AIRGRAM

PD-AAF-775 (2)

DEPARTMENT OF STATE

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TO · AID/W TOAID A-89

ENTERED 10/20/76

DATE SENT 10-29-75

FROM · USAID/Quito

SUBJECT · Evaluation and Proposed Restructuring of Loan 518-L-034

REFERENCE · a) TOAID A-80; b) STATE 155355; c) STATE 125404

A. SUMMARY

(The classified Summary section of this airgram was forwarded on 10/28/75, registry No. 1948488).

B. BACKGROUND

The loan was authorized in June, 1970, to provide credit resources and technical assistance in support of a GOE program of small industry development. It was designed to facilitate institutional innovation and establish a mechanism through which AID-financed inputs could be channeled to expand and modernize operations of the target group, small entrepreneurs. Thus, two classes of outputs were envisioned in the project design. One class was intermediate outputs or the establishment of certain acceptable institutional and administrative arrangements. The other, dependent class of outputs was credit and technical assistance to small entrepreneurs.

The implementation of L-034 was initially slowed by a series of factors exogenous to the project. A 23 month delay occurred between the authorization date and date of loan signature in May of 1972. In early 1973, a complete turnover of GOE technical staff in charge of project management caused a second loss of loan momentum. This turnover also meant the loss of all GOE personnel who had

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PAGE 1 OF 13 PAGES

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AID AND OTHER CLEARANCES

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participated in designing the loan and its operational specifics and led to the appointment of new personnel of differing outlook. The cumulative effect of these factors was a weakening of the institutional and administrative arrangements for implementing the loan.

Further implementation difficulties were created in mid-1973 by GOE passage of its "Fondos Financieros" legislation. This legislation altered and adapted the prior "Trust Fund" mechanism for implementing the loan in order to accommodate new GOE initiatives, such as the levying of portfolio distribution requirements on private banks, the creation of internal lines of short term credit and so forth. Moreover, the legislation spun-off technical GOE personnel from the Central Bank to the Ministry of Industries, resulting in fragmentation of the loan's implementing structure. This fragmentation - or separation of technical (project appraisal) from financial (credit risk) responsibilities - has continued and is identified by both GOE and USAID as the primary structural bottleneck constraining loan use at present. That is, the Ministry personnel appointed in early 1973 have defined their role as the technical one of generating small entrepreneur investment proposals. Little regard has been shown for the criteria of participating banks or the Central Bank. For this reason, the banks have been reluctant to rely upon the Ministry's credit approvals or technical capabilities.

Due primarily to the fragmented implementing structure, the level of sub-lending to small entrepreneurs from L-034 has fallen short of expectations. It is possible, however, to briefly assess the loan's performance at the output level. Between the meeting of CP's to Initial Disbursement in late 1972 and 9-30-75, L-034 had financed 32 subloans, with corresponding disbursements of $480,000. Thirteen of these subloans were extended in Quito/Guayaquil while 19 were outside the major cities, including rural and small city operations in Vinces, Milagro, Portoviejo, Manta, Montecristi and Riobamba. Approximately $168,000 was disbursed for short-term purposes with around $312,000 disbursed for medium to long-term purposes, primarily equipment/machinery financing. Small manufacturing industries benefitting to date from loan-financed credits include makers or processors of metal, plastic products, small appliances, furniture, windows, bricks, glassware, food preserves, sausages, rubber tires, poultry, rock crushing, rice, etc. Although not fully verified, it is estimated that 165 jobs have been directly created in these enterprises as a result of receiving loan-financed credits. This estimate of job-creation is, at present, the

only available indicator of benefit incidence at the project purpose level. There have not yet been enough subloans (outputs) to warrant attempts at measuring other purpose level benefits such as the extent of expansion or modernization among credit recipients, e.g. in terms of percentage increments in production and income.

The major accomplishment of L-034 to date has been of an institutional or intermediate output nature. Taken together with a 1970 World Bank cattle loan and AID Loans L-032 and 033, the Small Enterprise Assistance Loan was instrumental in establishing the Central Bank facility for the rediscount financing of developmental credits extended by the public and private banking systems. The Central Bank had previously limited its concerns to macro-economic problems, e.g. balance of payments and public finance. This new facility has successfully mobilized and channeled GOE resources - mostly in the form of short-term lines of credit - to a variety of productive uses in the agriculture, industrial, fishing and tourism sectors. L-034 has thus helped institutionalize an approach to a pressing GOE need, namely the need to open new channels for the movement of Ecuador's resources to developing sectors. The GOE continues to self-improve the effectiveness of its financing facility on the basis of experience with it.

In brief, the institutional effect of L-034 and the other loans mentioned above has been substantial and worthwhile. It is now accomplished. The real task of this joint GOE-USAID evaluation was to identify bottlenecks to the use of L-034 and ways of overcoming them in order to facilitate a more rapid flow of project outputs and, thus, increased benefits as measured by job-creation and incremental production from the target enterprises.

This task has been facilitated by a dynamic new Minister of Industries with a strong private banking background. His proposals and wishes are reflected below. We believe other key changes in the GOE will also have a positive influence upon implementation of the loan. One is the early October appointment of a new General Manager at the BNF who has close working knowledge of AID loan projects L-032, L-033, and L-034. Another is the new Minister of Financing - appointed in September - who shares this prior experience with, and interest in, these loan projects.

C. PROJECT BOTTLENECKS AND PROPOSALS TO OVERCOME THEM

1. Ineffective System of Dual Credit Approvals. As briefly described above, the movement of L-034 has been constrained by a fragmented implementing structure. That is, the role of the Ministry unit has not been coordinated well with the role of the participating banks and vice versa. This is evidenced by communication difficulties, a duplication of efforts and a resulting proliferation of red tape and paperwork as each institution continues to utilize its own system of processing credit requests. Symptomatic of such ailments are loan progress reports from the Ministry unit. These reports show large numbers and amounts of credits approved at the Ministry but do not include data on the participating bank approvals necessary to finance the credits. In brief, as the structure now stands, both the Ministry and the participating bank separately approve a credit before it becomes eligible for discount at the Central Bank and subsequent reimbursement by AID. The length of, and difficulties inherent in, this system of dual credit approvals is identified by both GOE and USAID as the primary, structural bottleneck to improved performance of the L-034 project.

The proposal for eliminating this bottleneck is to restructure the process by which credit proposals are reviewed, approved and, subsequently, monitored. The agreement is to change the nature of services performed by the Ministry unit, assigning sole credit decision authority to the Participating banks who retain all credit risks. The Ministry will maintain responsibilities for the monitoring of loan-financed investments and general follow-up TA. In addition, the Minister has strongly expressed that increased promotion of the loan project will be carried out by the Ministry unit. This means that participating banks will go directly to the Central Bank with eligible credits for discount to the AID loan. The prior requirement of dual credit approvals by both Ministry and participating bank is thus eliminated.

The role of the Ministry unit in monitoring loan-financed investments will be further detailed in the revised Manual of Operations and the new Annex No. 1 to the Loan Agreement.

2. Complex Procedure of Partial Discounts. L-034 currently finances not more than 80 percent of eligible subloans on a credit-by-credit basis. This causes a subsidiary division of credits and repayment notes into parts of 1/5th and 4/5ths which results in time-consuming paperwork and red tape between the Central Bank and participating banks. Financing by partial discounts is another bottleneck to the use of L-034.

The proposal for overcoming this bottleneck is to permit 100 percent AID loan-funding of eligible medium and long-term credits. Participating banks will finance all short-term credit requirements of the target group. In addition, banks will cover any difference between the CIF and sales price of imported equipment/machinery. This means that, on a global basis, the banks will be financing substantially more than 20 percent of target group needs.

3. Unduly Low Limit on Subloan Size. Another bottleneck constraining the movement of L-034 is the original $30,000. limit on size of subloan. This limit was established in early 1970, along with a $60,000. limit on sub-borrower assets. Given the wide range of small industry - and the correspondingly different levels of capital investment needed (e.g., small metal working firms have high fixed requirements) - these limits now appear to have been too low even in the beginning of the loan project. Since 1970, world-wide inflation has made those limits clearly unrealistic.

With AID/W approval, we previously settled upon $80,000. or sucre equivalent as the maximum size of eligible credit. The proposal resulting from current negotiations is a minor increase in that limit to $100,000. or sucre equivalent. A corresponding increase in the asset limit to $200,000. is also proposed*.

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* The GOE proposed that the loan finance credits of up to $200,000. or sucre equivalent which is the current limit on both lending and sub-borrower assets in the Ecuadorean Law for Small Industry and Artesan Development. We questioned whether firms needing $200,000. credits were the same as the target group addressed by the loan and indicated that other sources of financing seemed available to these larger firms, e.g. COFIEC and CV-CFN, Ecuador's financieras for industry. The outcome of the give-and-take on this issue was the compromise proposal shown above.

4. Regulatory Restriction. This bottleneck is a restrictive regulation of the GOE Monetary Board. To date, the Central Bank has been unable to discount credits extended at other than 9 percent interest unless special exceptions are legislated (as have been for the World Bank cattle loan, part of which goes out at 12 percent). One effect of this restriction has been to exclude 8 percent BNF "créditos de capacitación" from financing by L-034.** A large part of the demand for these special credits (described below) is going unfilled due to limited BNF credit resources for small industry. The Minister proposes to make the regulatory amendment needed to allow discounts and loan-financing of them.

BNF "créditos de capacitación" are directed toward the marginal segment of Ecuador's small industry sector. The BNF applies the following criteria in determining whether the client is entitled to these 8 percent credits or BNF "créditos bancarios" at higher rates. The entrepreneur must work in the firm and derive at least 50 percent of his income from it. He is unable to obtain credit from other sources at reasonable terms. This program is conducted throughout the BNF's country-wide system of 54 branches. It thus benefits the rural entrepreneur as well as those in Quito and Guayaquil.

Implementation of this regulatory change will facilitate loan-use for the benefit of small entrepreneurs most needing it. The proposal is feasible in terms of our mandate to assist the poor majority in rural areas. It is also feasible and meaningful because of the demand factor mentioned above.

** The Capital Assistance Paper (p. 34 and p. 5) contemplated assistance to the BNF in its "capacitación" program. The assistance has not yet materialized due to the above bottleneck.

Our assessment is that, if the four proposals described above are approved and implemented, performance under L-034 will improve dramatically. Breaking current bottlenecks will increase the flow of subloans to target enterprises. This, in turn, will lead to additional benefits at the project purpose level, including job creation and the production - enabling effect of expanded and modernized facilities. Finally, the post loan period replication of these benefits - encouraged by a stronger BNF and an improving GOE financing facility - will continue contributing to the original project goal: a vigorous, growing "middle class" of industry and the stabilizing influence that implies.

D. PROPOSED PERFORMANCE TARGETS

The GOE proposes revised performance (disbursement) targets, extending through 6-30-77. We believe that these targets are realistic and that implementation of the joint GOE-USAID restructuring proposals will maximize the probabilities of drawing down the $3.8 million loan balance in accordance with them. The targets are as follows:

Performance Period	Performance Target
Through 6-30-76	$ 800,000.
7-1-76 through 12-31-76	$ 1.2 million
1-1-77 through 6-30-77	$ 1.8 million

These targets, along with the procedure of semi-annual reviews and deobs (if any), will be confirmed in the Implementation Letter extending the TDD. The GOE understands that any shortfalls below the agreed targets will be promptly deobligated from the loan.

E. ACTION REQUESTED

The following AID/W actions are requested:

1. Approval of the joint proposals described in Section C above.

2. Approval of the revised performance targets outlined in Section D above.

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BREWSTER

A N N E X

Subject: Loan Agreement No. 518-L-034
Small Enterprise Assistance
Implementation Letter No.

Dear Mr. Minister:

This Implementation Letter forwards the recently executed Amendment to the Loan Agreement. In addition, it includes the revised Annex No. 1 to the Agreement, Description of The Project.

The attached Loan Agreement Amendment is self-explanatory. It eliminates reference to the Trust Fund in Article V, thereby reflecting and confirming mutually agreed Special Covenants and Warranties. You will also note that Section 5.01 d) now provides that banks participating in the Project may meet their 20 percent contribution requirement on a global, rather than credit-by-credit, basis.

Pursuant to Section 1.02 of the Loan Agreement, and on the basis of our recent agreements and your letter No. ----, the Loan Agreement Annex is revised as shown below. The revised Annex reflects the current loan budget as well as arrangements and responsibilities for administering the Project. As you know, these arrangements and responsibilities have evolved from their original form in the Loan Project due in part to legislative changes such as the issuance of Supreme Decree No. 374 and subsequent decrees and related regulations. Thus, the revised Annex No. 1 satisfies Section 4.01 b) of the Loan Agreement by updating and setting forth our mutual agreements for carrying out the Loan Project.

Annex I, DESCRIPTION OF THE PROJECT

The Project shall consist of AID and Borrower cooperation in financing the costs of credit and technical assistance for small business enterprises. Except as AID and Borrower may otherwise agree in writing, the enterprises to be assisted by the Project shall be small businesses with assets (excluding land and buildings) valued at up to the equivalent in sucres of two hundred thousand United States dollars ($200,000.), requiring credits of up to the equivalent in sucres of one hundred thousand United States dollars ($100,000.) and not having access to credit at reasonable terms or to technical assistance.

I. Credit Resources

A. AID/Loan. Approximately US$4,200,000 shall be made available as medium and long term credit for eligible enterprises.

B. Borrower Contribution. The Borrower shall make available resources to assist in financing the costs of credit. These resources shall be made available through the establishment of lines of credit from the Financial Funds mechanism of the Central Bank of Ecuador.

II. Technical Assistance Resources.

A. AID Loan. Up to $250,000. of the loan shall be available to finance costs of technical assistance commodities and services incurred from the effective date of this Loan Agreement to December 31, 1974, by the Program Office of the Ministry of Industries, Commerce and Integration. Any portion of this $250,000. not utilized for costs incurred as of December 31, 1974, may thereafter be utilized as credit for eligible enterprises.

B. Borrower Contribution. Beginning on January 1, 1975, all operating costs of the Ministry Program Office shall be financed by the Borrower. In addition, all costs incurred by the Central Bank of Ecuador in administering the loan shall be financed by the Central Bank.

III. Administration

The Ministry Program Office shall promote and coordinate financial and technical assistance to the small industry sector and shall monitor the use of loan-financed sub-loans. Participating banks shall make the credit decisions. Credit funds from the loan will be channeled through the Financial Funds mechanism of the Central Bank. The Central Bank shall act as the financial administrator of loan resources and shall be responsible for:

a) Accounting for the use of loan funds in accordance with the distribution set forth in this Annex and Implementation Letters.

b) Establishing and maintaining adequate books and records at the Central Bank in accordance with Section 4.09 of the Loan Agreement.

c) Processing all requests for disbursement or the issuance of commitment documents under the loan.

d) Financial reporting on the use of loan funds and related credit contributions of the Borrower and banks participating in the Project.

These responsibilities shall be carried out in accordance with the administrative and policy manual (as amended) approved by AID pursuant to Section 3.01 d) of the Loan Agreement.

Sincerely yours,

Harry Ackerman,
Mission Director

LOAN AGREEMENT AMENDMENT

(518-L-034)

Amendatory Agreement dated this day of 1975, between the Republic of Ecuador ("Borrower"), represented by the Minister of Finance and acting through the Ministry of Industry, Commerce and Integration ("Ministry"), the Central Bank of Ecuador ("Bank") and the United States of America, acting through the Agency for International Development ("A.I.D.").

WHEREAS the parties hereto have entered into a Loan Agreement, A.I.D. Loan 518-L-034, dated May 16, 1972, and;

WHEREAS, the parties hereto wish to amend said Loan Agreement;

NOW THEREFORE, the parties agree as follows:

1. Article 5, Special Covenants and Warranties, is hereby amended in its entirely to read as follows:

"Section 5.01. Lending Operations. The Borrower and the Bank agree that they shall:

a) Prohibit the use of the loan to refinance sub-borrower debts.

b) Discuss with A.I.D., at regularly scheduled intervals set forth in Implementation Letters, and in cooperation with the PFIs, the progress of the Project and reach agreement on any changes in policies, directions or other pertinent matters required to achieve fulfillment of the goals of the Project;

c) Maintain segregated accounts for the funds to be loaned through the PFIs and the Technical Assistance Fund; and

d) In the total level of lending operations, provide that financing will not be permitted in situations in which less than twenty (20) percent of the total amount of subloans funded is provided from the PFI's own resources, or in which less than twenty (20) percent of risk of loss is borned by the PFI.

Section 5.02. Disbursement for Guaranteed Subloans.

The borrower agrees that disbursements of the Loan with respect to DFI subloans guaranteed shall be made only when and to the extent necessary to pay off such guaranties.

2. Annex I, Description of the Project is amended in its entirely to read as attached here or and made a part hereof.

3. In all other aspects said Loan Agreement dated May 16, 1972, shall remain in full force.

IN WITNESS WHEREOF, the parties hereto have executed this amendment the of the month of 1975.

REPUBLIC OF ECUADOR

BY: _____

Title: Minister of Finance

UNITED STATES OF AMERICA

BY: _____

Title: Director USAID Ecuador

BY: _____

Title: Minister of Industry Commerce & Integration

CENTRAL BANK OF ECUADOR

BY: _____

Title: General Manager