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DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

EL SALVADOR

GLOBAL CREDIT PROGRAM FOR MICRO AND SMALL ENTERPRISES IN EL SALVADOR

(ES-L1136)

LOAN PROPOSAL

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CONTENTS

ANNEXES	
Annex I	Development Effectiveness Matrix – Summary
Annex II	Results Matrix
Annex III	Fiduciary Agreements and Requirements

REQUIRED LINKS	
1	Monitoring and evaluation plan
2	Environmental and social management report

OPTIONAL LINKS	
1	Economic analysis of the project
2	Analysis of demand
3	National Micro and Small Enterprise Survey 2017
4	Program Operating Regulations
5	Law for the promotion, protection, and development of micro and small enterprises
6	Manual for managing credit risk and concentration
7	Strategic plan 2015-2019
8	Credit policy
9	Safeguard policy filter

ABBREVIATIONS

API	Interfaz de Programación de Aplicaciones [Applications programming interface]
BCR	Banco Central de la Reserva de El Salvador [Central Reserve Bank of El Salvador]
BFA	Banco de Fomento Agropecuario [Agricultural Development Bank]
CONAMyPE	Comisión Nacional de la Micro y Pequeña Empresa [National Micro and Small Enterprise Commission]
ECLAC	Economic Commission for Latin America and the Caribbean
ICAP	Institutional Capacity Assessment Platform
MSEs	Micro and small enterprises
SECMCA	Consejo Monetario Centroamericano [Central American Monetary Council]
SMEs	Small and medium-sized enterprises
SSF	Superintendencia del Sistema Financiero de El Salvador [Financial System Superintendency of El Salvador]

PROJECT SUMMARY

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<table>
<tr><th colspan="5">Financial Terms and Conditions</th></tr>
<tr><td colspan="3">Borrower:</td><td colspan="2">Flexible Financing Facility[a]</td></tr>
<tr><td colspan="3">Banco de Fomento Agropecuario [Agricultural Development Bank] (BFA)</td><td>Amortization period:</td><td>25 years</td></tr>
<tr><td colspan="3">Executing agency:</td><td>Disbursement period:</td><td>4 years</td></tr>
<tr><td colspan="3">Banco de Fomento Agropecuario [Agricultural Development Bank] (BFA)</td><td>Grace period:</td><td>5.5 years[b]</td></tr>
<tr><td colspan="3">Guarantor:</td><td>Interest rate:</td><td>LIBOR-based</td></tr>
<tr><td colspan="3">Republic of El Salvador</td><td>Credit fee:</td><td>[c]</td></tr>
<tr><td>Source</td><td>Amount (US$ million)</td><td>%</td><td>Inspection and supervision fee:</td><td>[c]</td></tr>
<tr><td>IDB (Ordinary Capital):</td><td>20</td><td>100</td><td>Weighted average life:</td><td>15.25 years</td></tr>
<tr><td>Total:</td><td>20</td><td>100</td><td>Approval currency:</td><td>U.S. dollar</td></tr>
<tr><th colspan="5">Project at a Glance</th></tr>
<tr><td colspan="5">Project description/objective: The general objective of the project is to increase economic activity in El Salvador. The specific objective is to boost economic activity among the final beneficiaries by providing access to credit under better conditions for micro and small enterprises (MSEs). The program will place special emphasis on women entrepreneurs and municipios with high rates of marginalization.</td></tr>
<tr><td colspan="5">Special contractual conditions precedent to the first disbursement of the loan proceeds: As a special contractual condition precedent to the first disbursement, the program Operating Regulations will have been approved and entered into force under the terms and conditions approved previously by the Bank (paragraph 3.4).</td></tr>
<tr><td colspan="5">Exceptions to Bank policies: A partial exception is requested in relation to the program execution obligations specified in Operational Policy OP-303 “Guarantees Required from the Borrower.” The Republic of El Salvador will guarantee the loan payment obligations, including interest and fees and the local counterpart contribution. This exception is justified because Article 11 of the Law on State Financial Administration provides that obligations relating to loan execution are outside the legal mandate of the authorities of the Republic of El Salvador (paragraph 3.5).</td></tr>
<tr><th colspan="5">Strategic Alignment</th></tr>
<tr><td>Challenges:[d]</td><td>SI ☑</td><td colspan="2">PI ☑</td><td>EI ☐</td></tr>
<tr><td>Crosscutting themes:[e]</td><td>GD ☑</td><td colspan="2">CC ☐</td><td>IC ☑</td></tr>
</table>

[a] Under the terms of the Flexible Financing Facility (document FN-655-2), the borrower has the option of requesting changes to the amortization schedule as well as currency, interest rate, and commodity conversions. The Bank will take operational and risk management considerations into account when reviewing such requests.

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

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

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

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

I. DESCRIPTION AND AND RESULTS MONITORING

A. Background, problem addressed, and rationale

1.1 **Macroeconomic conditions.** El Salvador is Central America's fourth largest economy. An open economy that has been dollarized since 2001, it is vulnerable to external shocks and natural disasters. It has had stable but moderate growth compared with other Central American economies (averaging 2% per year in the last decade compared with 3.8% for the Central American and Dominican Republic region as a whole).[1] For 2019, midyear growth projections were revised downward from 2.6% to 2.3%, based on global economic growth prospects and the performance of the United States economy.[2] The trade and services sector generated the largest share of output at 70.6% of GDP in 2018, followed by manufacturing and construction with 23.7% and agriculture with 5.7%.[3] The latter sector is dependent on climate conditions and is showing signs of stagnation.[4] Gross fixed capital formation represented 16.5% of GDP in 2018, compared with an average of 20.1% in the other countries of Central America and the Dominican Republic.[5] The current account deficit for 2018 came in at 4.4% and is expected to widen to 5% of GDP in the medium term. The main export categories correspond to low-value-added activities, such as textiles and maquila services (which represented 62% of total exports in 2018), with the United States as their main destination market (44% of total exports).

1.2 **Demographic changes and economic activity.** With a population of 6.6 million, El Salvador is the third most populous country in Central America, and its economy supports 2.7 million jobs. Of the total population, 43% live in rural areas,[6] far from the services offered by urban centers, and 39.2% live in localities and municipios with fewer than 2,000 inhabitants. In all, 50% of rural dwellers are engaged in nonagricultural activities (United Nations, 2019).

1.3 Rural women form a significant group, representing 51.3% of the total population;[7] however, their participation in paid activities is low (29% of jobs). Women's labor force participation rate is 30% less than men's,[8] and on average they earn 20% less than their male peers. Although poverty is measured at the household level, both poverty and extreme poverty are more prevalent among women than among men (in the 20-59 year age bracket).[9] Along with Bolivia and Guatemala, El Salvador has one of the highest proportion of women employed in low-productivity activities (67.2% of all employed women in 2016).

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1 *World Economic Outlook* (April 2019) and Central American Monetary Council (SECMCA).

2 Central Reserve Bank of El Salvador (BCR) (June 2019).

3 Based on BCR data.

4 Growth of just 0.5% in 2018, compared to 4.2% in the CARD countries.

5 *World Development Indicators*.

6 According to the 2000 census, the rural population is projected to be 27.6% of the total in 2030 (United Nations, 2019, *Nueva Definición de lo Rural en América Latina y el Caribe*).

7 Multipurpose Household Survey (2015).

8 Also lower than in neighboring countries Honduras, Nicaragua, Guatemala, and Costa Rica. See International Monetary Fund (2019).

9 See ECLAC (2019). *Social Panorama of Latin America 2018.*

1.4 **Micro and small enterprises (MSEs) and their economic importance.**[10] MSEs[11] have a very large impact on economic activity in El Salvador. According to figures from the Superintendency of Competition of El Salvador,[12] they produce 35% of GDP, account for 99.3% of all businesses, and generate 67.6% of total employment. El Salvador has an estimated 317,795 MSEs, of which 60.8% are microenterprises, 33.9% are ventures (*emprendimientos*), and 2.32% are small businesses.[13] Salvadoran MSEs operate mainly in commerce (51.8%), services (32.3%), and manufacturing and other industry (15.4%). Over half of all MSEs (59.4%) are owned by women, and 54.2% of all employed women are MSE owners.

1.5 In terms of geographical distribution, 29.6% of all MSEs are located in the Metropolitan Area of San Salvador, 24.4% are in the western zone (where La Libertad and the city of Antiguo Cuscatlán are located), 19.8% are in the central zone of the country, and 18.4% are in the eastern zone. In short, MSEs are distributed throughout the country, although they are concentrated in the areas with the highest human development indexes. MSEs are the main drivers of local and regional economies, since more than half (51.3%) of their main customers are in their immediate vicinity (neighborhood, caserío, canton), 37.7% are in the local market, 7.7% are in the regional market, and a minority of 2.2% are in the national market.

1.6 The vast majority (93.7%) of these enterprises operate within the legal framework governing natural persons,[14] which affects the way in which they are set up and run. In fact, using income and expenditure records and value-added tax (VAT) payments as proxies for informality shows that Salvadoran MSEs are largely informal. According to recent data from the National Micro and Small Enterprise Commission (CONAMyPE), 56.5% of MSEs do not keep any income and expenditure records, while just 15.6% keep formal accounts and 7.7% declare value-added tax. An economic study of Salvadoran MSEs[15] shows that 63.8% of these businesses generate gross monthly income up to US$2,000; 19% earn between US$2,000 and US$5,000; and 1.2% bring in over US$5,000.

1.7 **Financing of MSEs in El Salvador: the demand side.** Lack of access to financing for MSEs is a critical obstacle to improving growth factors and economic opportunities, especially in more remote areas. Access to financing for

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[10] Unless otherwise indicated, MSE data were taken from the National MSE Survey 2017, available at: https://www.conamype.gob.sv/download/encuesta-nacional-de-la-mype-2017/.

[11] In El Salvador, MSEs are defined in the Law for the Promotion, Protection, and Development of Microenterprise and Small Business, of 2014. By law, a microenterprise is any natural or legal person that operates with a gross annual sales level of up to 482 times the minimum monthly wage and has up to 10 workers. A small business is an economic unit with annual sales of between 482 and up to 4,817 times the minimum monthly wage and has a maximum of 50 workers. Ventures (*emprendimientos*), meanwhile, are unremunerated businesses with gross annual sales of less than the threshold for microenterprises. The program will use the definitions established by this law, as amended.

[12] Superintendency of Competition (2017). *Estudio sobre la Caracterización del Mercado de Prestación de Servicios Financieros a las MyPE en El Salvador*, San Salvador, El Salvador.

[13] National Small and Medium-sized Enterprise Commission (CONAMyPE) (2014): *Política Nacional para el Desarrollo de la MyPE*.

[14] The economic unit is represented by a person who is the owner of a self-employed or own-account family establishment.

[15] See CONAMyPE (2014), op. cit.

production-oriented purposes makes working capital available to purchase inputs and scale up operations, and it makes it possible to invest in equipment and infrastructure, restructure production activities, and adopt new technologies and sustainable technical-production capacities. These activities, in turn, increase earnings, enhance the capacity to participate in markets, and make business ventures more sustainable. Eliminating restrictions on access to credit would increase the number of MSEs that invest, the size of their investments, the scale of their activities, and jobs and income for the population, helping to break the cycle of low investment, small scale, and low activity. In general, impact evaluations of credit incentive programs have been positive. For example, in Colombia, Eslava et al (2012) found that firms that had received credit from Bancóldex had increased their output, employment, and productivity by more than 34%, 19%, and 22%, respectively. The literature has extensively documented the lessons learned from improved access to credit, offering guidance for the design of policies to maximize their effectiveness and prevent adverse effects, such as crowding-out of, or capture of benefits by, the private sector (IDB, 2010 and 2014; OECD/ECLAC, 2013; World Bank, 2014).

1.8 By economic sector, most businesses with access to credit have been in the commerce sector (53.4%), followed by services (31.9%) and industry and manufacturing (14.2%). In general, credit is mainly sought for working capital (82.5%), followed by the purchase of raw materials and inputs (7.2%) new machinery or equipment (6.1%).

1.9 From the start of their operations, MSEs are mostly financed from their own resources or loans from family and friends (76.8%), followed by commercial or private banks and the cooperative system (14.2%), informal lenders (3.2%), and public financial entities (1.5%). Access to the formal financial system[16] differs according to the size of the business: microenterprises received just 12% of total credit, while small enterprises account for 20%. This finding implicitly correlates with the levels of formality of the businesses: greater formality makes it easier to obtain financing through the financial sector. From a gender perspective, 76% of women's ventures are financed out of their own resources and loans from family and friends, compared with 46% in the case of men—a significant disparity. Just 16.32% of women engage with the formal financial sector. Although this figure is higher than the average for MSEs in general, it should be noted that women's lack of assets is a major access barrier. This represents a challenge in terms of reducing the financing gap for this particular group.

1.10 The main barriers identified when seeking access to credit were the lack of mortgageable assets or pledgeable collateral (39%), the lack of a guarantor (14.6%) (paragraph 1.17, supply side), the low degree of formalization of the business (10%) (paragraph 1.6), and a low credit score (7.1%). In this regard, although El Salvador has a Law on Personal Property Collateral, a registry, and guarantee funds, MSE access is limited for the reasons mentioned above. Of the MSEs that obtained credit, 93% named a guarantor as surety, as opposed to other options. The problem is made worse by the fact that the level of collateral requested from MSEs in

[16] The formal financial system is understood as encompassing commercial and private banks, the cooperative system, and public banks.

commercial loans may be higher than 100%.[17] Informality also affects the price of credit: MSEs are often charged interest rates in excess of 35%, compared with the average lending rate in the Salvadoran financial system of 6.5% in December 2017.[18] By raising their level of economic activity, MSEs would be able to increase their scale, with positive effects on income and formality.

1.11 In conclusion, in terms of the demand for MSE financing in El Salvador, the foregoing empirical evidence shows that: (i) there are disparities in access to the financial sector that favor larger enterprises (paragraph 1.9); (ii) funding is primarily obtained from outside the formal financial system, with the main source being self-financing (paragraph 1.9); (iii) there is a gap in financing for women entrepreneurs (paragraph 1.9); (iv) MSEs are concentrated in the Metropolitan Area of San Salvador and the western region of the country, which suggests the need to channel financing to the more remote areas of the country, especially given their local importance as economic units (paragraph 1.5); and (v) there are barriers to access, including lack of collateral, informality, lack of scale, the absence of guarantors, and low credit rating (paragraph 1.10).

1.12 **El Salvador's financial system: the supply side:**[19] The Salvadoran financial system consists of 64 entities. Of these, 24 accept deposits, including commercial banks (14), cooperative banks (6), and saving and loan associations (4), under the supervision of the Financial System Superintendency of El Salvador (SSF). As of 31 March 2019, the banking subsystem had total assets of US$17.549 billion, equivalent to 70.3% of GDP, with annual growth of 5.2%. Five entities (four with foreign parent companies) own 80% of total banking sector assets, including outstanding loans of US$12.372 billion (70.5% of total assets). Lastly, past-due loans represent 2% of the consolidated portfolio. Complementing this, the country's microfinance system, consisting of cooperative banks and saving and loan associations, had total assets of US$1.887 billion, of which the credit portfolio represented 72%, with an arrears rate of 1.9%. Nonetheless, the figures for arrears tend to be volatile owing to macroeconomic conditions and other factors exogenous to the financial system.

1.13 Banking sector liabilities totaled US$15.592 billion, mainly concentrated in deposits from the public (US$12.598 billion or 80.8% of total liabilities). A full 76% of total liabilities are set to mature in less than one year, which means that bank funding is very short term. This produces a significant maturity mismatch throughout the system. A similar situation prevails in the country's microfinance system, which has total liabilities of US$1.577 billion, of which more than 80% are short-term. The total capital of the banking sector was US$2.16 billion, with a capital-to-risk-weighted assets ratio of 17.7%, 150 basis points higher than the average for Central America, Panama, and the Dominican Republic.[20] In conclusion, the Salvadoran financial system has a significant degree of asset concentration, with portfolio growth

[17] Superintendency of Competition, op. cit.

[18] Ibid.

[19] Figures obtained from the Superintendency of the Financial System on El Salvador (SSF). See: https://ssf.gob.sv/estadisticas/.

[20] Figures obtained taken from SECMCA. See: http://www.secmca.org/IndB.html.

outpacing GDP and a relatively high level of capital compared with its regional peers. Lastly, to reiterate, funding for the banking subsector is very short in term.

1.14 In terms of lending, 46.6% of loans in the consolidated financial system go to the goods-producing sector while the remainder are for consumption and housing purchases.[21] Access to financing from entities in the financial or cooperative system increases as businesses grow.[22] Currently, the sources of financing for the formal financial system include commercial banks (37.2%), the cooperative system (27%), and public financial entities (9.5%, including the BFA). According to figures from the Central Reserve Bank of El Salvador (BCR), total credit issued to the private sector stood at US$13.828 billion at the end of 2018. Of this, 46.6% targeted companies resident in El Salvador, which posted the strongest year-on-year portfolio growth of 9.5%, driven mainly by the commerce and construction sectors. However, a detailed analysis shows that large companies receive 50% of total credit extended to the private sector. El Salvador's MSEs receive only 24.5% of lending to the business sector, which points up the financial constraints that they face.

1.15 Other market failures that government banks need to address to finance productive development relate to: (i) loan conditions, since the tenors offered to MSEs in El Salvador are concentrated in the short term (43% of individual loans are for up to 6 months, and 32% are for terms ranging from 6 to 12 months);[23] and (ii) financial inclusion in all parts of the country, since lending is highly concentrated in the central zone but very sparse in municipios that are more marginalized.

1.16 In El Salvador's consolidated banking subsector, 85% of lending is concentrated in the central-zone departments of San Salvador and La Libertad. Municipios in the western, paracentral, and eastern departments are barely served by the financial system (receiving just 6%, 3%, and 6% of total lending, respectively). In other words, supply is concentrated in the Metropolitan Area of San Salvador, zones with higher human development indexes, and the largest urban areas.

1.17 The lack of financing for MSEs can be attributed to specific obstacles that restrict lending and make it more expensive: (i) higher associated risks than in other sectors, and insufficient risk management instruments, and as a result the banking sector's loan portfolio is concentrated in the consumption (35%), housing (20%), and commerce (13%) sectors; (ii) greater constraints on available collateral and its execution (lack of collateral was identified as the main reason for denial of credit in 54% of cases), owing to a lack of existing capital and informality (the informality of the enterprise was the reason for denial of credit in 10% of cases);[24] (iii) high operating costs of lending at small scales; and (iv) low rates of return among MSEs. A full 60% of small businesses go unserved by the financial sector (67% in the case of female-owned businesses).

[21] Harmonized Monetary and Financial Statistics (BCR).

[22] A survey by CONAMyPE found that the 12.9% of the smallest enterprises, classified as ventures (*emprendimientos*), have access to such financing, compared with 18.1% of those classified as microenterprises and 20.9% of small enterprises.

[23] In the case of group loans, maturities are relatively longer at 24 to 36 months (47%) to finance the purchase of assets and remodeling of premises.

[24] Survey of the General Directorate of Statistics and Censuses - CONAMYPE (2017), op. cit.

1.18 **Program rationale and intervention strategy.** As described above, MSEs in El Salvador face several barriers to medium- and long-term financing for production-oriented purposes. The intervention proposed with this program will expand the supply of financing for MSE production-oriented projects, offering longer tenors than those available in the financial sector. In addition to providing credit, support to improve the credit technology tools and to upgrade technology at the beneficiary MSEs will enhance access to financial services for this type of enterprise (paragraph 1.29). The focus on women entrepreneurs and underserved municipios facing higher rates of vulnerability and marginalization will help target a portion of the operation's resources to sectors with low rates of inclusion.

1.19 **The Agricultural Development Bank.** The BFA is a decentralized official credit institution attached to the Ministry of Agriculture, with its own founding charter. Its mission is to provide access to financial services that promote the development of the country's strategic production sectors, especially MSEs and the agricultural sector, within a self-sustainability framework.[25]

1.20 The BFA has the authority and capacity to help remediate the market failures that prevent MSEs from obtaining medium- and long-term credit, while facilitating the financial inclusion of women and areas with higher poverty rates. Working through its different banking segments, the BFA can help improve the capacity of Salvadoran MSEs to invest in sustainable technologies and working capital and to increase their scale and productivity.

1.21 The BFA has a distribution network of 43 branches, reaching underserved areas and acting as a credit catalyst. The BFA portfolio serves the most marginalized municipios, with a total of 76% distributed in departments located in the western (24.4%), paracentral (22.6%), and eastern (28.8%) zones. For MSEs specifically, it has credit lines for entrepreneurs, factoring, and export promotion, and others targeting women entrepreneurs. In the area of climate change vulnerability, it has a strategy, a sustainability committee,[26] and specific products providing parametric insurance to cover catastrophes and indirect damage. It also promotes renewable energies and energy efficiency.

1.22 As of June 2019, the BFA had assets of US$395 million, with a credit portfolio of US$270 million (an average loan size of US$22,000), which represents 2.1% of all bank loans in El Salvador. The BFA portfolio is concentrated in the agricultural (52.3%), commerce (13%), and consumer (15%) sectors. The past-due portfolio at that date was 3.5%, with coverage of 87.6%. Its liabilities consist of public deposits of US$300 million (leverage of 92.6%). The BFA is a solvent bank that is active in the Salvadoran financial system. As it has not previously executed any operations with the IDB Group, technical assistance will be provided through cooperation resources, in order to strengthen its lending instruments and conduct monitoring and evaluation of program outcomes and impacts.

1.23 The BFA has updated and adjusted its processes in accordance with its 2015-2019 Strategic Plan, which includes capital strengthening, improvement of the business model with differentiated market segments, expansion of services, and enhancement of portfolio performance. The BFA will make it easier for eligible

[25] Legislative Assembly of El Salvador: Decree No. 312: "Law of the Agricultural Development Bank".

[26] The BFA is a party to the United Nations Principles for Responsible Banking (UNEP-Fi).

Salvadoran MSEs to get access to financing by providing eligible subloans under conditions agreed upon with the Bank through program Operating Regulations and in accordance with its institutional capacity.

1.24 The BFA is one of three government development banks in El Salvador that engage in production-financing activities, pursuant to the provisions of the Law for the Promotion, Protection, and Development of Micro and Small Enterprises, which, in addition to this function, establishes coordination mechanisms with CONAMyPE. These entities are fundamental elements of the fabric through which Salvadoran MSEs are promoted and financed. As a credit institution, the BFA is responsible for solving several of the market failures present in the financial system, including: (i) assuming the transaction costs inherent in operating as a financial institution in the rural sector, by allocating more than 50% of its portfolio to highly marginalized municipios;[27] (ii) issuing loans with amortization periods matched to the investment activity and expansion of medium- and long-term production activities or restructuring. Accordingly, the BFA portfolio in marginalized areas consists of medium- and long-term loans[28]—50% in terms of the number of loans and 46% in value as of June 2019; and (iii) serving segments that are not considered creditworthy owing to information asymmetries and lack of information or absence of collateral or credit history, and also targeting women. The BFA portfolio channels 20% of its medium- and long-term credit to women. In 2018, it had a sustainability management unit with four lines of activity, including social performance, gender, diversity, and environmental management. Activities are pursued in collaboration with the National Women's Institute and the "Ciudad Mujer" network, through regular visits, talks, and roadshows to offer financial services to this population group.

1.25 **Estimate of potential demand**. The demand study estimated potential demand at US$2.6 billion, based on El Salvador's 259,416 MSEs and an average loan size expected in this operation of US$10,000. The value of this program and the expected number of beneficiaries represent 0.8% of this potential demand, which leaves ample room for implementation with very low risk of crowding out the private sector. The calculation is based on the data provided by the 2017 National MSE Survey,[29] conducted by CONAMyPE, which estimates the number of MSEs in the country and identifies their financing needs and sources.

1.26 **The Bank's experience in the sector**. The Bank has undertaken a number of production development loan operations with El Salvador. Firstly, it has accumulated execution experience with Bandesal, through the global credit program "Financing Productive Development for El Salvador" (3271/OC-ES), which is now fully disbursed. This program sought to boost productivity growth in El Salvador by supporting two specific areas: (i) financing of principal production-oriented credits for micro, small, and medium-sized enterprises in El Salvador (approximately US$80 million); and (ii) first-tier financing of renewable energies (approximately US$20 million). From a broader perspective, the Bank also has wide-ranging

[27] Municipios subject to high rates of marginalization are as identified in the current population census. They include the areas of extreme, severe, medium, and moderate poverty, encompassing 187 of the country's 262 municipios in its 14 departments.

[28] Medium-term credits are defined as those with tenors of between six months and one year, while long term credits are those with tenors longer than one year.

[29] CONAMyPE (2017).

experience in MSE interventions in Latin American and Caribbean countries, through loans, both with and without sovereign guarantee. Relevant operations in which the final beneficiaries are similar to those of this program include the following, by country: Colombia (4439/OC-CO and 2193/OC-CO), Chile (3677/OC-CH), Mexico (3531/OC-ME and 2656/OC-ME), Nicaragua (3042/OC-NI), and Paraguay (3354/OC-PR).

1.27 **The Bank's lessons learned in the sector.** Based on previous experiences, lessons learned, and good practices have been included in the design of this program, including the importance of: (i) promoting the countercyclical role that this type of operation can play by calming the market at times of credit contraction; (ii) targeting resources to segments in which lending has an impact on productivity, e.g., an impact evaluation of one program demonstrated an increase in the per-hectare sales of rural economic units that had received financing through a loan from the Bank;[30] [31](iii) supervising the financial conditions under which resources are issued to end-users, in order to prevent market distortions and ensure that additionality is not exhausted; (iv) guaranteeing the institutional capacity of the BFA to evaluate and monitor subloans and risk management practices; and (v) systematically compiling, managing, and maintaining program data, so the results can be analyzed and used in future interventions.

1.28 **Complementarity with other current Bank operations.** The operation "Strengthening the Climate Change Resilience of El Salvador's Coffee Growing Forests," 4870/OC-ES, will complement the present operation by providing financing to the coffee sector in El Salvador to enable it to enhance the resilience, productivity, and income of small production units. In addition, in 2018 a program, 4567/GN-ES, was approved with Bandesal, with the aim of supporting efforts in El Salvador to reduce the energy consumption of small and medium-sized enterprises and the concomitant greenhouse gas emissions, by increasing the availability of suitable financing in the financial system for investments in energy efficiency. There are also complementarities with IDB Invest operations targeting MSEs, with which the efforts of this program have been coordinated, in particular loan 2961/OC-ES with Banco Agrícola, S.A., which is a partial credit guarantee for microenterprises. The latter operation, targeting businesses at the base of the pyramid (mom-and-pop stores, diners, *pupuserías*), established a US$10 million risk-sharing guarantee facility for microenterprises. The operation facilitates credit for MSEs in need of guarantees and complements the credit efforts of the proposed program. In addition, the proposed program complements IDB Invest efforts by expanding the geographic coverage of MSE credit.

1.29 **Innovation**. The Bank has been working with the BFA to improve the latter's risk management tools. In particular, to expand MSE access to financing, alternative credit scoring tools are being developed, using artificial intelligence techniques in conjunction with nontraditional qualitative and quantitative MSE data.[32] One of the

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30 Approved with resources from loan RG-K1445.

31 Aparicio et al (2019): *Effects of Productive Credit Through National Development Financial Institutions: Evidence from Rural Mexico*.

32 The Bank has had previous experience in applying these tools through IDB Lab technical cooperation programs ATN/ME-12932-RG and ATN/ME-133359-HA, which piloted the application of psychometric tools by financial institutions in countries such as Peru and Haiti.

reasons for the scarcity of lending to MSEs is the risk that financial institutions perceive in association with these enterprises. This occurs because the financial sector evaluates these businesses using the traditional technology of credit risk analysis. A scoring and rating model is being calibrated, through the regional technical cooperation program ATN/OC-15604-RG, which will make it possible to develop an application programming interface (API) for the estimated rating and corresponding probability of nonpayment by the MSEs.[33] This is pioneering work in Central America, where for the first time a fintech platform will be working with a development bank to enhance its credit technology. The credit technology and expertise of the BFA are expected to be improved when the technical cooperation is completed. The Bank will also be supporting the institutional strengthening of the BFA in two further areas: (i) the use of digital tools and improvement of the supervision and evaluation of its programs, through its participation in the regional technical cooperation program ATN/OC-17575-RG. This will provide strengthening with instruments for the capture, use, and processing of digital information and systems for monitoring and evaluating its projects;[34] and (ii) tools to support MSE digitization, channeled through the regional technical cooperation program ATN/OC-16243-RG, with a view to strengthening e-commerce sales through self-diagnosis of obstacles in the stages of digitalization, targeting three areas: (a) sales platform; (b) means of payment; and (c) logistics and distribution; together with recommendations and a roadmap for advancing the digital process.[35]

1.30 **Strategic alignment**. The program is consistent with the Second Update to the Institutional Strategy 2020-2023 (document AB-3190-2) and aligns with the following development challenges: (i) social inclusion and equality, by supporting the production activities of small-scale farmers, as well as geographically remote populations; and (ii) productivity and innovation, by making it easier to obtain financing for production-oriented investment and technological change in a sustainable manner. It is also aligned with the crosscutting theme of gender equality and diversity, by targeting the program's subloans to women entrepreneurs and measuring the corresponding results (paragraph 1.32). In particular, the BFA's existing credit lines will be used to onlend to women who own or manage MSEs, taking into account the credit constraints faced by this group in El Salvador (paragraphs 1.18 and 1.19) within the framework of the BFA's proposed strategy on the matter (paragraphs 1.21, 1.22, and 1.25). It also aligns with the crosscutting theme of institutional capacity and rule of law, by improving the BFA's institutional capacity as a government development bank, through technical cooperation programs addressing issues such as credit risks and technologies (paragraph 1.29). The program is aligned with the Corporate Results Framework 2020-2023 (document GN-2727-12), through the following indicators: (i) micro / small / medium enterprises financed; and (ii) farmers with improved access to agricultural services and investments, including women. In addition, it is aligned with the Sector Strategy

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33 The Bank has been working with the BFA under a contract with INBONIS, a Spanish fintech, through which the credit scoring and rating model was calibrated. The API was tested during a trial period in the last quarter of 2019.

34 The technical cooperation was approved in September 2019 and is expected to continue in 2020, focused on the monitoring and evaluation of public development banks, including the BFA

35 The technical cooperation has made it possible to design a knowledge replication tool (mockup), which is expected to be used in a 2020 test environment at the BFA.

on Institutions for Growth and Social Welfare (document GN-2587-2) through its component on providing access to financial services to the majority. The program is also consistent with the Support to SMEs and Financial Access/Supervision Sector Framework Document (document GN-2768-7), particularly by linking access to finance with higher levels of productivity and the need to develop policies for financing production development. The program is consistent with the Agriculture and Natural Resources Management Sector Framework Document (document GN-2709-5), given its recognition of the need to strengthen rural financing through investments for increased productivity. It is also consistent with the IDB Group Country Strategy with El Salvador 2015-2019 (document GN-2828), through the dialogue area of productive development and financial inclusion, since it promotes financial inclusion in El Salvador through Objective 3 of Strengthening Public Finances. The program is also aligned with the Plan of the Alliance for Prosperity in the Northern Triangle, which focuses on defining policies and promotion actions in strategic sectors that enable micro, small, and medium-sized enterprises to integrate successfully into value chains and create quality jobs, particularly in areas with high levels of poverty, crime, and emigration.

B. Objectives, components, and cost

1.31 **Objectives.** The general objective of the project is to increase economic activity in El Salvador. The specific objective is to boost economic activity among the final beneficiaries by providing access to credit under better conditions for micro and small enterprises (MSEs). The program will place special emphasis on women entrepreneurs and municipios with high rates of marginalization.

1.32 **Beneficiaries**. This program, as executed by the BFA, is expected to benefit a total of 2,000 MSEs, of which at least 400 are headed by women and 400 are located in highly marginalized municipios.

1.33 **Sole component. Improved access to financing (US$20 million).** The program is structured around a sole component for US$20 million. The loan proceeds will be delivered to the BFA, which will then onlend to MSEs to finance eligible production-oriented projects in El Salvador. Special emphasis will be placed on highly marginalized municipios and women entrepreneurs (paragraph 1.32).

1.34 **Eligible beneficiaries and product lines**. The program's eligible beneficiaries will be natural and legal persons considered as venture and MSE[36] borrowers from all economic sectors, except the coffee sector and its value chain (paragraph 1.28).[37] In accordance with its equality and nondiscrimination policy, the BFA will target the resources of this program to eligible beneficiaries in highly marginalized municipios (footnote 27) and on women. The program Operating Regulations will identify banking segments and credit lines eligible for onlending to eligible beneficiaries through direct subloans, including: "Banking for microenterprise," "Banking for small

[36] Pursuant to the criteria established by the Law for the Promotion, Protection and Development of MSEs in El Salvador (see footnote 11 - which defines MSEs according to this Law)).

[37] The coffee sector is already being served/prioritized by operation 4870/OC-ES, which was approved in 2019 for US$45 million.

and medium-sized enterprise" and "Banking for agriculture."[38] Lending for women will be channeled though the credit line "Financing for Women Microentrepreneurs and Entrepreneurs of Ciudad Mujer"[39] and any other credit line with a gender focus that meets the conditions specified in this document and in the program Operating Regulations. The program will provide long-term credit (maturity longer than 12 months) through individual loans to finance production-oriented credits in amounts of up to US$100,000, subject to the exceptions identified in Section 7 of the program Operating Regulations. In all cases, the subloans will be consistent with the program objective (paragraph 1.31). The resources may be used to finance investments through direct subloans in activities that include, but are not limited to, the following: purchase of raw materials, technology, infrastructure, irrigation, equipment, transportation, storage, bulking, and any other purpose related to improving and increasing the scale of the economic activity. Exceptions are listed in the program Operating Regulations; in no case will projects classified as category "A" or "B" be financed, pursuant to the Bank's regulations and the related expenses specified in the program Operating Regulations exclusion list. Eligibility criteria for both beneficiaries and projects and exclusions from financing will be defined in the program Operating Regulations.

C. Key results indicators

1.35 The program's expected impact will be: (i) an increase in sales by MSE beneficiaries of the program, compared with nonbeneficiary MSEs; and (ii) an increase in the percentage of MSEs receiving financing. The expected outcome indicators will be: (i) average percentage change in average annual sales by beneficiary MSEs; (ii) percentage change in the BFA portfolio of medium- and long-term lending to MSEs; (iii) percentage change in the BFA portfolio of long-term loans to rural MSEs in municipios with high levels of poverty; (iv) percentage of the BFA portfolio of long-term loans to MSEs headed by women; (v) nonperforming rate of the BFA portfolio of medium- and long-term loans to MSEs; and (vi) increase in average tenor of loans issued to beneficiary MSEs.

1.36 **Economic analysis.** The economic evaluation identifies the income and expenditure flows generated in a typical MSE financed with credits originated by the program and, where appropriate, with the borrowers' own resources. Calculating these flows and discounting them at a rate of 12% produces a net present value of US$4.47 million and an internal rate of return of 17%. The sensitivity analysis continues to report positive results vis-à-vis various impacts, such as: (i) a reduction in initial sales levels; (ii) a reduction in the expected impact of the credit; and (iii) delays in implementing the operation (economic analysis).

[38] As specified in the BFA Credit Policy: (i) Agriculture: loans for working and operating capital and investments in agricultural and fishing activities; (ii) Microcredit: loans of up to US$25,000 for activities in the commerce, industry, agribusiness and service sectors; and (iii) SMEs: loans of over US$25,000 for activities in the commerce, industry, agribusiness and service sector.

[39] Women entrepreneurs with a business profile prepared by CONAMyPE, the Salvadoran Vocational Training Institute, or other institutions that provide training and other services to women entrepreneurs. The subloan, of up to US$5,174, will be used exclusively for the startup or development of new businesses.

II. FINANCING STRUCTURE AND MAIN RISKS

A. Financing instruments

2.1 **Origin and use of the resources.** The proposed project will consist of a global credit program for US$20 million, to be funded from the Bank's Ordinary Capital.

Table 1. Project costs (US$ million)

Component	IDB – Ordinary Capital
Sole component: Improved access to medium- and long-term financing	20
Total	**20**

2.2 **Disbursement plan.** As jointly analyzed with the BFA and taking into account the organic growth of the portfolio, the portfolio is expected to be disbursed in equal installments of US$5 million per year, over a four-year period measured from the date on which the loan contract takes effect.[40] The timing of the disbursements was estimated using data received from the BFA and estimates of demand.

Table 2. Disbursement schedule (US$ million)

	Year 1	Year 2	Year 3	Year 4	Total
IDB	5	5	5	5	20
Percentage	25	25	25	25	100

2.3 The Bank will disburse program resources through any of the modalities envisaged in the Financial Management Guidelines for IDB-financed Projects (OP-273-12). Disbursement requests will be accompanied by the information specified in the program Operating Regulations.

B. Environmental and social risks

2.4 As this is a financial intermediation operation, it cannot be classified ex ante according to Directive B.13 of the Bank's Environment and Safeguards Compliance Policy (OP-703). Environmental and social due diligence was conducted pursuant to Directive B.13, with an analysis being made of the potential socioenvironmental risks of the eligible subprojects and the capacity of the BFA, as executing agency, to manage those risks. Based on the results of this due diligence, and given the low risk profile (i) of the BFA and (ii) of the subprojects eligible for program financing, the operation is considered to be of low financial intermediation risk (FI-3). Given the size of the individual credits (average US$10,000 per subloan) and their nature (support for MSEs targeting financial inclusion in highly marginalized municipios and women entrepreneurs), the subprojects to be financed will be category "C" operations. In contrast, category "A" and "B" subprojects will not be eligible for financing.

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40 The funds are deemed committed as from the date on which the financed enterprises sign the respective contracts.

C. Fiduciary risks

2.5 The institutional capacity assessment made of the BFA found that it is in a position to undertake the fiduciary management activities of the loan operation. Fiduciary risk has therefore been rated as low, mainly because the BFA has the necessary organizational structure, regulations, systems, and human talent.

D. Other key issues and risks

2.6 **Development risk.** The risk that there will be little demand for financing for production-oriented projects of MSEs or of the prioritized segments, namely women and areas of high vulnerability, is estimated to have medium impact and likelihood of occurrence. Although a potential demand has been envisaged that could be met with project resources using conservative assumptions and real data, long-term credit is not common among Salvadoran MSEs. Also, exogenous non-macroeconomic phenomena, such as climate events or natural disasters, may reduce the demand for funding from the program. The BFA will promote new financial instruments or conditions that are introduced by the program to help mitigate this risk. In addition, the technical cooperation projects complementing the program (paragraph 1.29) will help identify and target the allocation of funding.

2.7 **Macroeconomic fiscal sustainability risk**. The risk of exogenous macroeconomic or financial shocks affecting real demand that could reduce the appetite for borrowing, particularly in sectors such as MSEs, is also estimated to have a medium impact and probability of occurrence. Moreover, the BFA might reduce its supply of medium- and long-term credit due to a greater perception of risk among the final beneficiaries. Nonetheless, the program has been designed to serve as a countercyclical instrument targeting MSEs in the event of a reduction in the supply of credit. The program, along with its additionalities, will also make it possible to improve the institution's credit risk technology, by mitigating information asymmetries in shock situations.

2.8 **Sustainability**. The program is expected to maintain continuity and exert a long-term effect on decisions by beneficiary MSEs to seek longer-term financing. Moreover, funds obtained from subloan recoveries will be used to make additional loans in the same type of activities, thereby enabling the BFA to accumulate experience in financing these types of projects and more effectively manage the type of risk inherent in them. In addition, technical cooperation activities in terms of loan support (paragraph 1.29) will develop institutional risk management capacity and generate a long-term effect on the entity's credit technology and the eligible MSEs.

III. IMPLEMENTATION AND MANAGEMENT PLAN

A. Summary of implementation arrangements

3.1 **Borrower and executing agency.** The borrower and executing agency of this operation will be Banco de Fomento Agropecuario [Agricultural Development Bank] (BFA). As executing agency, the BFA will be responsible for the administration, execution, control, and monitoring of program resources. The operation will have the sovereign guarantee of the Republic of El Salvador in respect of the borrower's financial obligations.

3.2 **Execution and administration.** The Bank will deliver the funds to the BFA for onlending to eligible beneficiaries (paragraph 1.34), to fulfil the objectives described in the program Operating Regulations. The BFA will implement the project through its current organizational, administrative, and financial structure. The BFA Finance Division will be responsible for program administration and coordination with the Bank.

3.3 **Program Operating Regulations.** The program Operating Regulations will specify responsibilities in administration, risk management, and coordination with the Bank, as well as the characteristics of eligible beneficiaries, management and monitoring agreements, and credit regulations, among other issues.

3.4 **Special contractual conditions precedent to the first disbursement of the loan proceeds. As a special contractual condition precedent to the first disbursement, the program Operating Regulations will have been approved and will have entered into force under the terms and conditions approved previously by the Bank.** This condition is essential, since the program Operating Regulations will define guidelines, procedures, and coordination mechanisms for program implementation.

3.5 **Exceptions to Bank policies.** A partial exception is requested in relation to the program execution obligations specified in Operational Policy OP 303 "Guarantees Required from the Borrower." The Republic of El Salvador will guarantee the loan payment obligations, including interest and fees and the local counterpart contribution. This exception is justified because Article 11 of the Law on State Financial Administration provides that obligations relating to loan execution are outside the legal mandate of the authorities of the Republic of El Salvador. The BFA has organizational, regulatory, technological, and human resource structures that are sufficient to execute the operation (paragraph 2.5).

3.6 **Disbursements and advances.** The BFA will maintain a special account for the funds intended for the operation, which will be used to make disbursements according to the beneficiaries' needs and to receive income from loan repayments. Pursuant to the Financial Management Guidelines for IDB-financed Projects (OP-273-12), disbursements will be based on liquidity needs and released once 80% of the cumulative balance after the immediately preceding advance has been justified. For this purpose, the BFA will prepare a financial plan to serve as the basis for the advances or any other disbursement modality deemed appropriate.[41]

3.7 Funds obtained from recoveries of subloans made with project funding that accumulate in excess of the amounts needed to service the loan may only be used to make new subloans that substantially conform to the standards set forth in the contract and in the program Operating Regulations of this operation.

3.8 **Financial statements.** The BFA will present annual financial statements for the project, pursuant to the terms of reference agreed upon with the Bank, and as part of its annual financial statements. The financial statements will be submitted within 120 days after the end of the fiscal year. The project's final financial statements will be submitted within 120 days after the date of last disbursement.

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[41] The deadline for committing the resources will be three and a half years, running from the effective date of the loan contract.

3.9 **Audit**. The project will be audited by the Supreme Audit Office or an independent firm of auditors acceptable to the Bank, under the procedures established in the current audit guidelines.

B. Summary of arrangements for monitoring results

3.10 **Reports.** Project implementation will be monitored through semiannual progress reports issued by the executing agency and submitted within 60 days after the end of each six-month period. The reports will be based on the commitments specified in the Results Matrix (Annex II) and on the financial progress reports mentioned in the General Conditions of the Loan Contract. The semiannual progress reports will also include the updating and monitoring of the Project Risk Matrix.

3.11 **Evaluation.** The project results will be will be evaluated through an ex post cost-benefit analysis of the income and expenditure flows generated by the intervention (monitoring and evaluation plan), together with the corresponding analysis of the evolution of the relevant portfolio for this intervention. Preparation of the evaluation will begin six months before the scheduled closing date for the operation and will be delivered during the subsequent twelve months or in accordance with the Bank's policies at that time. The operation's administrative budget includes the funds needed to perform the program evaluation and audit, among other items.

3.12 **Information.** The BFA will compile, store, and maintain all information, indicators, and parameters, including the annual plans and the final evaluation, as necessary to prepare the project completion report.

Development Effectiveness Matrix		
Summary	**ES-L1136**	
I. Corporate and Country Priorities		
1. IDB Development Objectives		
Development Challenges & Cross-cutting Themes	**-Social Inclusion and Equality -Productivity and Innovation -Gender Equality and Diversity -Institutional Capacity and the Rule of Law**	
Country Development Results Indicators	**-Micro / small / medium enterprises financed (#)* -Farmers with improved access to agricultural services and investments (#)***	
2. Country Development Objectives		
Country Strategy Results Matrix		
Country Program Results Matrix		**The intervention is not included in the 2019 Operational Program.**
Relevance of this project to country development challenges (If not aligned to country strategy or country program)		**It is consistent with the dialogue area of productive development and financial inclusion.**
II. Development Outcomes - Evaluability		**Evaluable**
3. Evidence-based Assessment & Solution	**9.0**	
3.1 Program Diagnosis	**2.4**	
3.2 Proposed Interventions or Solutions	**3.6**	
3.3 Results Matrix Quality	**3.0**	
4. Ex ante Economic Analysis	**10.0**	
4.1 Program has an ERR/NPV, or key outcomes identified for CEA	**3.0**	
4.2 Identified and Quantified Benefits and Costs	**3.0**	
4.3 Reasonable Assumptions	**1.0**	
4.4 Sensitivity Analysis	**2.0**	
4.5 Consistency with results matrix	**1.0**	
5. Monitoring and Evaluation	**8.5**	
5.1 Monitoring Mechanisms	**2.5**	
5.2 Evaluation Plan	**6.0**	
III. Risks & Mitigation Monitoring Matrix		
Overall risks rate = magnitude of risks*likelihood	**Medium**	
Identified risks have been rated for magnitude and likelihood	**Yes**	
Mitigation measures have been identified for major risks	**Yes**	
Mitigation measures have indicators for tracking their implementation	**Yes**	
Environmental & social risk classification	**B.13**	
IV. IDB´s Role - Additionality		
The project relies on the use of country systems		
Fiduciary (VPC/FMP Criteria)	**Yes**	**Financial Management: Budget, Treasury, Accounting and Reporting, External Control, Internal Audit. Procurement: Information System, Price Comparison.**
Non-Fiduciary		
The IDB's involvement promotes additional improvements of the intended beneficiaries and/or public sector entity in the following dimensions:		
Additional (to project preparation) technical assistance was provided to the public sector entity prior to approval to increase the likelihood of success of the project	**Yes**	**A scoring and rating module is being designed (ATN/OC-15604-RG). Instruments for obtaining, using and processing digital information are being created, including monitoring and evaluation systems (ATN/OC-17575-RG). Regional TC ATN/OC-16243-RG supports the strengthening of the MSE digitalization.**

Note: (*) Indicates contribution to the corresponding CRF's Country Development Results Indicator.

The Salvadorian economy has grown at a rate of 2% during the past decade while in comparison the region comprising Central America & the Dominican Republic has grown at an average of 3.8%. In El Salvador, micro and small enterprises (MSEs) contribute 35% of GDP, comprise 99% of all businesses and employ 68% of the work force. The vast majority, or 77%, finance their operational business needs with their own private resources or loans from relatives or other informal sources. Furthermore, 85% of all credit extended is concentrated in the metropolitan areas while only 29.6% of MSEs are located there. Thus, there is a need to improve financing to more disperse and rural zones. Barriers to traditional credit that MSEs face include their lack of guarantees and low level of formalization. On the supply side, 76% of all the financial system's liabilities are short-term and this impacts to shorten the duration with which credit is consequently offered. Of the loans extended to MSEs 43% have terms of up to 6 months and 32% have terms of between 6-12 months. Furthermore, 60% of MSEs have women proprietors and 67% of occupied women do so in low productivity activities, in part due to scarce financing. In this context, the program's general objective is to increase economic activity in El Salvador. The specific objective is to catalyze the final beneficiaries through access to credit for MSEs at better terms and conditions. The program will emphasize the inclusion of MSEs in highly marginalized municipalities as well as women owned businesses. The program will provide financing through a first-floor banking scheme with BFA that will provide credit at periods longer than 12 months through individual loans to MSEs for productive loans such as for example for the acquisition of technology, irrigation, or equipment, among others. Results to be measured include an increase in the level of sales for beneficiary MSEs, the percent of total beneficiaries that are comprised of either women-owned firms or firms in municipalities with high-poverty levels, as well as an increase in the average term duration for credit extended. The cost benefit analysis shows that the project is of net benefit to society. At closure, a reflexive analysis of results will be conducted.

RESULTS MATRIX

Project objective:	The general objective of the project is to increase economic activity in El Salvador. The specific objective is to boost economic activity among the final beneficiaries by providing access to credit under better conditions for micro and small enterprises (MSEs). The program will place special emphasis on women entrepreneurs and municipios with high rates of marginalization.

EXPECTED IMPACT

Indicators	Unit of measure	Baseline	Baseline year	Final target (2023)	Means of verification	Comments
Change in average annual sales by MSE beneficiaries of the program, compared with nonbeneficiary MSEs	%	0	2019	14	Commercial information system of the Agricultural Development Bank (BFA)	This indicator is measured as the average annual difference between the average sales of beneficiary MSEs and those of a comparison group. The baseline is zero because it is assumed that there are no differences between the two groups at the start of the program. The target is obtained from calculations included in the economic analysis. During program execution, the baseline may be updated in response to information generated by the initial credit applicants. This indicator will be measured by a comparison with a control group of rejected credits that can be matched with the beneficiaries.
Percentage of MSEs in El Salvador that operate in the rural sector and have access to credit	%	1.5	2018	2	National Micro and Small Enterprise Survey	This indicator will measure the level of financial inclusion among rural MSEs in El Salvador. The baseline is calculated using information from the 2017 National Survey of Micro and Small Enterprises conducted by the National Micro and Small Enterprise Commission (CONAMyPE). The target represents the aggregate impact expected from the program. This indicator will be measured using data from the next edition of the survey.

EXPECTED OUTCOMES

Indicators	Unit of measure	Baseline	Baseline year	Final target (2023)[1]	Means of verification	Comments
Specific objective: To boost economic activity among the final beneficiaries by providing access to credit under better conditions for micro and small enterprises (MSEs)						
Average percentage change in annual sales by MSEs	%	1.1	2019	3.3	BFA commercial information system	Access to credit is expected to boost the beneficiary MSEs' sales growth. To calculate this indicator, the mean annual sales growth for each benefited MSEs will be found; and this value will then be averaged across all beneficiary MSEs in the first cohorts. This subsample will be used to allow sufficient time for effects to materialize between the baseline and the follow-up. The baseline (corresponding to trend annual sales growth) and targets are obtained from the calculations included in the economic analysis. During program implementation, the baseline may be updated on the basis of information obtained from the initial credit applicants, as mentioned above. The BFA's commercial information system will make it possible to obtain annual sales data for calculating the final value of the indicator at the end of the program.
Percentage change in the value of the BFA portfolio of medium- and long-term loans to MSEs	%	To be determined	2019	Baseline* (1,024)^3	BFA financial information system	This indicator seeks to measure the trend of the BFA's loan portfolio relevant to this program's target population. It consists of medium- and long-term loans (tenors longer than 12 months) extended to rural MSEs from any funding source. The target was based BFA projections.
Percentage of program beneficiaries that are rural MSEs located in municipios with high levels of poverty	%	0	2019	20	BFA financial information system	This indicator seeks to measure the proportion of program beneficiaries that are rural MSEs located in municipios with poverty levels classified as moderate, high, or extreme. The baseline is zero because this indicator will be measured with respect to the final project beneficiaries. The target was based on BFA projections.

[1] The outcome indicators will be calculated at the end of the program, but annual information will be obtained from the program during implementation to allow these estimates to be made.

Indicators	Unit of measure	Baseline	Baseline year	Final target (2023)[1]	Means of verification	Comments
Percentage of program beneficiary MSEs that are headed by women	%	To be determined	2019	20	BFA financial information system	This indicator seeks to measure the proportion of program beneficiaries that are MSEs headed by women. The baseline will be determined based on the information gathered from the project as agreed with the BFA. This indicator is pro-gender.
Nonperforming loan ratio in the BFA's portfolio of medium- and long-term loans to MSEs	%	3.5	2019	3.5	BFA financial information system	The loans used to calculate this indicator will include those financed by the program, together with other medium- and long-term loans (tenors longer than 12 months) made to MSEs but financed from other sources. The nonperforming loan ratio is expected to be maintained throughout the life of the project.
Average tenor of loans granted by BFA to beneficiary MSEs	Months	9	2019	15	BFA financial information system	The aim is to measure the increase in the average tenor of loans granted to program beneficiary MSEs. The baseline corresponds to the average current value before the program. The target corresponds to BFA projections.

OUTPUTS

Outputs	Unit of measure	Baseline	Baseline year	Year 1	Year 2	Year 3	Year 4	Final target (2023)	Means of verification	Comments
Sole component: Improved access to medium- and long-term financing (US$20 million)										
Amount channeled in medium- and long-term credit to MSEs	US$ million	0	2019	5	5	5	5	20	BFA	
Milestone 1: Amount in medium- and long-term credit to MSEs for environmental sustainability operations	US$ million	0	2019						BFA	Includes investments for climate change adaptation or mitigation.

FIDUCIARY AGREEMENTS AND REQUIREMENTS

Country:	El Salvador
Project number:	ES-L1136
Name:	Global Credit Program for Micro and Small Enterprises in El Salvador
Executing agency:	Banco de Fomento Agropecuario [Agricultural Development Bank] (BFA)
Prepared by:	Gumersindo Velázquez, Senior Procurement Specialist, and Juan Carlos Lazo, Financial Management Specialist (FMP/CES)

I. SUMMARY

1.1 The fiduciary evaluation of El Salvador's Agricultural Development Bank (BFA), which will serve as the program's executing agency, was based on the Institutional Capacity Assessment Platform and the fiduciary risks identified for the program. Although the BFA lacks experience in managing Bank-financed operations, the evaluation concludes that it has a high level of capacity to execute this program, and the associated fiduciary risk is low.

1.2 The BFA is not covered by the State Financial Administration Charter (the AFI Law), nor is it part of the General State Budget, and neither is it required to keep its budget, treasury, and accounting records in the Integrated Financial Administration System (SAFI). Nonetheless, it does have reliable procedures, mechanisms, and systems for institutional financial management, as reported in the institutional capacity assessment report.

II. FIDUCIARY CONTEXT OF THE EXECUTING AGENCY

2.1 The BFA has been operating as an official credit institution since 4 May 1973. Its mission is to facilitate access to financial services for all of the country's production sectors, especially targeting productive and agricultural development, rural areas, indigenous or native peoples, women and other groups that are largely excluded from commercial bank services, all within a framework of self-sustainability. In the last four years, the BFA has endeavored to consolidate a sustainable development management approach, based on economic growth, social development, and environmental protection. Eighty percent of the institution's portfolio consists of loans to the productive sectors. When a disaster affects agriculture, it involves the entire value chain. The BFA's clientele and operations are vulnerable to the socioenvironmental effects of climate change, mainly in the agriculture sector, which absorbs 52% of its annual disbursements.

2.2 The BFA's various financial indicators, both vertical and horizontal, point to a robust institution. The composition of its portfolio, and its policies, procedures, and processes are also clearly defined, and it has qualified professional staff, functional and reliable information systems, as well as clear working procedures for fulfilling its functions.

III. Fiduciary Risk Evaluation and Mitigation Actions

3.1 Fiduciary risk in terms of financial management poses a low risk, mainly because this is the first time that the BFA will execute a program of this type financed by the IDB. To mitigate this risk, an intensive training and advisory program will be undertaken for staff who will be involved with the program. It will be particularly important to prepare program Operating Regulations that define clear procedures and mechanisms including information on formulation of the budget and accounting and treasury records, as well as adequate identification of credit lines that meet the conditions of the program, so as to identify, record, follow up, and control the proceeds of the IDB loan at any time. The program Operating Regulations should clearly indicate when an expenditure should be recognized. The executing agency, which will operate as a first-tier bank, is not expected to make any procurements.

IV. Procurement Management

4.1 The operation is structured as a global credit program, through which funds are provided to the BFA, for onlending to micro and small enterprises (MSEs) as direct beneficiaries of the loan. Accordingly, the provisions of paragraph 3.13 "Procurement in Loans to Financial Intermediaries" of document GN-2349-15 "Policies for the Procurement of Goods and Works Financed by the Inter-American Development Bank" are applicable. These provide that in loans of this type, procurement is usually undertaken by the beneficiaries in accordance with established private sector or commercial practices.

4.2 **Records and files**. The documentation of the subloans to be financed by the operation will be held at the BFA. The program files and records will be managed in accordance with the "Instructions for the Organization and Administration of the BFA file." The official disbursement request forms must be used to prepare and file program reports, listing subloans subject to reintegration of expenses.

V. Financial Management

5.1 **Programming and budget.** The program budget will be managed by the BFA, applying the mechanisms and procedures used for its own budget. This is prepared annually according to a fiscal year beginning on 1 January and ending on 31 December and includes portfolio placement projections to identify financing needs or excess liquidity. There is an established process for budget formulation, approval, and execution. Consistent with the provisions of the Law of the Financial System for Development Promotion, the budget must be approved by the institution's Board of Directors and then signed off on by the Board of Governors. Any necessary amendments to the budget must follow the same procedure as when the budget is first approved.

5.2 **Accounting and information systems**. The BFA will maintain the program's accounts using its own accounting system (COMPLUS), in which accounting and treasury operations are integrated and use the data of the approved budget as reference, together with complementary records as deemed necessary to present information to the Bank. In preparing its financial statements, the BFA applies the accounting standards applicable to banks in El Salvador, in conjunction with the regulations issued by the Superintendency of the Financial System. The program's audited financial statements will be prepared on a cash basis, using information generated by the BFA system, which will identify the transactions financed by the IDB. The accounting records to be used for program execution and record-keeping must be designed to ensure that the relevant information is clear and easily identifiable. The terms set out in paragraph 3.8 of the loan proposal will also be met.

5.3 **Disbursements and cash flows**. The Bank will disburse program resources through any of the modalities envisaged in the Financial Management Guidelines for IDB-financed Projects (document OP-273-12). Disbursement requests must be accompanied by the information specified in the program Operating Regulations.

5.4 **Disbursements and advances.** The BFA will maintain a special account for the funds assigned to the operation, to make disbursements according to the beneficiaries' requirements and to receive income from loan repayments. Pursuant to the Financial Management Guidelines for IDB-financed Projects (OP-273-12), disbursements will be based on liquidity needs and released once 80% of the cumulative balance after the immediately preceding advance has been justified. For this purpose, the BFA will prepare a financial plan to serve as the basis for the advances or any other disbursement modality deemed appropriate.

5.5 **Internal control.** As a public institution, the BFA applies the Technical Standards for Internal Auditing applicable to financial system entities and the Internal Auditing Standards of the Government Sector, issued by the Audit Office of the Republic, based on the global standard of the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The BFA has an Internal Audit Division, which reports directly to the institution's Board of Directors.

5.6 The approved audit methodology includes a reporting section in which any findings must be followed up and resolved within a specified time period. The results of each audit are presented to the Audit Committee set up by the BFA Board of Directors. The institution has a robust code of ethics, with mechanisms to ensure it is applied.

5.7 The BFA has an Integrated Risk Division, which is tasked with evaluating, monitoring, and supervising the risks generated by its operations.

5.8 **External control and reports**. The program's external control will be entrusted to a firm of independent auditors, contracted by the BFA. The firm may be the same as also audits the BFA's own financial statements, with a view to obtaining a comprehensive view of control over the executing agency and management of the program. Nonetheless, the firm must be on the list of those deemed eligible by the IDB to audit operations financed with its resources. If a competitive process is held, the guidelines set out in the New Governance Framework for the Management of External Audits of Operations Financed by the IDB must be followed. The annual financial statements will also be prepared in accordance with the aforementioned framework. To ensure the effectiveness of the audit work, the firm in question must be hired no later than September of the fiscal year to be audited.

5.9 **Supervision**. The first supervision activity will be to hold a workshop to disseminate the IDB's fiduciary policies to relevant BFA staff. The financial monitoring of the program will include supervision visits, as indicated in the financial supervision plan. The fiduciary supervision visits for financial management will include verification of the financial and accounting arrangements used to manage the program, and follow-up of the implementation of any recommendations issued by the independent auditor of this program, or others. The auditor will verify compliance with the requirements of the program Operating Regulations.

5.10 **Execution mechanism**. The executing agency will be the BFA, which will implement the program's technical and financial activities. The proceeds of the IDB loan will be disbursed in accordance with the program Operating Regulations prepared for this operation. All financial management activities will be executed by BFA permanent staff, given that the institutional capacity assessment found that it had sufficient capacities to rely on the existing structure and processes.

5.11 **Characteristics of the loans**. The issues raised in these fiduciary agreements and requirements will be elaborated in detail in the program Operating Regulations, which will require the approval of the undersigned fiduciary specialists in their areas of competency.

5.12 **Other financial management agreements and requirements.** There are no other agreements apart from those mentioned above. Nonetheless, the fiduciary agreements and requirements included in this annex may be adjusted as the program is under way, based on updated risk analyses and the institutional capacity assessment performed during program execution.

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE-___/__

El Salvador. Loan ____/OC-ES to Banco de Fomento Agropecuario (BFA)
Global Credit Program for Microenterprise and Small
Business in El Salvador

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 Banco de Fomento Agropecuario (BFA), as Borrower, and with the Republic of El Salvador, as Guarantor, for the purpose of granting the former a financing aimed at cooperating in the execution of a Global Credit Program for Microenterprise and Small Business in El Salvador. Such financing will be for the amount of up to US$20,000,000 from the resources of the Bank's Ordinary Capital, and will be subject to the Financial Terms and Conditions and the Special Contractual Conditions of the Project Summary of the Loan Proposal.

(Adopted on __ ____________ 20__)

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