



Additional Financing Appraisal Environmental and
Social Review Summary
Appraisal Stage
(AF ESRS Appraisal Stage)

Date Prepared/Updated: 04/06/2023 | Report No: ESRSAFA542



BASIC INFORMATION

A. Basic Project Data

Country	Region	Borrower(s)	Implementing Agency(ies)
Ecuador	LATIN AMERICA AND CARIBBEAN		
Project ID	Project Name		
P180477	Ecuador - Promoting Access to Finance for Productive Purposes for MSMEs - AF		
Parent Project ID (if any)	Parent Project Name		
P172899	Promoting Access to Finance for Productive Purposes for MSMEs		
Practice Area (Lead)	Financing Instrument	Estimated Appraisal Date	Estimated Board Date
Finance, Competitiveness and Innovation	Investment Project Financing	3/20/2023	5/31/2023

Proposed Development Objective

The project development objective is to promote access to finance for productive purposes for micro, small and medium enterprises in the context of the COVID-19 crisis.

Financing (in USD Million)	Amount
Current Financing	260.00
Proposed Additional Financing	570.00
Total Proposed Financing	830.00

B. Is the project being prepared in a Situation of Urgent Need of Assistance or Capacity Constraints, as per Bank IPF Policy, para. 12?

No

C. Summary Description of Proposed Project [including overview of Country, Sectoral & Institutional Contexts and Relationship to CPF]

The proposed Additional Financing (AF) would scale up the original IBRD Financial Intermediary Financing to US\$ 540 million that will be executed in seven years with the objective of promoting access to finance for productive purposes



for micro, small, and medium enterprises (MSMEs). The additional US\$280 million of IBRD financing will be allocated to Component 3. Retroactive financing will be allowed under the AF up to a maximum of US\$112 million (40 percent of the AF) made one year before the expected loan signing date.

The Project is fully aligned with the Country Partnership Framework (CPF) for FY19-FY23, Objective 3: Improve financial sector inclusion and intermediation, as it promotes a more efficient allocation of resources while crowding in commercial bank financing and including a larger number of small and medium enterprises (SMEs) in the formal financial sector. The Performance and Learning Review (PLR) for FY19-FY23, which is currently under preparation, underscores the key contribution of the Project towards achieving this objective. The Project also contributes to CPF Objective 1: Enhance efficiency of public spending, as it helps remove a potential source of contingent liability for the government thus increasing fiscal efficiency. Moreover, the Project contributes indirectly to CPF Objective 2: Improve conditions for private sector development, as it stimulates private investment in the productive sector. This Project is also aligned with Ecuador's Opportunities Creation Plan 2021-25, which aims – among other things – to foster productivity and competitiveness in key sectors of the economy, and to promote an economic system that foster investment and a modernization of the financial sector. Finally, the Project also fits into the pillars of the World Bank Group Global Crisis Response Framework.

The AF would bring four changes to the original project. These are presented below:

- i) Increase and/or modification some of the existing end targets in the results framework. A set of indicators will be revised to adjust both the annual and end targets to reflect: (a) progress to date under each indicator; (b) the allocated amount of the additional financing; and (iii) the new closing date of the original loan. Another set of indicators will be adjusted to clarify its definitions and to improve the projected annual targets. These second group includes PDO Indicators (Number of sub-loans disbursed under the Project; Share of second-tier financing of the Corporación Financiera Nacional (CFN)) and Intermediate Results Indicators under Component 3 (Number of MSMEs receiving sub-loans financed with project funds; Number of MSMEs receiving sub-loans financed with Project funds that are owned and/or led by women; Volume of total sub-loans disbursed under Project; nonperforming loans (NPLs) of credit lines used by participating financial institutions (PFIs) with Project funds versus the NPLs of CFN's first tier lending to MSMEs);
- ii) Inclusion of an explicit indicator in the results framework to measure sub-loans to MSMEs that finance projects with a climate mitigation or adaption component. Currently, the volume of sub-loans to MSMEs disbursed for activities related to climate mitigation and adaptation is an additional indicator included in the Project Operations Manual (POM) for monitoring purposes. Given the vulnerability of Ecuadorean MSMEs to climate change, the upgrading of this indicator to the results framework of the Project is warranted. Climate adaptation and mitigation investments can include projects that involve the use and/or production of renewable energy, clean transportation, sustainable waste management, eco-efficient products or infrastructure, etc. Additionally, as part of Component 2 (Development and Improvement of Financial Products to Promote Access to Finance for MSMEs), the Project will support MSMEs in identifying the effect of climate impacts on their business and develop climate adaptation measures and climate resilience strategies, and will provide technical assistance to PFIs to include climate-smart terms and conditions (e.g., automatic grace periods in the event of a natural disaster to provide cash-flow relief) in financing supported by this Project.
- iii) Inclusion of a private capital mobilization (PCM) target in the results framework for sub-loans to MSMEs under the line of credit (Component 3). It is estimated that this requirement will mobilize private capital for at least \$30 million, which has been added to the total Project cost.



iv) Extension of the closing date of the original loan by 2 years to December 31, 2027. The extension of the closing date of the original loan will provide sufficient time to implement the scaled-up Project. It will also provide more time to gather information on financial and other indicators of beneficiary MSMEs, in order to measure the impact of second-tier lending on real outcomes and growth of firms. Moreover, an extension of the closing date of the original loan would allow for more time to achieve results under Component 2 which is taking longer to achieve critical mass and Component 1, under which some institutional strengthening activities have taken longer to get started due to uncertainties related to the planned merger.

The AF will allow for a scaling up of the Project's impact in terms of volume, number of loans and number of beneficiaries, including female owned MSMEs, and it will allow the promotion of climate resilient MSMEs and the mobilization of private capital. The Project will then continue to have four main components: (1) Strengthening the institutional capacity of CFN; (2) Development and improvement of financial products to promote access to finance for MSMEs; (3) Credit line intermediated by CFN to PFIs for on-lending to MSMEs; and (4) Project management.

Component 1 – Strengthening the Institutional Capacity of CFN (US\$ 3 million, unchanged from original project). This component has provided technical assistance and capacity building to CFN. Under this component the Project has financed, inter alia: (a) Design of a corporate governance strengthening plan for CFN to incorporate international best practices in terms of mandate definition, and board appointment and composition, among others, and to align with the expected legislative and regulatory changes; (b) Assessment of the financial viability of CFN to ascertain the true extent of the quality of its assets and clean up its balance sheet. Accordingly, this activity includes the design of an NPL resolution strategy that would reflect the macroeconomic context, the legal and judicial systems, the fiscal capacity of the government and the type of assets in the NPL stock; (c) Assessment of the current strategy of CFN and development of a new business plan to align with the results of the corporate governance reform and the financial viability assessment; (d) Design and implementation of a monitoring and evaluation strategy to measure the effect of access to credit on final borrowers, including female-owned enterprises and first-time borrowers; (e) Design and implementation of an environmental and social management system and standards for CFN's second-tier lending; and (f) Technical assistance to strengthen the capacity of financial intermediaries accessing second-tier financial products, including the strengthening of their environmental and social management systems.

Component 2 – Development and Improvement of Financial Products to Promote Access to Finance for MSMEs (US\$ 42 million, unchanged from original project). This component has supported CFN to develop new or improve existing financial products to promote access to finance for productive purposes, especially for MSMEs. Specifically, under this component the Project has financed:

- (a) Subcomponent 2a – technical assistance (US\$ 2 million, unchanged from original project). Under this subcomponent, the Project has financed a technical assistance program aimed to (i) strengthen the National Guarantee Fund (NGF), especially its risk management system and pricing policy; and, (ii) design, test and evaluate new financial products for MSMEs with potential to be scaled up (e.g. risk sharing facilities, alternative financial instruments, climate resilience financial products, specialized products for female-owned MSMEs and Indigenous Peoples and Nationalities, Afro-Ecuadorians and Montubians (IPAM)-owned MSMEs, FinTech solutions).
- (b) Subcomponent 2b – capitalization of NGF for special COVID-19 program (US\$ 20 million, unchanged from original project). This subcomponent has supported the activation of a special emergency guarantee program to alleviate the economic effects of the COVID-19 crisis on productive MSMEs, guaranteeing liquidity and covering their working capital and investment needs to maintain productive activity and employment. Under this subcomponent, the Project



has capitalized a special guarantee program, which has become a part of NGF's capital and has been extended to PFIs that lend to beneficiary MSMEs.

(c) Subcomponent 2c – capitalization of NGF for standard programs (US\$ 20 million, unchanged from original project). This subcomponent will support the standard operations of NGF. Under this subcomponent, the Project will capitalize NGF, which will use its equity to provide guarantees to PFIs that will lend to beneficiary MSMEs for working capital and investment purposes. It is expected that final borrowers will include firms from sectors with high potential for productivity growth as well as female-owned enterprises, IPAM-owned MSMEs and first-time borrowers.

Component 3 – Credit Line Intermediated by CFN to PFIs for On-Lending to MSMEs (US\$ 493 million, of which: original project -US\$ 213 million- and AF -US\$280 million IBRD financing-). This component has supported CFN to establish and expand second-tier lending operations to serve MSMEs through the commercial and the cooperative banking sector. Under this component, the Project has financed the provision of lines of credit to eligible private PFIs, which in turn on-lend to eligible private MSMEs. CFN has assumed the credit risk of the PFIs, while the latter have taken on their books the credit risk of the MSMEs. Beneficiary MSMEs have gotten access to finance for working capital and investment purposes. Preliminary data shows that final borrowers include firms from sectors with high potential for productivity growth as well as female-owned enterprises, IPAM-owned MSMEs and first-time borrowers.

Component 4 – Project Management (US\$2 million, unchanged from original project). This component has focused on supporting CFN to effectively execute the Project. Under this component, the Project has finance, inter alia: (a) Recruitment and training of the Project Coordination Team (PCT) members including, if necessary, specialists responsible for procurement procedures, financial management, environmental and social management, and the overall execution of the Project; (b) Acquisition of equipment and furniture for the PCT; (c) Monitoring and evaluation activities; (d) Study tours for relevant CFN staff; (e) Stakeholder and citizen engagement plan, including implementation of a Grievance Redress Mechanism (GRM); (f) Communication strategy; and (g) Project's financial audits.

D. Environmental and Social Overview

D.1. Detailed project location(s) and salient physical characteristics relevant to the E&S assessment [geographic, environmental, social]

In line with the parent Project, the AF will continue to support second-tier lending operations nationwide. Second-tier meaning a credit line intermediated by Corporación Financiera Nacional (CFN) to Participating Financial Intermediaries for on-lending to micro, small, and medium enterprises (MSMEs). CFN will use the WB funds to enable PFIs to channel investments with MSMEs. The exact location of the MSMEs to be financed will not be known until implementation.

The AF will continue to finance loans disbursed through eligible PFIs to MSMEs for productive purposes, meaning working capital or investments that will help firms run their businesses, improve their production processes, improve businesses management, and create or improve their products. The AF will not finance consumer loans, housing loans, student loans, etc. CFN will continue to identify PFIs according to the criteria established under the parent Project and reflected in the Project Operations Manual.



The proposed AF aims to scale up the development effectiveness of the Project by: (i) allocating additional funds under Component 3 where a credit line will be intermediated by CFN to PFIs for on-lending to MSMEs; and (ii) allowing retroactive financing under Component 3 and according to details mentioned in section C.

As part of Component 3, CFN will continue seeking to establish and expand second-tier lending operations to serve MSMEs through private commercial banks and the cooperatives. The AF will continue to finance the provision of lines of credit to eligible private PFIs, which in turn will on-lend to eligible private MSMEs. CFN will assume the credit risk of the PFIs, while the PFIs will assume the credit risk of the MSMEs. Beneficiary MSMEs will get access to finance for working capital and investment purposes. Eligible MSMEs will not receive loans for land acquisition for speculative purposes, but only for productive projects that may require land acquisition, for which, in the ESMS and the project's operating manual, a due diligence requirement is included to ensure that in the event that a productive project requires land purchase, this transaction does not generate land conflicts, or require the physical and/or economic displacement of people and/or their economic activities or the restriction of access to natural resources. To this end, on July 29, 2021, this ESMS was reformed by including two additional eligible activities: (i) financing of land acquisition as part of productive projects, including the need for a due diligence to avoid physical or economical resettlement; and, (ii) financing of construction activities for sale (real state).

Same as in the parent Project, clearly defined eligibility criteria detailed in the Project Operations Manual and ESMS will continue to be followed during the implementation of the AF, in order to ensure that the loan proceeds are used for the intended purposes following the obligations described in the Loan Agreement, including E&S requirements. Only FI subprojects entailing low and/or moderate E&S risks will be financed with this operation; specifically, CFN has created an exclusion list of activities, as an annex to the ESMS, works or projects that CFN will refrain from financing as part of this line of credit with the WB.

Under the parent Project, CFN financed, through the PFIs, mainly working capital and acquisition of fixed assets for micro enterprises mostly dedicated to trading activities, with no significant E&S risks according to Ecuadorian legislation and the ESMS. Additionally, funds have been allocated for working capital and asset acquisition for micro enterprises dedicated to agricultural and manufacturing activities. The E&S risks associated with these activities have been controlled during the selection phase in accordance with the criteria established in the ESMS of the PFIs, so that funding has been provided exclusively for activities corresponding to a low and moderate E&S risk classification.

As evidenced in the semiannual reports submitted by CFN, the E&S performance of the activities completed under the parent Project was satisfactory.

D. 2. Borrower's Institutional Capacity

CFN is the Borrower and project implementing agency. CFN is authorized, regulated and supervised by the Superintendency of Banks of Ecuador (SBE). It was founded in 1964. CFN's sole shareholder is the Central Bank of Ecuador (BCE). CFN has written policies, manuals and procedures for the management of its financial and operational risks. CFN has a management information system that allows the monitoring of the financial and risk situation, including the preparation of various reports (weekly, monthly, quarterly and annual) addressed to internal (CFN) and external (SBE, credit risk rating agency, external auditors) audiences. The organizational structure of CFN is in line with what is required by regulation, observing separation of functions and internal control systems.

Under the parent Project CFN developed an Environmental and Social Management System (ESMS) applicable for activities covered by subcomponents 2a, 2b and Component 3, which provides a basis for building or adapting the



management systems of participating financial institutions and sets the conditions for environmental and social financing, including an environmental and social policy; procedures for identifying and evaluating activities that could be financed; mechanisms for risk categorization, risk management and environmental and social impacts of subprojects; organization and competencies; and communication and reporting mechanisms.

There were some initial difficulties during the construction of the ESMS due to challenges in the process of conceptualizing a mechanism for assessing the risks of a wide range of activities; however, after intense work by the PCT with the support of the Bank, the necessary agreements were reached to make the ESMS viable, achieving a satisfactory ESMS implementation and even scaling up the applicability of this ESMS to CFN's entire portfolio. The first version of this ESMS was approved on October 2, 2020. On July 29, 2021, this ESMS was reformed by including two additional eligible activities: (i) financing of land acquisition as part of productive projects; and (ii) financing of construction activities for sale (real state).

The ESMS is up to date and since no new environmental and social risks or impacts are anticipated for this AF, it is expected that the ESMS will continue to be maintained unchanged.

CFN has a PCT in place, headed by the Product and Service Development Management, and supported by qualified personnel from the Business Development Sub-Management (Environmental and Social Specialist), the Financial Business and Fundraising Management (Financial Coordinator), the Fundraising Sub-Management, and the National Guarantee Fund Process Management (Procurement). In addition, the team also coordinates activities with the Human Resources Management (Labor Management Procedures, Capacity Building Plan); with the Claims Management (Complaints and Claims Mechanisms, Accidents, Incidents); and with the Marketing Management (Information Dissemination and Communications).

The implementation of the E&S provisions for the AF will be carried out by the same CFN's PCT staff who have been implementing the parent Project E&S measures. In accordance with the ESCP the PCT staff dedicated to E&S compliance are: (i) a senior representative who will assume the overall responsibility for coordinating the management of the environmental and social aspects of the Project; and (ii) an environmental and social specialist responsible for the day-to-day implementation of the ESMS during Project implementation. During the semiannual evaluations carried out by the Bank and within the semiannual reports, the Bank evidenced that CFN's institutional capacity is appropriate, as the activities outlined in the E&S instruments prepared under the parent Project were adequately and timely completed, including the implementation of a training program to ensure effective E&S performance of the PFIs.

It is to be noted that CFN has achieved a successful E&S management of the Project by relying on project staff with extensive knowledge of the project and the ESMS operation, therefore, in light of a scenario of merger between CFN and Banecuador (although postponed until the end of 2024), E&S risks and impacts are foreseen due to a potential shortfall in Banecuador's capacity to assume the E&S management of the project, which could pose a significant institutional capacity risk. Before an eventual merger, the Bank should perform a due diligence to ensure an adequate transfer of knowledge and responsibilities from CFN to Banecuador, guaranteeing that the E&S management of the project has sufficient institutional capacity. Additionally, the Bank deems it appropriate to develop a transition plan to ensure continuity in the E&S management of the Project, avoiding operational risk.

II. SUMMARY OF ENVIRONMENTAL AND SOCIAL (ES) RISKS AND IMPACTS

A. Environmental and Social Risk Classification (ESRC)

Moderate



Environmental Risk Rating

Moderate

The environmental proposed risk classification for the AF is Moderate under the World Bank ESF. Along with the parent Project, and considering the nature and magnitude of the potential environmental risks and impacts of FI subprojects they would be : (i) predictable and expected to be temporary and/or reversible; (ii) low in magnitude; (iii) site-specific, without the likelihood of impacts beyond the actual footprint of the project; (iv) low probability of serious adverse effects to human health and/or the environment (e.g., do not involve use or disposal of toxic materials, routine safety precautions are expected to be sufficient to prevent accidents, etc.). The activities of the FI subprojects will no increase water and energy consumption due to the manufacturing of new products, increment air pollution because of industrial processes, e-wastes from computer hardware upgrades, among others. Also, no loans that would lead to significant adverse impacts on biodiversity and habitats, or on cultural heritage, would be supported. CFN has created an exclusion list to delineate the FI subprojects that will not be subject to investment with this credit line with the World Bank. Ultimately, only low and/or moderate risk investments will be financed. As detailed under section D., under the parent Project CFN financed, through the PFIs, mainly working capital and acquisition of fixed assets for micro enterprises mostly focused on trading activities; while a reduced portion of funds have been allocated for working capital and asset acquisition for micro enterprises dedicated to agricultural and manufacturing activities; therefore, for most of the activities financed, no material environmental risks have been foreseen, as the funds contributed to the flow of capital to support microenterprises operating, while the environmental risks associated with the activities financed in the agriculture and manufacturing sectors were considered low or moderate according to the ESMS classification agreed between CFN and the Bank, such as risks associated with the generation of minor volumes of domestic effluents; generation of low volumes of common, biodegradable or recyclable waste; minor and occasional generation of noise and vibrations during equipment installation; among others. As above mentioned and since the AF does not provide for the implementation of types of activities other than the parent Project, and as CFN and the PFIs will apply the same environmental provisions established in the E&S instruments of the parent Project, no changes in the environmental risks that will result from the implementation of this AF are anticipated.

Social Risk Rating

Moderate

Social risk is considered moderate for the additional financing. Although the Environmental and Social Management System and management instruments have been adequately applied by the project coordination team during the parent project, it is considered that the potential risks identified remain and need to be managed for this new stage of the operation. It has been observed that the criteria for classification and evaluation that have been carried out with the application of the evaluation flowchart that is part of the ESMS, have been functional for the characteristics of the financial product and have been accepted by the interested parties (financial institutions) and the final beneficiaries (clients of the financial institutions). Main risks are related to: labor issues through deficient compliance with labor regulations such as Health and Safety ; lack of participation of small cooperatives and MSMEs in remote areas of the country due to lack of access to clear and culturally appropriate information; and possible exclusion of some subgroups among the MSMEs due to limited efforts from second tiers FI regarding strategies / approaches to address specific ethnic needs to ensure successful participation of these groups in accessing the offered product. For example, this could include information and communication campaigns with cooperatives that provide loans to MSMEs run by IP, in remote areas or to women run businesses. No adverse impacts on indigenous peoples is expected, whereas PFIs will be encouraged to lend to IP-owned businesses. Land acquisition and resettlement will not be supported and loans that would result in either are included as part of the exclusion list. Also, Sexual Exploitation

Public Disclosure



and Abuse (SEA)/ Sexual Harassment (SH) risks has been assessed and addressed in the implementation of the parent project, including screening and putting in the corresponding measures to prevent and mitigate the SEA/SH risks. In this regard, this risk remains low, since the project is mainly a financial intermediation operation, and to prevent any event, each of the PFIs has institutional codes of conduct.

B. Environment and Social Standards (ESSs) that Apply to the Activities Being Considered

B.1. General Assessment

ESS1 Assessment and Management of Environmental and Social Risks and Impacts

Overview of the relevance of the Standard for the Project:

This standard is relevant.

Under the parent Project CFN designed and implemented an ESMS for a second tier credit line with the WB, which includes a categorization process for assessing the E&S risk level of each of the proposed loans. As the AF is intended to scale up the financing extent of the parent Project components but without providing for additional activities under its Components, the anticipated operations under the AF will continue to be carried out in accordance with the existing ESMS. The ESMS is commensurate with the nature and magnitude of environmental and social risks and impacts of FI subprojects, the types of financing, and the overall risk aggregated at the portfolio level, in line with para. 40 of the E&S Policy. The ESMS includes, among others, these components (refer to ESS9 for further details on the ESMS and its different components) : (a) E&S policy; (b) E&S procedures and capacity to screen subprojects conduct due-diligence to evaluate E&S risk and assign risk category; (c) systems/processes for due diligence to evaluate, monitor, review and manage E&S risks and impacts of subprojects; (d) organizational capacity and competence; and (e) external communications and reporting mechanisms on E&S performance.

The ESMS specifically includes the following elements to avoid and/or mitigate potential E&S risks and impacts, relevant to ESS1:

1. Exclusion list. As an important part of the ESMS, CFN has created an exclusion list of activities, works or projects that CFN refrains from financing as part of this line of credit with the WB. The CFN Exclusion List for the credit line with the WB explicitly includes projects involving substantial and high-risk activities/sectors, such as: involuntary resettlement; infringement of natural and critical natural habitats: production or commercialization of any product or activity considered illegal according to the laws or regulations of Ecuador; production or activities affecting lands owned or claimed by indigenous peoples; production or trade of alcoholic beverages (except beer and wine); production, trade, storage or transport of large volumes of hazardous chemicals; and any dams that would be considered high or substantial risk to support.
2. Process of E&S Risks and Impacts Identification. CFN has as part of the ESMS robust procedures for screening, review, and approval of E&S assessment. This includes a process for categorizing projects based on their level of E&S risks and using as reference the WB's criteria for E&S risk categorization of projects, E&S due diligence, and E&S monitoring and reporting for implementation of their first-tier and second-tier lending. CFN's ESMS ensures that any PFI receiving funds is compliant with WB ESF requirements, and has an ESMS to manage the ESHS aspects of its subloans (for implementation of the credit line, CFN will enter into a Subsidiary Financing Agreement with eligible



PFI to on-lend to eligible MSMEs through Subloan Agreements). Under the proposed AF, E&S obligations will be contractually passed through to PFIs and MSMEs .

Regarding non-discrimination provisions, CFN lending policies, criteria and procedures and related capacity are aligned to national legislation in this matter, to ensure no discrimination against and provide reasonable accommodations for vulnerable and minority groups (IPs, afro-Ecuadorians, women, people with disabilities, LGBTQ individuals, other racial and ethnic minorities, etc.).

In accordance with national legislation, financial operations have a non-discrimination and inclusion perspective, a legal framework that also covers this operation. CFN verifies compliance with national law, and also carries out an evaluation of PFIs' parity and inclusion policies, with specific indicators. Specifically, the AF will promote a gender equality approach within this component and will include a specific gender indicator in the results matrix to measure the number of MSMEs owned and/or led by women receiving subloans with Project funds.

During the implementation of the parent Project, CFN demonstrated that most of the activities supported were related to financing working capital and acquisition of fixed assets for micro enterprises. In these cases no material E&S risks were found and the activity E&S risk was considered low, as the funds contributed to the flow of capital to support microenterprises operations. Additionally, a reduced portion of funds were allocated for working capital and asset acquisition for micro enterprises dedicated mainly to agricultural and manufacturing activities. In these cases, the associated E&S risks were considered low or moderate according to the project E&S instruments.

During the implementation of the parent Project CFN and the Bank agreed to finance the activity of "construction of houses for sale", whose E&S risk is categorized as moderate according to the criteria established in the general classification of activities carried out by CFN within the ESMS, reflecting the categorization of risks according to the ESF and section II. A. To ensure that "build for sale" activities fall within a low to moderate risk, the project's ESMS includes provisions, such as restrictions on the financing of certain economic activities, for which a thorough review is carried out through an Environmental and Social Risk and Impact Identification / Validation Procedure of a subloan by the PFI. In addition, prior to the financing of this activity, the submission of the relevant E&S permits for the subproject is required, along with OHS risk management tools and others described in the project ESMS section "a. Procedure for Identification / validation of E&S Risks and Impacts of a subloan by the PFI".

From the E&S risks identification and management point of view, the implementation of the activities under the parent Project have demonstrated its design and related E&S instruments provide strong features to the Project, since: (i) CFN has a E&S risk classification tool which ensures that any activity to be financed shall be considered of low or moderate E&S risk, regardless of the line of business or the purpose of the loan and therefore not requiring complex mitigation measures in any case; (ii) CFN relies the E&S management of the Project on PFIs whose environmental and social management system is validated in advance by CFN and according to the Project ESMS, and (iii) the final beneficiaries are not natural persons, but micro, small and medium-sized companies legally constituted, which provides an additional level of control since they are legally required to comply with national E&S regulations.

During the implementation of the Parent Project, CFN also demonstrated extensive capacity for the application of its ESMS as a tool for both the validation of the ESMSs/Instruments/mechanisms of the PFIs, as well as for the verification of the eligibility of the credits presented by the PFIs. From the E&S perspective, the process of pre-validation of PFI eligibility, as well as the processes to review and validation of compliance with all requirements,



which take place after credit placement, constitutes a double check that the project management meets E&S requirements according to the relevant ESSs. These processes have been detailed in CFN's semiannual compliance reports and through on-site visits where the Bank inspected the PFIs' ESMSs and verified that the PFIs have assigned qualified personnel to E&S management.

As a result of the assessment of the implementation of CFN's and PFIs' ESMSs, the Bank recognizes the following lessons learned: (i) ESMSs enable an effective initial E&S screening appropriate for project operation; (ii) are easy to apply for both second and first tier operations; (iii) clearly detail non-financeable and excluded activities; (iv) facilitate the verification of compliance of E&S legal requirements; (v) have become the basis for E&S management for CFN and some PFIs; and (vi) CFN's E&S management system was adopted as a base for enhancing the regulations of the banking system in Ecuador by making it mandatory for all financial institutions in the country to incorporate a mechanism for E&S risks and impacts management in the lending operations they finance.

As the AF anticipates retroactive expenditures reimbursement, prior disbursement of funds on a retroactive basis CFN will demonstrate that the funds allocated by the PFIs, and the financed activities, were compliant with the requirements of CFN's ESMS, and therefore with relevant requirements set forth in the ESSs. To this end, CFN will be required to provide the Bank with a consolidated report evidencing that allocated funds covered with retroactive financing are eligible under the criteria included in the POM, and therefore comply with E&S requirements under the project ESMS requirements (see more details under ESS9).

ESS10 Stakeholder Engagement and Information Disclosure

Standard 10 is relevant. Considering that this is a second-tier banking operation, the "primary" stakeholders are the financial institutions, both the participating ones and those that could potentially join later. In any case, the first instance of consultation, participation and feedback is given by this interaction, and since it is a financial product, the next instance are the beneficiaries of the loans granted with this line of financing, who receive information directly from the financial institution and maintain a communication relationship at the commercial level and also have access to the corresponding grievances redress mechanisms.

CFN has developed a Stakeholder Engagement Plan (SEP) that is tailored to the needs of the project in terms of consultation, participation and communication, which has been under implementation and will be kept in place for the AF. Regarding the implementation of the SEP, it should be noted that as this is a financial intermediation project, the PPPI program has been managed at two levels: i) a first level that addresses the relationship and participation between CFN, IFIs/IFPs, production associations and other stakeholders, with whom consultations have been carried out and permanent feedback has been received during the Parent Project implementation process; and, ii) a second level that addresses the relationship and participation of the final beneficiaries (MSMEs) with the IFPs. In this regard, CFN has implemented a broad communications strategy. In a first phase, the strategy was used to inform MSMEs about the developed or improved financial products available to them, including culturally appropriate material for beneficiaries belonging to indigenous peoples. Once the participation agreements were signed, the communication strategy was based on visits to the end users (MSMEs) to evaluate and document the progress made by the enterprises after receiving access to financing.

For this AF, CFN is updating the SEP, including a summary of stakeholder engagement conducted during the parent project implementation and strengthening the grievances redress mechanism chapter. This new version is under preparation and, according to the project ESCP will be further consulted, and ready to disclose no later than 60 days after the Effective Date.



B.2. Specific Risks and Impacts

A brief description of the potential environmental and social risks and impacts relevant to the Project.

ESS2 Labor and Working Conditions

This standard is relevant. This project is classified as a FI project and ESS2 applies to both the responsible FI itself and to second-tier FIs. CFN has a Human Resources department, called Human Talent Management, which coordinates the internal labor management of the institution. This unit is responsible for managing all the labor aspects related and ensuring compliance with labor regulations, in accordance with current national labor legislation.

CFN has prepared and keep its Labor Management Procedures instrument, which is aligned with the requirements of ESS2 and ESS9 and is the basis for ensuring compliance with local labor regulations in each of the participating institutions.

Regarding the risk associated with sexual harassment, CFN has a code of ethics that includes language related to sexual harassment in the institution and has protocols and procedures to address the occurrence of this type of events. For second-tier, the project includes requirements on prevention and attention to cases of sexual harassment and non-discrimination in second-tier financial institutions and performs the corresponding follow-up, as well as recording them in the corresponding GRMs. In this regard, during implementation, CFN has verified that the PFIs have mechanisms for the prevention and/or attention to cases of sexual abuse or harassment, such as codes of conduct and specific procedures, and as reflected in their performance reports, the PFIs have these procedures in place and there have been no cases of complaints or allegations of sexual harassment or abuse.

The document containing the labor management procedures (LMP) of this project are in force and will also be maintained for additional financing.

ESS3 Resource Efficiency and Pollution Prevention and Management

This standard is relevant but given the nature of the envisioned sub-projects is likely to be addressed through screening and compliance with local/national laws per paras. 14 and 16 of ESS 9.

FI subprojects for activities and sectors of substantial and/or high risks won't be financed with this operation. CFN's ESMS will include provisions to consider ESS3 requirements in the screening of all FI-Subprojects to exclude any subprojects with significant adverse impacts related to this standard. Even though the exact investments to be financed by MSMEs will not be known until implementation, no significant pollution and resource efficiency issues are expected to arise in the supported subprojects.

As described under the E&S Overview section, clearly defined eligibility criteria will be followed during the implementation of the AF. Eligibility criteria for productive investments (e.g., new equipment and machinery, vehicles, etc.) to be financed by MSMEs will include the use of best available technology (BAT), energy efficiency, and low-carbon considerations, as defined in the Project Operations Manual.

Given the nature of the sub-projects and the focus on providing a line of credit for working capital, there will be only a negligible difference in GHG emissions, thus no GHG accounting will be performed for the AF.



ESS4 Community Health and Safety

This standard is relevant but given the nature of the sub-projects is likely to be addressed through screening and compliance with local/ national laws per paras. 14 and 16 of ESS 9.

As under the parent Project, for subprojects to be financed by CFN, CFN’s ESMS will assess sub-project activities that may pose community health and safety risks. Given that the AF will finance loans to MSMEs for productive purposes, meaning working capital or investments that will help firms to run their businesses, improve their production process, improve business management, create or improve their products, the most important community health and safety potential risks could be related to temporary construction such as dust, noise, disposal of hazardous and non-hazardous wastes, safe operation of vehicles etc. Labor influx and related risks are not expected. The effective ESMS includes provisions to consider ESS4 requirements in the screening of all FI-Subprojects to exclude activities that could involve significant risks associated with community health and safety.

ESS5 Land Acquisition, Restrictions on Land Use and Involuntary Resettlement

This standard is not relevant.

Land acquisition is part of the exclusion list of the project. The project doesn’t support any sub-projects that require expropriation of land under Ecuadorian expropriation law. The Project will not finance subloans for activities that require the acquisition/renting of land through expropriation of land under Ecuadorian law, that involve involuntary resettlement (physical, economic relocation or restriction of access) or activities that promote involuntary physical and economic displacement of people and their economic activities; these include activities such as adjudication of disputed land or activities to be carried out on disputed land.

Subprojects requiring physical expansion will be subject to due diligence to verify that physical and economic displacement of people and their economic activities or restriction of access to natural resources is not required. In cases where the financed activity includes land purchase for productive purposes, the PFI shall conduct due diligence that includes a mandatory assessment as described in Annex 6 of the CFN’s ESMS, in order to validate that the productive activity to be financed does not contradict the project’s exclusion list and does not motivate involuntary physical or economic displacement or resettlement.

ESS6 Biodiversity Conservation and Sustainable Management of Living Natural Resources

As under the parent Project, this ESS is not expected to be relevant to the AF.

Eligible MSMEs will not receive loans for new primary production activities that would require a footprint expansion within environmental sensitive areas. The ESMS incorporates a list of excluded activities that could result in substantial or high risk Environmental and Social impacts, including interventions that interfere with natural and/or critical natural habitats, specifically those that involve significant conversion or significant degradation of these habitats.

The ESMS includes specific requirements to make sure that these do not convert or degrade any critical habitat and that are only of low or moderate risk nature in circumstances where the potential subprojects of the MSMEs involve



new or renewed forestry or agricultural plantations. For subprojects involving primary production and harvesting of living natural resources, the ESMS includes provisions requiring the assessment of the overall sustainability of these activities, as well as of their potential E&S impacts, in line with paras. 31-35 of ESS6. Also, in view of the potential for plantation subprojects to introduce invasive alien species, the ESMS ensures such subprojects are designed to prevent, reduce, and mitigate these potential threats to natural habitats.

The relevance of this ESS was assessed during the parent Project implementation and CFN demonstrated through its semi-annual reports that no funding requests were accepted, nor loans granted, for activities that could result in the degradation of environmentally sensitive areas, or may affect the conservation of biodiversity. Even if subprojects with minor impacts on biodiversity cannot be excluded, these impacts are expected to be addressed through compliance with local/ national laws per paras. 14 and 16 of ESS 9.

ESS7 Indigenous Peoples/Sub-Saharan African Historically Underserved Traditional Local Communities

This standard is not relevant but given the nature of the sub-projects it's addressed through screening and compliance with local/ national laws per paras. 14 and 16 of ESS 9.

CFN's exclusion list for first-tier lending states that no activities, works, or projects will be financed that "violate the rights of indigenous, afro-Ecuadorians and other ethnic minorities, as established in Ecuadorian laws and in the international conventions". Similar provisions apply to second-tier lending operations and are also part of its ESMS screening process and exclusion list for the project, complemented as needed to exclude any projects that involve substantial or high risks or adverse impacts on indigenous peoples. As described in the ESMS, provisions to avoid negative impacts on indigenous peoples are established in the preliminary evaluation of the environmental and social risk assessment systems that CFN performs prior to disbursing to the PFIs. Based on the general classification of activities and exclusion lists. Subloans with a risk level higher than that established in the project's eligibility criteria may not be financed with this line of funding. Additionally, as part of its criteria for justifying resources, CFN identifies how its operations are aligned with Financial Inclusion and Diversification, where it counts how many operations correspond to MSMEs represented by indigenous, Afro-Ecuadorian or Montubio communities, which is evaluated and monitored by CFN, through specific indicators.

ESS8 Cultural Heritage

This standard is relevant. Given the nature of the sub-projects is likely to be addressed through screening and compliance with local/ national laws per paras. 14 and 16 of ESS 9.

It is not anticipated that FI subprojects will have direct or indirect impacts on tangible or intangible cultural heritage and the exclusion list incorporates restriction for financing projects located i) within a legally protected area or a legally defined buffer zone; ii) located in, or in the vicinity of, a recognized cultural heritage site; or, iii) specifically designed to support the conservation, management and use of cultural heritage. CFN's ESMS includes provisions to consider ESS8 requirements in the screening of all FI-Subprojects to exclude activities that could involve significant impacts on cultural heritage. It is important to note that Ecuador has a well-developed legislative framework for the protection of its cultural, historical and archeological heritage under the environmental licensing process. Therefore, for any subprojects, including earth movement, the ESMS includes the preparation of a chance find procedure in accordance with national laws and regulations.



ESS9 Financial Intermediaries

This standard is relevant.

The AF aims at supporting CFN to expand second-tier lending operations to serve MSMEs through private PFIs. The same as under the parent Project, CFN will assume the credit risk of the PFIs, while the latter will take on their books the credit risk of the MSMEs. As such CFN is required under this operation to continue to monitor and manage the environmental and social risks and impacts of the 2nd tier FI Subprojects through an ESMS.

Under the parent Project, CFN developed, implemented, and maintained an ESMS, consistent with the requirements set out in ESS9 and proportionate to the 2nd tier FI subproject risks. The WB issued the no objection of the CFN's ESMS.

The ESMS, as defined in ESS9, includes:

- (a) E&S policy: CFN created a specific policy in compliance with the ESF.
- (b) Clearly defined E&S procedures and capacity: to screen subprojects (application of exclusion list, review of industry sector and technical aspects of each subproject) and conduct due-diligence to evaluate E&S risk and assign risk categories (low, moderate, substantial and high risk). High and substantial risk subprojects will be excluded.
- (c) Systems/processes for due diligence to evaluate, monitor, review and manage E&S risks and impacts of subprojects: evaluate the E&S performance of on-going subprojects and the portfolio on a periodic basis.
- (d) organizational capacity and competence: including a budget and a senior management position designated for reporting on the ESMS as well as providing training and capacity-building on ESMS procedures and performance.
- (e) External communications and reporting mechanisms on E&S performance.

As the AF anticipates retroactive expenditures reimbursement, CFN will provide evidence that the funds allocated by the PFIs, and the financed activities, were compliant with the requirements of CFN's ESMS, and therefore with the applicable requirements set forth in the ESSs. To this end, in order to demonstrate that the expenditures to be retroactively recognized fulfilled the requirements of the relevant ESSs, CFN will be required to provide the Bank with a consolidated report evidencing that allocated funds to be recognized under retroactive financing complied with the requirements set forth in the ESSs relevant to the Project. The report may be part of the semiannual compliance report.

The same as under the parent Project, CFN will require that the participating PFIs implement or update their ESMS. The requirements of the ESMS for PFIs will be the same as those requested by the WB to CFN. The IPFs ESMSs should include at a minimum the following components (refer to ESS9 for further details on the ESMS and its different components) : (a) E&S policy; (b) E&S procedures and capacity to screen subprojects conduct due-diligence to evaluate E&S risk and assign risk category; (c) systems/processes for due diligence to evaluate, monitor, review and manage E&S risks and impacts of subprojects; (d) organizational capacity and competence; and (e) external communications and reporting mechanisms on E&S performance.

The project's Operational Manual establishes that one of the eligibility criteria for PFIs is to have an Environmental and Social Management System (ESMS) that complies with the criteria established in the Project's E&S instruments described in the ESCP and in CFN's ESMS. This criteria has allowed CFN, prior to signing the participation agreement,



to evaluate the E&S assessment systems that the PFIs have, and to verify them through the application of a specific tool ensuring they have the capacity to manage their operational risks and impacts. Given that the alignment of CFN's ESMS with the E&S evaluation mechanisms used by the PFIs is mandatory, it has been observed that the process of evaluation and validation of loans placed has been effective during the implementation of the project, as reflected in the semi-annual reports.

As a contractual condition, CFN requires each PFI to appoint a senior representative from their management/administration to have overall responsibility for environmental and social performance, and an environmental and social specialist to be responsible for the day-to-day implementation of the ESMS. This information is submitted with the documentation of the PFI, prior to the Participation Agreement suscription, within a letter suscribed by the general manager of the PFI.

More information on the Exclusion List and evaluation of E&S risks is detailed in the sections under ESS1-8 above.

C. Legal Operational Policies that Apply

OP 7.50 Projects on International Waterways No

OP 7.60 Projects in Disputed Areas No

B.3. Reliance on Borrower’s policy, legal and institutional framework, relevant to the Project risks and impacts

Is this project being prepared for use of Borrower Framework? No

Areas where “Use of Borrower Framework” is being considered:

None.

IV. CONTACT POINTS

World Bank

Contact: Raquel Alejandra Letelier Title: Senior Financial Sector Specialist

Telephone No: +1-202-458-5408 Email: rletelier@worldbank.org

Borrower/Client/Recipient

Implementing Agency(ies)

Public Disclosure



V. FOR MORE INFORMATION CONTACT

The World Bank
1818 H Street, NW
Washington, D.C. 20433
Telephone: (202) 473-1000
Web: <http://www.worldbank.org/projects>

VI. APPROVAL

Task Team Leader(s):	Raquel Alejandra Letelier
Safeguards Advisor ESSA	Pablo Cardinale (SAESSA) Concurred on 06-Apr-2023 at 16:06:59 EDT