

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

E L S A L V A D O R

**STRENGTHNING OF FINANCIAL AND FAMILY-REMITTANCE
SERVICES FOR LOW-INCOME GROUPS**

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DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK
MULTILATERAL INVESTMENT FUND

EL SALVADOR

**STRENGTHENING OF FINANCIAL AND FAMILY-REMITTANCE
SERVICES FOR LOW-INCOME GROUPS**

(TC-02-02-01-4)

DONORS MEMORANDUM

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ABBREVIATIONS

CESI	Committee on Environment and Social Impact
FEDECACES	Federación de Asociaciones Cooperativas de Ahorro y Crédito de El Salvador de R.L. [Federation of Credit Unions of El Salvador]
GDP	Gross domestic product
MIF	Multilateral Investment Fund
ROA	Return on assets
ROE	Return on equity
SSF	Superintendencia del Sistema Financiero [Financial System Superintendency]
TOR	Terms of reference

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EXECUTIVE SUMMARY

Executing agency:	Federación de Asociaciones Cooperativas de Ahorro y Crédito de El Salvador de R.L. [Federation of Credit Unions of El Salvador] (FEDECACES)
Beneficiaries:	The project's direct beneficiaries would be the federation and its affiliated credit unions. Their ability to provide competitive financial and family-remittance services will be strengthened, their customer base consolidated, their institutional structure built up and their procedures and systems improved. The current and potential members and customers of FEDECACES' affiliated credit unions, who tend to be in low-income segments with limited access to financial-service providers, will be important indirect beneficiaries.
Amount and source:	MIF (Facility IIIA) nonreimbursable: US\$1,500,000 Local counterpart contribution: US\$ 800,000 Total: US\$2,300,000
Objectives:	The project's <i>general objective</i> is to improve access to financial services suited to the needs of low-income groups, especially those in the country's rural areas. The project's <i>specific objective</i> is to strengthen the financial and administrative capacity of FEDECACES-affiliated credit unions so that they are better able to serve this segment of the population. The project would have four components: (i) strengthening of family-remittance services and their linkage with other financial services; (ii) adaptation to conform to the rules governing nonbanking financial institutions; (iii) modernization of procedures and systems; and (iv) a training plan.
Terms:	Execution period: 36 months Disbursement period: 42 months

Special contractual conditions:

Prior to the first disbursement of the MIF resources for the project components, FEDECACES will: (i) submit the terms of reference (TOR) for the local coordinator and the international consulting services to provide advisory services; (ii) submit a project execution plan, and (iii) hire international consulting services for project execution. As a condition precedent to disbursement of 75% of the MIF resources, FEDECACES will contribute the total amount of the local counterpart contribution that is to be made in cash, and FEDECACES is to submit an evaluation of its environmental and social procedures and of the adjustments needed to bring those procedures into compliance with local legislation. FEDECACES will submit a project execution plan for the following year within 60 days after each calendar year (paragraphs 9.1-9.3).

Social and environmental impact:

The Committee on Environment and Social Impact (CESI) reviewed and approved the project on 29 March 2002 (TRG 13-02) and the agreements have been incorporated into the project (paragraph 4.5).

I. COUNTRY AND PROJECT ELIGIBILITY

- 1.1 On December 3, 1993, the Donors Committee declared El Salvador eligible for all modalities of Multilateral Investment Fund (MIF) financing. The project is eligible for MIF funding under the Small Enterprise Development Facility (Facility III-A), because it will strengthen the system of credit unions, thereby increasing the depth of financial markets, expanding remittance services and making financial services more accessible to microenterprise and small business.
- 1.2 The project would fit into the MIF's strategic objectives, particularly its policy of making financial services more accessible to people of modest means, especially microenterprises and small businesses. Both within El Salvador and in other countries of the region, the MIF has had extensive experience in developing these services by building up the specialized service providers like credit unions. Moreover, the MIF has singled out improved remittance services as a focus area in the broader context of development of financial services. This project would be the MIF's first venture into strengthening these kinds of services in El Salvador, and would thus add to its expertise on the subject and provide it with an opportunity to hone the tools it uses to assist these services.

II. BACKGROUND

- 2.1 During the 1990s, Salvadoran authorities concentrated on the rebuilding that was needed in the wake of the armed conflict of the 1980s. The main focus of attention was structural reforms in economic management and modernization of the state. The successful introduction of the new reforms paved the way for significant economic and political change, which in turn set the stage for stable macroeconomic management, liberalization of trade and state modernization. However, the mission of better integrating low-income groups into the broader economy continues to pose major social and economic challenges. To accomplish this mission, El Salvador needs rapid economic growth facilitated by more efficient use of the factors of production, all within a context of economic stability. And so, an expanded and more efficient family-remittance system becomes crucial to the country's economy, as does the expansion of financial services so that they reach low-income groups, particularly microenterprises and small business and people living in rural areas.

Migration and remittances

- 2.2 Although emigration has long been a feature of the history of Latin America and of the countries of the isthmus, El Salvador has seen a very pronounced increase in the number of émigrés since the 1970s, and most especially since the 1980s.¹ The vast

¹ The escalation of the armed conflict in the 1980s and the breakdown of an agricultural-export economy that was based, among other things, on cotton, were some of the factors driving the move toward emigration. The eastern and para-central portions of the country were particularly hard hit. There, emigration was on a massive scale.

majority of these émigrés have relocated in the United States. Estimates are that a total of 2.2 million Salvadorans are currently living in the United States, equal to 36% of the country's total population in 1999, which was 6.15 million. An estimated 72,000 people emigrate to the United States each year, which is roughly equal to the annual increase in El Salvador's economically active population. Nationwide, 16% of all households report having members who are immigrants abroad. In some departments that figure is almost 30%, while elsewhere it is as low as 11%.

- 2.3 As happened with other migratory movements, many Salvadoran émigrés regularly send funds (remittances) and other assets to their homeland. Although there are no reliable studies on the average value of these remittances, according to estimates they could be over US\$3,000 per year per remittance sender. Household surveys in El Salvador indicate that 20% of the households in the country are receiving remittances on a regular basis, although the figure can range anywhere from 12.5% to 37.7%, depending on the department. The studies done of the families at the receiving end of these transfers show that most fall into the relative-poverty income strata and that the transfers received represent approximately 49.8% of the family income.
- 2.4 Mirroring the increase in the number of émigrés since the 1980s, remittances to El Salvador have also increased. By the end of the 1990s they had become the major source of foreign exchange flowing into the country's economy, having risen steadily since the 1970s, at a pace in excess of 12% per annum, from approximately US\$28 million in 1976, to US\$1.750 billion in 2000. The figure is 13.8% of the GDP, 136.4% of the value of exports, and 37% of the value of imports. Remittances are estimated to be up 9% in 2001², aided mainly by the transfers that came in subsequent to the earthquakes, which compensated for the serious slowdown in inflows during the fourth quarter of that year.
- 2.5 The institutions and social networks that the immigrants use to send their remittances vary considerably in their efficiency, security, and cost to sender and receiver alike. An analysis of the use of remittances underscores their importance to the income of the receiving parties: almost 80% of the receiving households report that they use the remittances to pay consumption expenditures: 9% goes toward educational expenses, 4% toward medical expenses and 2.4% toward housing. The savings rate on remittances is 2%, while 1.5% is channeled into investments, generally in microenterprises and small businesses. A number of surveys have shown that 18% of the country's microenterprises are helped by remittances from

² Estimate of the Banco Central de Reservas as of February 2002.

abroad. The relatively weak propensity to save and invest the remittances is indicative of the precarious economic circumstances of most recipients. It also suggests that these economic segments do not have access to the financial system and that remittance services need to be integrated into a broader set of financial services tailored to this sector.

Access to financial services for low-income groups

- 2.6 One of the chief obstacles to the economic development of the low-income sector—particularly that of microenterprise and small business—is the lack of access to financial services, whether because service coverage is limited or because the prevailing products and terms are unsuited to the circumstances of that segment of the population. Traditionally, the greater problem had been the dearth of lending facilities making credit available to finance business activities. Now, however, the importance of savings products and other financial services for the economic and entrepreneurial development of the low-income sector is becoming more and more apparent. This would include efficient remittance services.
- 2.7 Because of their social origins and their ownership structure, cooperative financial institutions in El Salvador generally have a close relationship to the low-income segment of the population, for whom they are an important financial-service provider. This is especially true in rural areas, where traditional banks and the emerging specialized service providers have not yet made any appreciable inroads. Strengthening credit unions would thus increase the depth of El Salvador's financial markets.

The Federación de Asociaciones de Cooperativas de Ahorro y Crédito [Federation of Credit Unions]

- 2.8 One of the major providers of financial services are the member credit unions of the Federación de Asociaciones de Cooperativas de Ahorro y Crédito de El Salvador de R. L. (FEDECACES). FEDECACES was formed on 11 June 1966 under the Alliance for Progress³ as an organization to promote the organization and affiliation of credit unions and as a second-tier financial institution serving its members. By late 2001, FEDECACES had 29 affiliated credit unions in 13 of the country's 14 departments. Combined, these credit unions had 80,000 members and assets totaling US\$75 million, not counting the Federation's own assets of US\$15 million. The credit unions' loan portfolio was US\$50 million, while deposits came to US\$42.5 million. Lending and deposits have increased significantly in the last two years, at cumulative annual rates of 16.84% and 38.85%, respectively. The even greater increase in the number of savings deposits made it possible for the system to reduce its reliance on external financing. Even so, its total assets continued to grow.

³ On 25 April 1972, FEDECACES registered with the Salvadorian Institute for the Development of Cooperatives to obtain full legal capacity.

In 2001, the system's loan portfolio consisted of 43,825 credits, the average balance being US\$1,100. In that year, almost 25,000 loans were awarded, the average being approximately US\$1,700. The average balance in the system's 72,202 savings accounts was US\$586. This is indicative of just how much FEDECACES caters to the lower income sectors.

- 2.9 The **financial analysis** of the credit unions in the system using the PEARLS⁴ rating system reveals financial weaknesses, although significant changes are apparent in the quality of assets, productivity and earnings, as well as the growth among the individual institutions. For the system as a whole, the signs are more troubling. In recent years, the system has had net positive earnings, with a return on average assets of around 3%. However, at over 15%, the default rate is quite high and the lag in capitalization raises questions about reported revenues. The quality of the assets has taken a toll on the system's gross margins, which are running at approximately 13% despite effective asset rates of over 25% and a liabilities structure where low-yield resources predominate. The average financial cost of the deposits in 2001 is under 9%.
- 2.10 FEDECACES roots would cast it as a second-tier financial institution in the credit union sector. In the 1990s, however, the Federation started to adopt a more explicit strategy of **combining services and forming a financial network**. Accordingly, the system's "Central Liquidity Fund" was established in 1997 as an equalization fund, a clearinghouse for managing the system's excess liquidity, a second-tier bank and a lender of last resort for the system. Then in 1998, a services network was set up as a system within a system, whereby any networked FEDECACES-affiliated credit union can act as a service window for any member of another networked FEDECACES credit union. At the present time, 24 credit unions are part of the services network, making it possible to expand the financial services offered and extend their reach to make services available to even more people in the low-income sector. FEDECACES expects the other credit unions to join the network in the not-too-distant future, and to build up the technological base in order to be able to expand the services provided and make the system more efficient.
- 2.11 During its early years in the 1960s, the products that the FEDECACES system offered to its affiliated credits unions were generally limited to various lending services, financed mainly with international cooperation and by drawing upon its own capital base. Then, starting in the 1980s, the system introduced deposit services, offering a variety of savings products; later, with establishment of the services network, the system began to offer transfer services as well. In response to a growing demand on the part of their members, beginning in 1994 the credit

⁴ PEARLS is a set of financial ratios developed for the credit union sector, and is similar to the CAMEL system for the bank financial sector. The PEARLS rating system uses different analysis criteria and concepts to develop indicators. Those criteria and concepts include effective financial structure, liquidity, rates of return, and signs of expansion/growth.

unions added **remittance services** to their product menu. To that end, they signed cooperation agreements with a number of U.S.- and Canadian-based credit unions. Even so, up through 1999, the volume of business did not grow, averaging US\$81,000 and approximately 550 transactions per year.

- 2.12 However, when agreements were signed in 2000 with commercial remittance senders in the United States, the number and volume of transactions rose dramatically. In 2001, over 3,000 remittance transactions were handled, involving US\$1.2 million. Thus far in 2002, 1,266 transactions have been processed, for a total of US\$550,000. The surge in the remittance business points up the potential market that FEDECACES has for this product, as well as the weaknesses in the system's ability to meet demand efficiently through integrated systems. In particular, there are inefficiencies in the systems for transfer of remittances to the recipients in the home country because the different automated systems are not integrated. The credit unions have not yet devised a strategy for merging the remittance service into the package of financial products they offer to their members. To expand product supply, the staff of the credit unions will need more training; information-technology systems and procedures will have to be improved, and a strategy will have to be crafted for attracting remittance business and building up the customer base by getting remittance receivers to avail themselves of the other financial services the credit unions offer.
- 2.13 The credit union sector in general, and especially FEDECACES, are closely aligned with low-income groups, which is why they have developed financial services and products tailored to this segment. Historically, however, the ownership structure of the credit union sector has made it slow to modernize and impaired its ability to take the initiative in adapting its operations and management to conform to changes in financial regulations. To surmount these challenges and expand services, especially for the microenterprise and small business sector in rural areas, the system will have to be updated and its management and control structures strengthened, especially given recent changes in the laws governing the financial sector.
- 2.14 In March 2000, the Legislative Assembly passed the non-bank financial intermediaries act [Ley de Intermediarios Financieros No Bancarios] (LIFNB)⁵ to give the low-income sector in general, and the microenterprise and small business sector in particular, better access to financial services. That law, which took effect on July 1, 2001, established a framework for **regulation and oversight** of a wide assortment of formal financial service providers that had traditionally operated outside the boundaries of the regulated system. Under the new law, the Superintendency of Financial System (SSF) now has oversight authority over these providers when certain established conditions are met.

⁵ Decree 849, published February 16, 2000.

- 2.15 Because of their size, none of the credit unions affiliated with FEDECACES is subject to the LIFNB. However, this new law creates a window of opportunity for the system. The opportunity that the credit unions have to come under the LIFNB umbrella could set the stage for robust strengthening, expansion and modernization of the system. LIFNB-regulated credit unions are able to expand their markets by providing services to nonmembers. The law also offers incentives for greater integration of the system. Under the LIFNB, FEDECACES, with SSF authorization, can be accredited as an auxiliary oversight agency for the system and set up a federation stabilization fund. Under the LIFNB, FEDECACES and its affiliated credit unions could increase the assortment of services they offer and expand their markets. To do this, however, they would have to improve their management capability, especially in the areas of financial and credit risk management, internal monitoring and information systems. Upgrading personnel skills, improving reporting and control systems, standardizing procedures and facilitating the development of new products, as well as consolidating the credit unions' affiliation with FEDECACES, are essential to consolidate the system within the new context of regulation and oversight of financial activities, and to expand its market.

III. OBJECTIVES AND BASIC COMPONENTS OF THE PROJECT

A. Objectives

- 3.1 The project's *general objective* is to improve access to financial services suited to low-income economic groups, especially in the country's rural areas. The project's *specific objective* is to strengthen the financial and administrative capacity of the FEDECACES-affiliated credit unions to service this sector's needs. To accomplish its objectives, the project would focus on: (i) strengthening administrative and financial management in FEDECACES-affiliated credit unions, assisting their integration, standardizing procedures and improving the operational data and benchmarking systems; (ii) helping FEDECACES and its member credit unions to adapt to the new non-bank financial intermediaries act; (iii) improving and expanding the system's capacity to offer family-remittance services and to develop new financial products, especially for the remittance receivers, as part of a FEDECACES business strategy.

B. Components

- 3.2 In combination, the wide array of activities that the project will conduct will be a holistic approach to accomplishing the proposed objectives. Four main components are planned:

Component 1 – Strengthening family-remittance services and linking them with other financial services (US\$300,000: MIF, US\$200,000; local counterpart contribution, US\$100,000)

- 3.3 Remittance services have increased considerably since the FEDECACES credit unions first introduced them in 1996. Its remittance business rose from 639 transactions in 1996, involving close to US\$96,000, to 3,009 transactions in 2001, involving a total of US\$1.2 million. And in just one month this year—January 2002—there were 1,266 transactions involving US\$550,000. Yet despite the growing importance of this service, it is basically not automated within the FEDECACES network, which not only makes procedures less efficient but also increases the costs and risks associated with each transaction. The FEDECACES credit unions have not yet devised a strategy for merging the “remittance” product into their menu of financial services, either from the marketing standpoint or as a means of promoting other financial products that remittance receivers might use. Such services might include access to savings instruments, payment and transfer services, and lending facilities for microenterprises.
- 3.4 To strengthen remittance services, the project would help FEDECACES: (i) review the requirements and develop the technological options to add remittance services to the automated operations and information technology systems; (ii) acquire hardware and software to automate the services; (iii) design and introduce a training program for staff of the credit unions and FEDECACES, to instruct them in how to promote and administer the service; (iv) develop and introduce remittance-related financial products, including staff training; and (v) develop a plan for marketing the remittance service, which would include identifying strategic Salvadoran communities abroad and identifying and evaluating potential strategic partners abroad. The project would finance the hiring of specialized consulting services and the procurement of computer hardware and software.

Component 2 – Adaptation to conform to the regulations governing non-bank financial institutions (US\$500,000: MIF, US\$420,000; local counterpart contribution, US\$80,000)

- 3.5 Because of their size, FEDECACES and its member credit unions are not required to comply with the new LIFNB and are not subject to the Financial System Superintendency’s oversight. However, pressure from market competition and the ever-present need to build up the credit unions’ proficiency will necessitate fuller compliance with oversight standards, either by voluntarily acceding to the LIFNB or through better self-regulation.
- 3.6 To enable the credit unions and FEDECACES to comply with the new regulations, and better equip them to regulate themselves and monitor the system, the project will assist with: (i) training for trade unions, administrators and staff, to instruct them in the new regulations and what they mean for the growth of the credit unions

and the Federation; (ii) evaluation of the system's policies, procedures and data systems to check for compliance with the regulations, and development and introduction of a plan to introduce the necessary adjustments to bring them in line; (iii) using the system of "assisted inspections," FEDECACES-conducted audits of the ten credit unions in the system that have the most assets; (iv) development and introduction of financial modernization plans for credit unions that are not up to system standards; (v) review of FEDECACES' self-regulation and oversight systems and procedures and their adaptation in order to ready FEDECACES to serve as a subsidiary oversight agency under the LIFNB, including strengthening of the independent oversight unit and the building of "Chinese walls" to separate the oversight, audit, and advisory services areas to avoid conflicts of interest and use of insider information; (vi) the creation of a set of early-warning financial signals; and (vii) creation and implementation of an ongoing training program for the staff of FEDECACES and its member credit unions who are assigned to the self-regulation and oversight area and the auditing area.

- 3.7 With the heightened regulation, the project will provide FEDECACES with advisory assistance on the following, to retool existing products and create new ones: (i) developing a strategy and designing business plans specifically tailored to the system as a whole and to the individual credit unions; (ii) analyzing current and potential markets; (iii) designing new products; and (iv) developing and standardizing business strategies and procedures.
- 3.8 For execution of this component, the project will fund the hiring of specialized consulting services, including auditors/supervisors of financial institutions to conduct the assisted inspections. It will also fund management teams' participation in external training exercises in strategic planning.

Component 3 – Modernization of procedures and systems (US\$850,000: MIF US\$535,000; local counterpart contribution, US\$315,000)

- 3.9 To modernize the systems and procedures, the project will advise FEDECACES on the following: (i) revising and standardizing the system's handbooks of administrative and operating procedures; (ii) reviewing, updating and standardizing the systems, procedures and reporting for financial and administrative information; (iii) designing and implementing a systematic program of administrative and financial advisory services for the credit unions, including development and introduction of a system of productivity- and efficiency-benchmarking standards; and (iv) reviewing the system's current technologies and developing an information-technology strategy tailored to the system's technological possibilities and designed to accommodate the system's potential development. Included here are measures to introduce new financial services and to enable the exchange of accounting data, as well as the procurement of software and hardware to modernize automated procedures. The project will underwrite the cost of retaining specialized consulting services and the procurement of computer software and hardware.

Component 4 – Training plan (US\$200,000: MIF US\$100,000; local counterpart contribution, US\$100,000)

- 3.10 To strengthen the FEDECACES system and make it sustainable, FEDECACES and its member credit unions need instruction in the principles of administration and good management. The project will help FEDECACES design and implement a comprehensive training program targeted at: (i) the directors of the credit unions; (ii) the managers and administrative personnel of the credit unions and the Federation; and (iii) staff from various business areas. Particular attention will be devoted to training in financial and administrative management, risk assessment, compliance with prudential norms and auditing, as well as strategic and business planning. The project will pay the cost of contracting specialized consulting services, as well as selective procurement of training services by third parties in the country or region.

IV. EXECUTION AND BENEFICIARIES

A. Executing agency

- 4.1 The Federación de Asociaciones Cooperativas de Ahorro y Crédito de El Salvador de R.L. (FEDECACES) will be the project's executing agency. FEDECACES was created on June 11, 1966, as a second-tier credit union⁶ governed by the General Credit Unions Act. Presently, FEDECACES has 29 affiliated credit unions, giving it a presence in 13 of the country's 14 departments. FEDECACES also has two subsidiaries, each with its own legal standing: (i) a business called *Seguros Futuros*, which administers the system's insurance plans; and (ii) a business called *Asesores para el Desarrollo*, which provides consulting services to the system's credit unions and to third parties. One of FEDECACES' objectives is to promote the development of the credit-union movement in El Salvador, essentially in order to make financial services more readily available to the low-income sectors. The governing body of FEDECACES is its general assembly of member credit unions, which meets each year and delegates the functions of direction and supervision to the Administrative Council and the Oversight Board. Corporate Management is the highest administrative body within FEDECACES.⁷

B. Execution mechanism

- 4.2 Corporate Management will be responsible for managing and steering the project. It will appoint a local project coordinator, who will be its representative to the Bank

⁶ FEDECACES was granted full legal capacity on 25 April 1972.

⁷ FEDECACES was recently selected by the MIF, along with three other institutions out of a total of 58 applicants, to receive refinancing for its microcredit portfolio affected by the earthquake, under project TC-0103033, approved in August 2001.

for the 48-month period that begins once the project agreement is signed.⁸ The FEDECACES Management Council will appoint the local coordinator prior to the project's presentation to the Donors Committee. The costs of the project coordinator will be paid out of the FEDECACES own resources, as shown on the table of costs.

- 4.3 As a condition precedent to the first disbursement of the MIF grant proceeds that are to be used for project components, FEDECACES will present a project execution plan, which will feature a timetable of activities, a forecast of how the resources will be used, the terms of reference for the consultants to be hired for the first year, and the preliminary terms of reference for those to be hired thereafter. To prepare the project execution plan and the terms of reference and to monitor the project, FEDECACES will have the services of a specialized international firm for six months during the execution of the project's activities. The hiring of that firm will be a condition precedent to the first disbursement of the MIF grant proceeds earmarked for the project's components. MIF funds will be used to pay the costs of the consulting services, as shown on the table of costs. For the following periods, FEDECACES will submit an execution plan for the following year within 60 days after the end of each calendar year. The plan must include a schedule of activities, the projected use of the funds, and the terms of reference for the consultants to be hired.

C. Beneficiaries

- 4.4 The direct beneficiaries of the proposed project will be the Federation and its affiliated credit unions. The project will consolidate their customer base and improve their capacity to offer competitive financial and family-remittance services by strengthening their organizational structures, procedures and systems. Significant gains will also accrue to the project's indirect beneficiaries, who are the current and potential members and customers of FEDECACES-affiliated credit unions. These people tend to be in the lower-income sectors and have limited access to financial-services providers. One target group of particular importance are people in rural areas who are in need financial services.

D. Committee on Environment and Social Impact

- 4.5 The Committee on Environment and Social Impact (CESI) reviewed this project at its meeting TRG-13-02, on March 29, 2002. The nature of the project is such that it will not have any direct environmental or social impact; hence, no mitigation measures will be required. Nevertheless, to ensure that FEDECACES'

⁸ The plan is that the local coordinator would also head up the components on adjustments to conform to LIFNB standards and on modernization of systems and procedures, with a view to creating an independent oversight office.

environmental and social policies square with those of the MIF,⁹ before 75% of the MIF financing is disbursed the Federation is to submit to the MIF an evaluation of its procedures in this regard and propose and introduce the adjustments necessary to make certain that the loans it makes comply with national environmental, labor and social laws, and to ensure that its services are available to everyone, without discrimination. The costs of the evaluation will be paid with FEDECACES funds, as shown in the table of costs.

E. Sustainability

- 4.6 The project's economic sustainability correlates closely with the sustainability of the credit unions and FEDECACES itself. In the case of the credit unions, project sustainability will depend upon the effective net returns from the financial services they provide; in the case of FEDECACES, the sustainability will depend on what it charges for the services provided and on member fees. FEDECACES is currently charging the cooperatives for all its services and the training it would provide under the project would generate additional income. The analyses done during the project's preparation indicate that the returns that FEDECACES and the credit unions are realizing will enable them to stay in business. They also show that with the expanded services and improved efficiency, the system's net income will increase.
- 4.7 The technical sustainability of the project depends on the capacity to assimilate the proposed changes efficiently. FEDECACES' experience in promoting modernization and training within the system, and its close coordination with its advisory "arm" should facilitate the project's technical sustainability. Moreover, the establishment of a specific oversight unit supervised by a management-level executive should help ensure the sustainability of FEDECACES' adaptation to LIFNB standards and the modernization of its systems and procedures. That addition to its executive team should also help FEDECACES put into place "Chinese walls" to separate the oversight and self-regulation areas from the operations areas.

F. Status of project preparation

- 4.8 Project preparation is at an advanced stage. The document is the product of close and extensive cooperation among the executive and technical staff of FEDECACES, of the credit unions and the Bank's technical personnel. Once the local coordinator has been appointed and execution-related consulting services retained, project implementation should move swiftly. Preliminary terms of reference (TOR) for both positions have been prepared. Their presentation for Bank

⁹ See: MIF Environmental and Social Guidelines for MIF Financial Intermediary Operations, February 21, 2002. Application of these guidelines, however, is not required in the case of projects of the kind proposed here.

clearance is a condition precedent to the first disbursement. Also, as the project was being designed, a program of activities and a preliminary execution timetable were worked out in cooperation with FEDECACES and would be used as the basis for preparing the plans of execution. It is worth noting that FEDECACES is experienced in, and has the institutional capacity to conduct advisory and training technical cooperation programs. Therefore, fulfillment of the conditions precedent is not expected to take more than two months from the date on which the agreement with the Bank is signed.

V. COST AND FINANCING

- 5.1 The project's total cost is US\$2.3 million. US\$0.8 million (34.8%) will be financed with a contribution from FEDECACES and US\$1.5 million (65.2%) with MIF funds, broken down by general investment category and source of funding in the following table. A more detailed budget is in the project files.

Table 5.1: Table of costs (in US\$)

Concept	FEDECACES	MIF	Total	%
Project components				
Local/international consultants	100,000	820,000	920,000	
Software/systems	100,000	100,000	200,000	
Equipment	315,000	235,000	550,000	
Training/courses/internships	80,000	100,000	180,000	
Subtotal	595,000	1,255,000	1,850,000	80.4
Project execution and administration				
Local coordinator	100,000		100,000	4.3
Consulting services during execution		90,000	90,000	3.9
Environmental/social evaluation	10,000		10,000	0.4
"Cluster" activities		40,000	40,000	1.7
Evaluation		40,000	40,000	1.7
Auditing	50,000		50,000	2.2
Subtotal	160,000	170,000	330,000	14.3
Contingencies	45,000	75,000	120,000	5.2
Total	800,000¹⁾	1,500,000	2,300,000	100.0
%	34.8	65.2	100.0	

1) The FEDECACES contribution in cash is estimated at US\$500,000, which is 62.5% of its total contribution; see itemized budget.

- 5.2 The project will be carried out over a 36-month period; the disbursement period will be 42 months. Based on what the anticipated requirements of project execution will be, a revolving fund would be set up consisting of at least 10% of FEDECACES' cash contribution and the contributions from the MIF, so that the funds needed to perform the various planned activities will be readily available. By the time 75% of the MIF funds are disbursed, FEDECACES is to have made its full cash contribution.
- 5.3 Through the local coordinator, FEDECACES will undertake the following responsibilities: (i) establish and maintain adequate financial accounting systems,

internal controls and records, which will show clearly the precise sources and uses of all project funds. The project records are to be kept in such a way that: (a) the amounts received from various sources can be identified; (b) data on project outlays distinguish between proceeds from the MIF grant and funds from other sources; and (c) they are sufficiently detailed to show what goods have been purchased and what services have been retained; (ii) open separate and specific bank accounts to handle the proceeds from the MIF grant and the funds that FEDECACES contributes in cash; (iii) process the disbursement requests submitted to the Bank and maintain records thereof; and (iv) prepare and present to the Bank, throughout the project execution period, semiannual progress reports on use of the revolving fund and annual audit reports.

- 5.4 **External auditing.** Within 90 days of the close of the fiscal period, FEDECACES is to submit its financial statements, duly audited. It will also submit the project's duly audited annual financial statements. Within ninety (90) days after the last disbursement of proceeds from the MIF grant, FEDECACES will submit the project's final financial statements, including a breakdown of the expenses paid with the proceeds from the MIF grant and those paid out of the local counterpart contribution. The audits of the financial statements are to be issued by a firm of independent auditors acceptable to the Bank and are to be submitted in accordance with the terms of reference (TOR) and its auditing requirements. Proceeds from the FEDECACES contribution will be used to pay the auditing costs, as shown in the table of costs.

VI. JUSTIFICATION AND RISKS

A. Justification

- 6.1 Family remittances play a major role in the Salvadoran economy. They are especially instrumental in stabilizing incomes among low-income groups. However, at the present time the costs of these services for many senders and receivers seems high, in part because competition on the market is lacking and because the users of these services are not better integrated into the customer base of the formal financial system. The cost structure is such that a significant amount of the earnings of lower-income groups goes to the service providers. Transaction costs can also be quite high because service coverage is so limited, especially in rural areas. Credit unions have traditionally provided financial services to low-income groups and in geographic areas of less interest to formal commercial financial institutions.
- 6.2 Expanding the credit unions' service capacity and including remittances among the "menu" of products and services they offer, when combined with institutional strengthening and formalization of intermediaries, will serve to increase the depth of the financial market so that it reaches those of more modest means. In this context, the LIFNB becomes an opportunity and a major challenge to the

FEDECACES-affiliated credit unions and to the Federation itself, since it would enable them to expand their market as they transform themselves into more formal financial institutions subject to oversight by sector authorities.

- 6.3 The project is entirely consistent with the Bank's strategy as described in the country paper, in that it will strengthen private sector development, especially the development of the low-income economic sectors, by increasing the depth of the financial market. It also fits the guidelines described in the MIF Plan of Action on Remittances (MIF/GN-73) because of its innovative use of remittances as a financial service that will help harness savings and as a means to make other financial products available to more people.

B. Risks

- 6.4 There are factors that could be problematic for the project's successful execution: the very complexity of the operation and the financial development of the credit unions and FEDECACES. As for the complexity issue, while the project does combine a wide range of activities in an expansive approach to strengthening the Federation and expanding its services, the structure proposed for project execution and FEDECACES' experience with and capacity to conduct training activities should mitigate the risk.
- 6.5 The financial risks that the credit unions and FEDECACES face, which stem mainly from their activities as intermediaries, will not increase because of this project; in fact, such risks should tend to diminish as the procedures and processes are formalized and modernized. In this sense, successful execution of the project activities will in fact mitigate the underlying financial risks.

VII. MONITORING AND EVALUATION

A. Criteria and indicators to measure the project's performance

- 7.1 Qualitative and quantitative criteria will be used to monitor and evaluate the project. Annex I sets out the criteria for executing, monitoring and evaluating the project in the form of a logical framework. The table below summarizes quantitative indicators for monitoring and evaluating the objectives and components of the project.

Table 7.1: Quantitative Indicators for Monitoring and Evaluation - Objectives and Components

Concept ¹⁾	Indicator ²⁾	Base ³⁾	Target ⁴⁾
General objective	% deposits less than US\$600	35%	>50%
	% loans to microenterprises	15%	>25%
	% members, marginal urban and rural areas	n.a.	>15%
Specific objective	Return on Equity (ROE)	7%	>9%
	Return on Assets (ROA)	2.4%	>3.5%
	Asset growth	-, -	>27.5%
	Increase in deposits	-, -	>45%
Component 1	Revenues from services rendered/total revenues	n.a.	>15%
	Average # remittances processed per month ⁵⁾	1,300	>3,000
	Operating cost per remittance	US\$1.86	< US\$1
	Remittance transaction time	3 hours	<30 minutes
	Remittance customers who become members	< 5%	> 25%
Component 2a	Capital adequacy		> 10%
	Portfolio quality (default rate)	12.6%	< 5%
	Portfolio quality (default rate) FEDECACES	4.9%	<1%
	Coverage provisions	40%	> 75%
Component 2b	# of new members added	-, -	>40,000
	Part .harnessing financial sector savings	1.4%	> 2.0%
Component 3	Administrative expenses/productive assets (FEDECACES)	6%	< 5%
	Administrative expenses/productive assets	9%	< 6%
	Average productive assets/employees	151,000	175,000
Component 4	Trained staff	-, -	> 250

1) For the definitions, see Chapter III, Objectives and Activities. General and Specific Objectives, Chapter III, A; Components, Chapter III, B.

2) Calculated for the credit unions taken together, and for FEDECACES wherever indicated.

3) Data as of December 31, 2001; source: FEDECACES own financial data and estimates.

4) By project's end.

5) Average for the previous 12-month period.

B. Reports

- 7.2 As part of the project, FEDECACES will prepare semiannual progress reports on project activities and use of the revolving fund, and a final report. Those reports will monitor progress on the established specific objectives and will report the goals accomplished. They will also include observations concerning future activities and modifications needed in the plans of execution. Each report is to be delivered to the Bank within the 60-day period following the close of that 6-month period, while the final report will be delivered within the 60-day period following the last disbursement of MIF resources.

C. External evaluations

- 7.3 Two external evaluations will be done of the project, contracted and funded by the Bank using MIF resources. Once 33% of the proceeds from the MIF grant have

been disbursed, independent consultants will be contracted to do an initial evaluation, which will cover: (i) the progress made toward accomplishing the project's objectives, using the indicators for monitoring and measuring the project's impact; and (ii) the goals accomplished. Within 90 days of the project's completion, a final evaluation will be done which will examine, *inter alia*, the following: (i) the degree to which the project's specific objectives were achieved; (ii) the quality of the services being offered; (iii) the project's sustainability; and (iv) the project's impact. MIF resources will be used to pay the costs of the external evaluations, as indicated in the table of costs.

- 7.4 As part of the process of monitoring and evaluating the project and establishing what lessons have been learned, FEDECACES will take part in activities conducted under the MIF "Remittances Cluster", which will include: (i) FEDECACES participation in technical seminars to evaluate remittance initiatives in the region; (ii) the hiring of specialized consulting services for impact assessment and to draw lessons learned; and (iii) dissemination of project outcomes, lessons learned, and best practices. The Bank will hire the necessary services and MIF resources will be used to pay the attendant costs, as shown in the cost table.

VIII. EXCEPTIONS TO BANK POLICY AND PROCEDURES

- 8.1 Procurement of goods and services will be done in accordance with Bank policy and procedures and no exceptions are anticipated.

IX. SPECIAL CONTRACTUAL CONDITIONS

- 9.1 As a condition precedent to the first disbursement of the MIF grant proceeds that are to go towards the project's components, FEDECACES: (i) will submit the TOR for the local coordinator and the international consulting services during execution, for Bank clearance; (ii) will submit a project plan of execution; and (iii) will engage the international consulting services for project execution.
- 9.2 As a condition precedent to disbursement of 75% of the MIF resources, FEDECACES is to have paid in full that portion of its contribution that is to be made in cash, which is an estimated US\$500,000, or 62.5% of the contribution.¹⁰ In addition, FEDECACES is to submit an evaluation of its environmental and social procedures and of any adjustments needed to comply with local legislation.
- 9.3 Within 60 days after the end of each calendar year, FEDECACES will submit an execution plan for the following year (see paragraph 4.3).

¹⁰ This includes an item of US\$45,000 for "contingencies."

LOGICAL FRAMEWORK

OBJECTIVES	VERIFIABLE INDICATORS	MEANS OF VERIFICATION	ASSUMPTIONS
Goal: Make financial services appropriate for low-income groups more accessible.	% of deposits under US\$600 >50% % of loans to microenterprises >25% % of members in marginal urban and rural areas >15%	Periodic reports on the finances and management of the credit unions and FEDECACES	A stable macroeconomic environment and stable financial system The financial stability of the FEDECACES-affiliated credit unions
Purpose: Strengthen the financial and administrative capacity of the FEDECACES-affiliated credit unions to serve the needs of lower-income economic groups.	Growth of assets >27.5% Growth of deposits >45% ROE >9% ROA >3.5%	Periodic reports on the finances and management of the credit unions and FEDECACES	An abiding commitment on the part of the executives, management teams and staff of the credit unions and FEDECACES
Outputs: 1. Improved family-remittance services, offered in combination with other financial services	Revenues per service/ total revenues >15% Average # remittances transacted per month >3,000 Operating cost per remittance <US\$1 Transaction time per remittance <30 min Remittance clients' enrollment as members >25%	Project execution reports	The credit unions' technical capacity to make the adjustments correctly and on time
2. Management of the credit unions according to the rules governing non-bank financial institutions	Adequate capitalization >10% Portfolio quality, credit unions <5% Portfolio quality, FEDECACES <1% Coverage, loan loss provisioning >75% # of new members added >40,000 Part. harnessing financial sector savings >2%	Periodic reports on the finances and management of the credit unions and FEDECACES	Technical capacity to develop the corresponding training plans
3. Modern procedures and systems	Admin. expenses/product. assets (FEDECACES) <5% Admin. expenses/product. assets (credit unions combined) <6% Average assets/employee (credit unions combined)		The credit unions' capacity to penetrate the market
4. Training plan established and implemented	Staff trained >250		

OBJECTIVES	VERIFIABLE INDICATORS	MEANS OF VERIFICATION	ASSUMPTIONS
Activities: 1.1 Integrate remittance services into the automated management and information systems 1.2 Procure hardware and software 1.3 Train staff 1.4 Develop related financial products 1.5 Map out and implement a marketing plan	# of applications adapted and new reports Budget # and characteristics of participants; budget # of clients for the products Implementation plan and strategy; budget	Project execution reports	Technical and financial capacity of the credit unions and FEDECACES to implement the planned activities properly and on time
2.1 Train staff and executive personnel 2.2 Evaluate policies and procedures to determine the extent to which they conform to LIFNB standards 2.3 Conduct assisted inspections and prepare plans for bringing credit unions in line with LIFNB 2.4 Review self-regulation systems and create an early-warning system	# and characteristics of participants Review reports Audit reports LIFNB adaptation plans Review reports; establishment of financial monitoring indicators, reports	Consultants' reports	
2.5 Craft training plan 2.6 Develop strategic and business plan 2.7 Analyze markets 2.8 Design products 2.9 Standardize business strategies and procedures	Budget Define objectives and goals # of studies # of financial products introduced		
3.1 Update administrative and operations manuals 3.2 Update financial information systems, procedures and reports 3.3 Develop advisory program and benchmarking 3.4 Review the data base and develop a modernization strategy	New manuals # of financial reports; time to produce them Review reports; establishment of indicators Review report; determination of investment budget		
4.1 Design and implement plan for training in business tech. 4.2 Design and implement training plan, technology transfer 4.3 Design and implement diplomas program 4.4 Organize internships and exchanges	# of courses and activities; # of personnel trained		