Project Information Document (PID)

Concept Stage | Date Prepared/Updated: 17-Jan-2020 | Report No: PIDC28213

BASIC INFORMATION

A. Basic Project Data

Country	Project ID	Parent Project ID (if any)	Project Name
Ecuador	P172899		Promoting Access to Finance for Productive Purposes for MSMEs (P172899)
Region	**Estimated Appraisal Date**	**Estimated Board Date**	**Practice Area (Lead)**
LATIN AMERICA AND CARIBBEAN	Mar 23, 2020	May 28, 2020	Finance, Competitiveness and Innovation
Financing Instrument	**Borrower(s)**	**Implementing Agency**	
Investment Project Financing	Corporación Financiera Nacional	Corporación Financiera Nacional	

Proposed Development Objective(s)

The project development objective is to promote access to finance for productive purposes for MSMEs

PROJECT FINANCING DATA (US$, Millions)

SUMMARY

Total Project Cost	150.00
Total Financing	150.00
of which IBRD/IDA	150.00
Financing Gap	0.00

DETAILS

World Bank Group Financing

International Bank for Reconstruction and Development (IBRD)	150.00

Environmental and Social Risk Classification	Concept Review Decision
Moderate	Track II-The review did authorize the preparation to continue

Other Decision (as needed)

B. Introduction and Context

Country Context

1. **After sustaining more than a decade of robust growth on the back of high oil prices, Ecuador has seen a marked slowdown in Gross Domestic Product (GDP) growth since oil prices plummeted in mid-2014.** The remarkable episode of stable growth experienced during 2001-2014, where annual GDP growth averaged 4.5 percent, marked a break with two decades of booms and busts. Initially driven by stabilization reforms and the decision to adopt the US dollar as the legal tender in the early 2000s, growth was later fueled by high oil prices. However, this boom hid the accumulation of large macroeconomic imbalances and some structural problems such as an inefficient public sector, a lack of stabilization mechanisms in a dollarized economy, loss of competitiveness due to persistent inflation differentials with the US and limited private investment. These deficiencies became further evident when oil prices fell in 2014, exposing the inconsistency of the fiscal path with the dollarization framework. The ensuing fiscal consolidation combined with declining oil production and feeble private demand brought down average GDP growth to just 0.6 percent between 2015 and 2018, with no gain in poverty reduction and shared prosperity (the percentage of the population living below the national poverty lines and the Gini coefficient have remained at around 23 percent and 0.47, respectively since 2014). While official unemployment reached 4.6 percent in March 2019 (up from 3.7 percent at end-2018), the ‘adequate employment’ rate for the population working at least 40 hours per week and/or earning at or above the minimum salary of US$394 per month fell to a ten year low of 37.9 percent. More than 21,000 public-sector workers lost their job over the past year due to a reduction of the public wage bill, yet these losses are a fraction of the 241,000 private sector workers that lost employment in the same period.

2. **To address structural deficiencies and counter economic vulnerabilities, restore growth and improve essential social outcomes, the authorities have developed a comprehensive policy plan supported by international financial institutions.** This plan includes measures to ensure fiscal sustainability, strengthen the foundations of dollarization, and promote private investment while guaranteeing social protection of the most vulnerable population. The plan is being supported by a US$ 4.2 billion Extended Fund Facility agreed with the International Monetary Fund (IMF) in March 2019, with other international financial institutions committed to provide additional US$ 6 billion over three years. The International Bank for Reconstruction and Development (IBRD) approved an initial US$ 500 million Development Policy Loan (DPL) in June 2019 and is currently discussing the provision of additional US$ 300 million. The implementation of the plan has slowed down after the Congress in November rejected a comprehensive package of reforms submitted by the government. However, there are recent signs that the reform agenda is regaining momentum, with a reform of the tax code approved in December. This should pave the way for other important reforms to be approved during the first half of 2020. Ongoing consolidation efforts and recent social unrest are expected to lead to a 0.3 percent contraction in economic activity in 2019 yet growth should resume gradually during 2020-2022. This is, however, conditional upon an increase in private investment and non-oil exports that should compensate for lower public spending. The latter combined with the creation of employment in the private sector are also crucial to maintain consensus for the reform program and ensure its sustainability as the public sector goes through a significant downsizing.

Sectoral and Institutional Context

3. **Ecuador has a rather atypical financial sector structure.** Banks are the backbone of the financial system in Ecuador, accounting for nearly 80 percent of the system's assets. The banking sector includes three main segments: private banks, public banks and financial cooperatives. Twenty-two private banks account for about two thirds of the financial system's assets and about half of total banking sector assets. Public banks have gained importance in the provision of financial services over the past decade, and account for just under 20 percent of credit operations by the financial system. About 450 financial cooperatives also play an important role in the financial system, accounting for about a quarter of total banking assets. The banking system is prima facie stable and well-capitalized. Compared to private banks, public banks (and financial cooperatives) are subject to weaker regulatory requirements and oversight, contributing to relatively lower performance and posing relatively higher risks. Capital markets are underdeveloped compared to those in Latin America and the Caribbean (LAC) region, with limited participation of institutional investors.

4. **The banking sector's role in supporting private sector-led growth has substantially been constrained due to government interventions.** The sector is shallow, with private credit to GDP standing at 29 percent versus 48 percent in Colombia, 37 percent in Peru and 49 percent on average in LAC. Some of this has been due to the crowding out of the private sector by the public sector. Excessive liquidity requirements on banks have contributed to crowd out private sector financing. Moreover, central bank financing of the public sector has been particularly significant since the 2014 decline in oil prices, which adversely impacted government revenues. Central bank financing has been complemented by the pervasive presence of interest rate caps across all credit segments, limiting private banks' involvement in several sectors due to the binding nature of the ceilings in several markets. In 2018, legislative and other steps were taken to put an end to new central bank financing of the government and to the quasi-fiscal activities of the central bank. As part of the package of reforms agreed with the IMF, the authorities intend to go further in the coming months to bolster the central bank's autonomy and governance arrangements. As a part of the current DPL discussions, the World Bank is providing support to the authorities to gradually revise the current interest rate management framework to make it more responsive to cyclical and structural developments. These upstream reforms are expected to contribute to unlock private sector solutions in the future, other things being equal.

5. **Businesses, particularly micro, small, and medium enterprises (MSMEs), unsurprisingly consider access to finance to be an important obstacle to investment and to innovation.** This is despite relatively high and rising levels of banking penetration in the general population that are above those of some neighboring countries. The use of banks by Ecuadorian firms to finance investments is lower than the average for the region and for similar income country groups, while access to long-term finance is low even for large companies. MSMEs face particular difficulties in accessing financing. The tenors offered by private sector banks are short, usually less than two years, and few products are tailored to small businesses, as higher administrative costs lead banks to prefer to devote their efforts to large corporate clients. Moreover, there are no MSME-focused banks in Ecuador. Large corporations are catered to by private banks and some micro firms are served by financial cooperatives, leaving most micro and the SME segment underserved. Interest rate caps on loans to MSMEs add to the reluctance of banks to work with smaller firms, as the high transaction costs and the high risks associated with this segment make it non financially viable in most cases. International experience shows that MSMEs are more vulnerable to business cycle fluctuations and more susceptible to credit rationing. Therefore, ensuring adequate access to financing for MSMEs is critical for restoring growth and for job creation as MSMEs account for about 60 percent of formal employment in Ecuador. Traditionally, public banks have responded to the gaps left by the private banks, offering longer tenors and operating in sectors and regions that are underserved by the private sector.

6. **The *Corporación Financiera Nacional* (CFN) is the public bank that provides financing services to the productive sector, including SMEs.** Established in 1964, CFN is the oldest and largest state-owned development bank in Ecuador. It largely focuses on financing fixed assets and working capital as first-tier lender, but it plans to gradually transition to a modern second-tier bank to complement private lenders and crowd in commercial financing. In this context, it is already

working with a number of private banks and large financial cooperatives, which would act as participating financial institutions (PFIs) for this Project. CFN also manages a credit guarantee fund (National Guarantee Fund) to stimulate private lenders' financing to SMEs and acts a merchant bank, with equity participations in several companies including *Banco Pacífico*, the second largest commercial bank in the country. While well-capitalized, similar to other public banks in Ecuador CFN presents some key challenges that require immediate attention, including:

- **Poor corporate governance,** with unclear mandate and a board of directors prone to political interference, reflecting weaknesses in the legal framework (*Código Orgánico Monetario y Financiero*, the financial sector law);
- **Unsustainable funding structure**, which until recently relied on central bank financing but that after legislative reforms prohibiting central bank funding is left with an estimated finding gap of US$ 210 million in 2020;
- **Conflicting performance targets,** arising from the fact that public banks are required to meet annual lending targets with no regard for quality, resulting in relatively poor credit underwriting standards, which in the case of CFN are reflected in a very high level of nonperforming loans (13 percent at June 2019, compared to an average of 3 percent for private banks) and substandard loans (about one third of its loan portfolio);
- **Unlevel playing field and weak oversight**, as a result of several regulatory exemptions compared to private banks and conflicting powers of the non-independent financial supervisor overseeing high level government officials running public banks.

7. **The authorities are eager to reform CFN and other public banks to turn them into modern development banks with a clear mandate and sustainable business model.** With World Bank Group support, the authorities have prepared a reform of the *Código Orgánico Monetario y Financiero*, which includes a profound revision of the corporate governance framework of public banks to bring it in line with international best practices (expected to be submitted to Congress in the first half of 2020). At the same time, the authorities have requested World Bank Group technical assistance to undertake a financial viability diagnostic of public banks followed by the design of a new strategy based on second-tier lending. In the interim, public banks need fresh resources to be intermediated to the productive sector to stimulate investment, create jobs and mitigate the negative effects of ongoing fiscal consolidation, particularly on the bottom forty percent. This Investment Project Financing (IPF) forms part of this broad reform agenda supported by the World Bank Group.

Relationship to CPF

8. **The proposed Project is fully congruent with the Country Partnership Framework (CPF) for FY19-23 Result Area I: Supporting Fundamentals for Inclusive Growth[1].** Specifically, this Project contributes towards Objective 3 (Improve financial sector inclusion and intermediation) as it will promote a more efficient allocation of resources while crowding in commercial bank financing and including a larger number of SMEs in the formal financial sector. This IPF also contributes to Objective 1 (Enhance efficiency of public spending) as it will help remove a potential source of contingent liability for the government thus increasing fiscal efficiency. Finally, the Project contributes indirectly to Objective 2 (Improve conditions for private sector development) as it will stimulate private investment in the productive sector.

C. Proposed Development Objective(s)

9. **The project development objective is to promote access to finance for productive purposes for MSMEs.**

[1] Report No.135374-EC http://documents.worldbank.org/curated/en/633491560564064529/pdf/Ecuador-Country-Partnership-Framework-for-the-Period-of-the-FY19-FY23.pdf

Key Results (From PCN)

10. **The key results expected for the proposed Project will be measured by three PDO indicators:** (i) number of loans for productive purposes disbursed to MSMEs under the Project, (ii) volume of total loans disbursed through private eligible PFIs to MSMEs, and (ii) non-performing loan (NPL) ratio of lending from PFIs to final borrowers.

D. Concept Description

11. **The proposed Project is a US$ 150 million IBRD financial intermediary lending operation that will be executed in five years with the objective of promoting access to finance for productive purposes.** The proposed Project would support the borrower and implementing agency, CFN, to: (i) strengthen the institutional capacity of CFN, (ii) develop and/or improve financial products to promote access to finance; and, (iii) create and expand second-tier lending operations for MSMEs.

12. **The proposed Project consists of four main components:** (1) Strengthening the institutional capacity of CFN, (2) Development and improvement of financial products to promote access to finance; (3) Credit line intermediated by CFN to PFIs for on-lending to MSMEs; and (4) Project management.

13. **Component 1 - Strengthening the Institutional Capacity of CFN (US$ 3 million, IBRD).** This component will provide technical assistance and capacity building to CFN. Under this component the Project would finance, *inter alia*: (i) the design of a corporate governance strengthening plan for CFN; (ii) an assessment of the financial viability of CFN, (iii) an assessment of the current strategy and business plan of CFN, (iv) design and implementation of a monitoring and evaluation strategy to measure the effect of access to credit within final borrowers; and (v) design and implementation of an environmental and social management system and standards for second-tier lending.

14. **Component 2 - Development and Improvement of Financial Products to Promote Access to Finance for MSMEs (US$ 20 million, IBRD).** This component will support CNF 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 will finance: (i) technical assistance to strengthen the National Guarantee Fund for MSMEs and the e-Factoring platform, (ii) capitalization of the National Guarantee Fund for MSMEs, and (iii) technical assistance to design, test, and evaluate new financial products for MSMEs with potential to be scaled up.

15. **Component 3 - Credit Line Intermediated by CFN To PFIs for On-Lending to MSMEs (US$ 125 million, IBRD).** This component will support 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 will 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 latter will take on their books the credit risk of the MSMEs. Beneficiary MSMEs will include firms from sectors with high potential for productivity growth as well as female owned enterprises and first-time borrowers.

16. **Component 4 - Project Management (US$2 million, IBRD).** This component will focus on supporting CFN to effectively execute the Project. Under this component, the Project will finance, inter alia: (i) the recruitment and training of the Project Coordination Unit (PCU) team members including, if necessary, specialists responsible for procurement procedures, financial management, environmental and social management, and the overall execution of the Project; (ii) the acquisition of equipment and furniture for the PCU; (iii) monitoring and evaluation activities; (iv) study tours for

relevant CFN staff; (v) stakeholder and citizen engagement plan, including implementation of a Grievance Redress Mechanism (GRM); (vi) communication strategy; and, (vi) the Project's financial audits.

Legal Operational Policies	Triggered?
Projects on International Waterways OP 7.50	No
Projects in Disputed Areas OP 7.60	No

Summary of Screening of Environmental and Social Risks and Impacts

CONTACT POINT

World Bank

Pietro Calice, Daniel Ortiz del Salto
Senior Financial Sector Economist

Borrower/Client/Recipient

Corporación Financiera Nacional
Pablo Patino
General Manager
ppatino@cfn.fin.ec

Verónica Maldonado Matute
Gerente de Negocios Financieros y Captaciones
vemaldonado@cfn.fin.ec

Implementing Agencies

Corporación Financiera Nacional
Verónica Maldonado
Gerente de Negocios Financieros y Captaciones
vemaldonado@cfn.fin.ec

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

APPROVAL

Task Team Leader(s):	Pietro Calice, Daniel Ortiz del Salto

Approved By

Environmental and Social Standards Advisor:		
Practice Manager/Manager:		
Country Director:		