compiling this information. This arrangement will include references for the measurement of progress toward accomplishment of the specific purposes as summarily described in the attached logical framework.

VI. JUSTIFICATION AND RISKS

- 6.1 The CRACs and CMACs all serve the most marginal sectors of the population. Their branches are dispersed in all regions and in the most remote and inaccessible districts. Some commercial banks and other entities of the formal financial system view rural micro and small enterprise as a promising market. There is a perception of high risk, however, and there is no sign of any movement toward serving this clientele. The credit unions are the only resource for a large percentage of the low-income earners who wish access to financial services. Hence the importance of the credit unions' continuing to develop financial services suited to the needs of those communities.
- 6.2 This technical cooperation is in keeping with the Bank's policy for Peru; the 1998 country paper calls for assistance in modernizing the economy, with high priority to the private sector, and the strengthening of specific initiatives for financial intermediaries aimed at micro and small enterprises.
- 6.3 The following risks to the project have been identified:
- a. That the operation and ownership structure of the CRACs will not achieve soundness. The CRACs are private autonomous entities whose owners will have to agree with the project and work to accomplish its purpose.
 - b. That COFIDE and the SBS will not coordinate closely and continually exchange information on the performance and progress of the CRACs.
 - c. That investments will be placed in farm product lines whose approval has in the past been animated mainly by political rather than by technically objective considerations, thereby favoring the customers with the greatest economic or political power.
- 6.4 To reduce these risks, the project provides for: (i) extensive, careful audits and performance evaluations; (ii) in addition, COFIDE has experience in complex projects and has been working in full coordination with the SBS, and (iii) including the private sector as holders of core equity to ensure full openness on lending policy. In addition, COFIDE has the experience of having executed several entrepreneurial service projects through CENTRO COFIDE.

MIF
STRENGTHENING OF RURAL AND MUNICIPAL CREDIT UNIONS

Overall objective of the project

Give low-income earners improved access to financial services.

Specific objectives

Strengthen the administration of the rural credit unions (CRACs).
Support privatization of the municipal credit unions (CMACs).

Component	Specific tasks	Indicators
Institutional strengthening program		
Improvement of operations of CRACs	Heavy emphasis on: strategic planning; promotion of the attraction of deposits or development of new and redefinition of existing financial products; the strengthening of internal controls and auditing; development of the technology of lending to rural microenterprises; and the development of policies on portfolio management and financial operations with assets and liabilities.	Changes in deposits, acceptance of new products on market, portfolio indicators, external audits.
Reform of net worth structure	Support to participation by the private sector, which will be expanded by cleaning up the portfolios of the CRACs and improving the indicators of their profitability and productivity, promoting the mergers that are already taking place, and offering shares to microinvestors to supplement the very limited investment capacity of the present shareholders.	Capital contributions, number of mergers, composition and number of private shareholders.

Support to privatization of CMACs		
Increase private shareholders to majority	Financing of national and regional events for the directors and managers of CMACs; these events together with the financial information obtained from investment banks, will enable them to frame a definitive strategy for their privatization. The team of experts will coordinate with the investment bank during this policy-making stage.	Agreements concluded, number of CMACs privatized, composition of shareholders, proportion of municipal equity.
Ensure focus of new investors on the microentrepreneurial sector	There must be a "shareholders' agreement" stipulating that the majority shareholders will not swerve from the original purpose of the CMACs.	Agreements concluded, composition of placements among recipient economic sectors.

ASSUMPTIONS

The macroeconomic situation in Peru remains stable.
 Cooperation between COFIDE and the Superintendency of Banks and Insurance (SBS).
 The private sector becomes interested once the sector is seen to improve.
 Cooperation by municipal governments to allow privatization of CMACs.

PROPOSED RESOLUTION

**PERU. NONREIMBURSABLE TECHNICAL COOPERATION TO THE DEVELOPMENT
FINANCE CORPORATION OF THE REPUBLIC OF PERU
Financial Sector Reform Program II
Strengthening of Rural and Municipal Savings and Loans Offices**

The Donors Committee of the Multilateral Investment Fund

RESOLVES:

1. That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Multilateral Investment Fund, to enter into such agreements as may be necessary with the Development Finance Corporation of the Republic of Peru (COFIDE), and to adopt such measures as may be pertinent for the execution of the project referred to in Document MIF/AT-__, with respect to a technical cooperation the purpose of which is to support the strengthening activities of rural and municipal savings and loan offices included in the Financial Sector Reform Program II.

2. That up to the sum of US\$1.500.000, is authorized for the purposes of this resolution, chargeable to the resources of the Technical Cooperation Facility of the Multilateral Investment Fund.

3. That the above-mentioned sum shall be provided on a nonreimbursable basis.