DAI Contract No. PCE-I-00-99-00009-00

SALTO PROJECT

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Strengthening Access to Microfinance and Economic Liberalization Task Order (SALTO Project)

FOURTH QUARTER PROGRESS REPORT

(June 1, 2002 – August 31, 2002)

SALTO Project Team

September 1, 2002

Sponsored by USAID/Ecuador

DAI
Development *Alternatives,* Inc.

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I. EXECUTIVE SUMMARY

A. SALTO Project – Brief Description

The SALTO Project forms a central element of USAID/Ecuador's Poverty Reduction Strategy. Under this strategy, the activities of the SALTO Project are designed to achieve two primary objectives:

Intermediate Result 1 (IR1), Increased Access to Microfinance Services, focuses on efforts to significantly expand access to microfinance services to a greater universe of microenterprise borrowers. Access to credit, particularly well-targeted micro-credit, as well as savings products and other microfinance services, will allow poorer Ecuadorians to increase their annual income levels and at least partially recover from the severe recession of recent years. The microfinance sector activities scheduled under IR1 are designed to strengthen selected microfinance institutions (MFIs), to address regulatory, supervision and other policy issues that are critical to the development of the sector, and to strengthen other elements of the financial system infrastructure on which MFIs depend.

Intermediate Result 2 (IR2), Improved Macroeconomic Environment, concentrates on advancing a set of key macroeconomic reforms that are necessary for building public confidence in the government's management of public revenues and expenditures. Improved macro-stability and fiscal discipline should lead to more rapid economic growth, which indirectly will reduce poverty levels. Specifically, IR2 tasks are aimed at increasing government revenues (apart from petroleum sector income), developing a more transparent and comprehensive presentation of annual national budgets for public scrutiny and debate, and strengthening fiscal policy analysis capabilities. While these tasks relate to fiscal reform agendas, reforms in the financial sector or other structural reform areas may be added pending identification of high-priority requirements that could be addressed with SALTO resources. Specifically, special attention continues to be given to ways in which the SALTO Project may effectively support trade and investment policy reforms linked to Ecuador's National Competitiveness Agenda (Agenda Nacional de Competitividad).

B. Summary of Principal Accomplishments – Fourth Quarter (June 1, 2002 – August 31, 2002)

The principal work accomplishments during the current quarter are summarized below.

- IR 1A: MFI strengthening: Medium-term technical assistance agreements (convenios) have now been signed with all of the 7 MFIs initially selected for intensive SALTO support (three had been signed prior to the end of the previous quarter). Baseline data for results measurements has been established (to be further refined in the case of the four cooperatives in this group of MFIs). Support for Banco Solidario and Banco del Pichincha (Credifé) began via task orders with ACCION International (project subcontractor). Three-day strategic planning workshops were completed with each of the four cooperatives, including refinement of operating plans for the next twelve months. Leaders of these cooperatives, in addition to top microfinance officials of the Superintendency of Banks, completed a one-week senior management workshop in Costa Rica (INCAE). Information technology (IT) improvements for the four cooperatives were assessed in detail and a plan for efficient (reduced cost) procurement of software requirements was prepared – costs to be covered by participating cooperatives. Assistance was also initiated for one NGO -- Catholic Relief Services (CRS), and possible support for other NGOs was investigated.

- IR 1B: Regulation and Supervision of MFIs: Full implementation began on several elements of the comprehensive assistance agreement (Memorandum of Understanding) signed in May between USAID and the Superintendency of Banks. This included a major two-day microfinance training program for over 70 officers of the Superintendency, the issuance of first-ever microfinance norms (regulations) to be applied to all regulated MFIs, workshops in seven cities to introduce the new norms and receive feedback on needed refinements, and the drafting of a detailed Supervision Manual for use by Superintendency officers in both off-site and on-site reviews of MFI microfinance operations. There is continued very strong commitment from the top of the Superintendency through its principal divisions to integrate microfinance regulation and supervision into the national financial system. An intensive program for continued collaboration with the SALTO Project is planned for the forthcoming quarter.

- IR 1C: Financial Services Infrastructure: Again following the leadership of the Superintendency of Banks, initial work was completed during this quarter on the technical and legal requirements for the establishment of private credit reference bureaus in Ecuador. Plans are being elaborated for issuance of the necessary norms and licensing rules for the operation of private bureaus, to be in place ideally by the end of 2002. Project support to promote second-tier institutions serving the microfinance sector (source of liquidity and other financial services for MFIs), including the appropriate norms needed to regulate second-tier institutions, was also pursued. Work continued in support of the Red Financiera Rural (RFR) self-regulation program for non-regulated MFIs – a pilot program for selected RFR members is underway.

- IR 2A: Revenue Generated: A new agreement was reached with the Servicio de Rentas Internas-SRI (Internal Revenue Service) to carry out five specific tax policy and tax administration improvement activities before the end of 2002, and preparatory work to carry out these activities was completed. A new activity is also being designed for support of the Corporación Aduanera Ecuatoriana-CAE (Ecuadorian Customs Authority), focused on a thorough review and identification of improvement requirements for the CAE's new "zero paper" automated customs processing and information system.

- IR 2B and 2C: Improved Budget Transparency and Fiscal Analysis: A major positive development during the quarter was the appointment of a new Minister of Economy and Finance (MEF) and full commitment by the MEF to implement the new (May 2002) Fiscal Reform Law (Ley Orgánica de Responsabilidad, Estabilización y Transparencia Fiscal). The SALTO Project was asked to complete a full diagnostic of the needs of the MEF and the donor support (including SALTO resources) that may be available to strengthen MEF budget planning, fiscal analysis, financial management and other capacities over the short and long term. This work commenced as the quarter ended.

- Project Management: The two proposed contract modifications prepared for USAID consideration (Modification No. 1 to reallocate existing contract resources, and Modification No. 2 to extend the contract for three additional years to September 30, 2006) were delivered to USAID. New employment contracts, consistent with Ecuadorian law, were issued to SALTO local staff. SALTO has also received formal approval from the SRI as a tax-exempt organization eligible to receive refunds on value added tax (VAT) expenditures, a potentially significant breakthrough and one that will save funds both for the project and USAID.

C. Priority Actions for Next Quarter

For the next quarter, ending November 30, 2002, actions requiring high-priority attention include:

- Negotiation and signature of both Modification No. 1 and Modification No. 2 of the SALTO contract, reallocating and expanding resources to carry out SALTO Project objectives over a new five-year period (vs. the current two-year timeframe);
- Implementation of the next round of IR 2 tax and customs activities, as well as fiscal reform initiatives for the MEF pending results of the diagnostic now underway;
- Continued intensive implementation of activities with the Superintendency of Banks, aimed at completing actions on norms and procedures for regulation of MFIs, second-tier institutions, and private credit reference bureaus prior to the end of 2002; and
- Preparation and approval of the SALTO Project Year Two Work Plan.

NB: This is a presidential election year in Ecuador. Many actions for the next quarter are keyed to needs to complete critical institutional development improvements prior to the inauguration of a new government in January 2003.

More detailed summaries of current quarter accomplishments are provided in Section II. Specific scopes of work for short-term technical assistance (STTA) advisors, STTA reports, STTA resumes, reports on in-country workshops and international exchanges, and other project documents are available in the SALTO Project office as well as on-line (for DAI and USAID staff) via TAMIS (DAI's automated Technical Assistance Management Information System). Section III summarizes Project Management work during the quarter, and Section IV discusses actions requiring priority attention in the next quarter.

II. Implementation of SALTO Work Plan

The Year One Work Plan for the SALTO Project was approved by USAID on December 31, 2001. It grouped project tasks into six principal activities – three under each of the project's two Intermediate Results – and divides Year One tasks into Phase 1, ending February 28, 2002, and Phase 2, covering the balance of Year One through September 30, 2002. In the case of IR 2, it also reflected a reordering of macroeconomic reform tasks to emphasize a higher priority for work on tax and customs administration improvements. Progress of work on IR 1 and IR 2 is reported below.

A. Intermediate Result 1 (IR 1): Increased Access to Microfinance Services

IR 1 consists of three interrelated activities (sub-IRs) designed to build a sustainable microfinance sector in Ecuador. Accomplishing IR 1 objectives requires an approach that addresses both industry and institutional-level constraints affecting the development of the sector. Implementation in this quarter continued at a rapid pace.

IR 1.A: Microfinance Institutions (MFIs) Strengthening

The key to the success of IR 1 is the enhanced performance of individual MFIs – the separate banks, cooperatives, and NGOs providing microfinance. The strategy of the project centers on the selection of a limited number of leading MFIs, with whom the SALTO project has signed medium-term assistance agreements (convenios). The objectives of each agreement will vary by MFI, e.g., build institutional capacity, reach operational and financial sustainability, develop and provide new microfinance products, improve management information systems, and other specific goals. Baseline data on participating MFI performance at the beginning of the agreements compared to performance when the agreements are completed will be a prime measure of project **results**, with the bottom line being significant expansion of microfinance portfolios both in total value and total number of clients served.

It should be noted for this quarterly report that we are beginning to give new attention to project support for additional MFIs, i.e., beyond the seven institutions initially selected. There is likely to be a need to provide direct support to additional banks, cooperatives and NGOs that are emerging as significant providers of microfinance services, and expansion of support to include a larger number of MFIs will lead to increased results directly attributable to the project. In particular, it is likely that banks and specialized microfinance financieras (the latter based on transformation of NGOs into for-profit MFIs) will play a larger role in country-wide expansion of microfinance (in terms of total numbers of MFI clients and volumes of microfinance services), although regionally based cooperatives and other NGOs will also be very important players.

During the past three months, work accomplishments under IR 1.A included:

- signing of technical assistance agreements with all seven of the MFIs in the initial group selected for support (three agreements had been signed the previous quarter);
- completion of 3-day strategic planning workshops with three of the four cooperatives – the workshop for the fourth cooperative was completed during the previous quarter – and start-up of specific STTA assignments to strengthen the cooperatives;
- signing of task orders with ACCION International (one of the SALTO subcontractors) for long-term support for both Banco Solidario and Banco del Pichincha (Credifé);
- completion of a two-day "Exposition of Software Solutions" and workshop on IT (information technology) needs of MFIs, followed by two STTA assignments led by DAI experts Gabor Simon and Carlos Paredesa to prepare detailed IT requirements of SALTO-supported MFIs that could be unified into a single, cost-effective procurement action;
- participation by top leaders of the four cooperatives, as well as two microfinance officials from the Superintendency of Banks, in a one-week senior management seminar in Costa Rica (INCAE program); and
- special support to strengthen microfinance operations of one NGO (Catholic Relief Services-CRS), and initial support for a second NGO (Misión Alianza).

IR 1.A work continued to be led by Fernando Fernandez, the SALTO Project's long-term Microfinance Specialist, in close collaboration with USAID/Ecuador's Senior Microfinance Sector Development Advisor. They led the 3-day strategic planning workshops for three of the cooperatives in June and July, specifically for the Cooperativa de Ahorro y Crédito de la Pequeña Empresa de Cotopaxi-CACPECO (Cotopaxi Small Enterprise Savings and Credit Cooperative, located in Latacunga), the Cooperativa de Ahorro y Crédito Manuel Esteban Godoy-COOPMEGO, located in Loja, and the Cooperativa de Ahorro y Crédito Progreso-COOPROGRESO, operating in Quito and areas north of Quito. The fourth workshop, for Cooperativa de Ahorro y Crédito Riobamba-COAC/Riobamba (Riobamba Savings and Credit Cooperative), was completed the previous quarter.

All workshops were held at off-site locations. They brought together the senior board members, the General Manager, the heads of the credit, marketing, legal, human resources and other departments, and other staff of each cooperative for the purpose of re-examining existing strategic plans, consensus building on objectives (particularly those related to expansion of microfinance services), and identification of priorities for SALTO support. Each cooperative has since submitted to SALTO its revised 5-year strategic plan, together with a detailed 1-year operating plan for the immediate year ahead and updated baseline information. It should be noted that, in the case of the cooperatives, special care is being taken to segregate credit portfolio information by loan categories (e.g., housing, consumer, personal, and business loans). Business (microfinance) loans generally represent no more than 30% of the portfolio, and this category is the relevant baseline data for SALTO purposes. During the next quarter, DAI STTA microfinance specialist Nate Bourns will work with SALTO and USAID staff to further refine baseline data and indicators for measuring results.

Two top officials of each of the four cooperatives (in most cases the board president and the General Manager) participated in the one-week senior management seminar in Costa Rica during August 12-17, 2002. The seminar, sponsored by INCAE (Instituto Centroamericano de Administración de Empresas), focused on "Strengthening Management and Leadership" (Fortaleciendo la Gerencia con Liderazgo). It served to build skills for the SALTO group and a sense of common purpose in their objectives in Ecuador, and also exposed the group to a cross-section of over 80 leaders from similar institutions in other Latin American countries. Uniformly high marks on the value and quality of the program were given by the participants in their evaluation reports submitted to SALTO.

Specific assistance to individual cooperatives also began. Rafael Tejeda, STTA advisor under the Quisqueya Finance Ltd. subcontract, completed a two-week assignment in August with COAC/Riobamba, resulting in a fully detailed action plan for SALTO assistance through September 2003 on the cooperative's financial and organizational structure and expansion of microfinance services. Tejeda also delivered an in-depth course on fundamentals of microfinance to COAC/Riobamba board members and staff. A similar exercise for the other three cooperatives will be completed early in the next quarter.

Assistance for both Banco Solidario and Banco del Pichincha (Credifé) began via two task orders with ACCION International. Each program involves the provision of a long-term technical advisor – Luis Orlando Cardenas for Banco Solidario and Luis Albinez for Credifé. Support for Banco Solidario is concentrated on portfolio expansion in rural areas using up-to-date computerized microcredit technology (including development and application of "PortaCredit systems"), and on improvements in market intelligence and refinement of products to meet market demand. Support for Credifé covers four areas: expansion of nation-wide operations using standard products, e.g., automatic loan renewals, fixed asset financing; risk analysis and strengthening of credit decision-making; organizational development emphasizing position descriptions and salary schedules; and improved management information systems and reports.

Support requirements for Sociedad Financiera Ecuatorial-SFE were defined during the quarter and specific activities will now begin. SFE, although the newest MFI among the seven initially selected by SALTO – having started operations in early 2002 – is rapidly expanding its portfolio. SFE has also been selected by the Superintendency of Banks as a principal site for its pilot program for training bank supervisors in applying microfinance regulations (see IR 1.B, below).

As emphasized in the previous quarterly report, information technology (IT) and communications systems have emerged as critical needs for a majority of MFIs. SALTO STTA experts Gabor Simon and Carlos Paredes are leading an effort to identify common IT improvement requirements faced by cooperatives (and some NGOs), that will facilitate software procurements at reduced cost levels. During June 26-27, 2002, SALTO sponsored a first-ever "Exposition of Software Solutions" for institutions specialized in microfinance. Seven international and local firms presented their software systems to a large group of interested MFIs. Follow-up work by the STTA consultants with individual MFIs has resulted in a definition of common needs and the preparation of a competitive solicitation process through which a successful offeror will be selected to provide IT software and licenses to participating MFIs at reduced unit costs. In the quarter ahead, details on the procurement process will be further defined with USAID/Ecuador. It is important to note that the MFIs themselves will meet the costs of software procurements using their own funds, obviating possible needs to seek waivers for procurement of non-U.S. origin software if SALTO resources were involved. SALTO funds will be used to cover costs of technical assistance and training in putting the new IT systems in place.

Finally, work in this quarter included new support for two NGOs. SALTO is providing the services of STTA advisor Guadalupe López de Llergo to assist Catholic Relief Services (CRS) in a complete revision of its microcredit products, based on the MicroSave Africa methodology. The process includes market research, new product development, pilot testing and later roll-out to all CRS programs in rural zones of the country. Another NGO, Misión Alianza, works in the Guayaquil area with support from Norway. This NGO is entering a phase of conversion to for-profit status as a regulated financiera, a process that SALTO wants to encourage with NGOs ready for this transformation. Fernando Fernandez led a two-day seminar for Misión Alianza in August on the challenges of transformation. The SALTO IT team has also met with Misión Alianza and the NGO will likely be among the participants in the software procurement plan.

IR 1.B: Policy Regulation and Supervision

The second activity under IR 1 is the fostering of a facilitative microfinance policy and regulatory environment. The policy environment involves the set of economic, tax and other laws and policies that affect the ability of MFIs (and the microenterprises they serve) to operate in the country. The regulatory environment concerns the more specific standards and norms established by the Superintendency of Banks to exercise prudential supervision of the sector, monitor institutional performance of MFIs, and ensure safety and soundness of MFI financial operations that protect depositors and other investors.

Work accomplishments during the quarter were again concentrated on the Superintendency of Banks. The comprehensive assistance agreement (Memorandum of Understanding) signed in May 2002 between USAID and the Superintendency entered into full-scale implementation, including:

- issuance by the Superintendency of the country's first-ever norms (regulations) governing microfinance operations of Ecuadorian financial institutions;
- completion of a series of workshops across the country to introduce the new norms, and the definition of modifications that will be made to the norms based on feedback received from banks and cooperatives;
- drafting of a complete, detailed Supervision Manual for application of the new norms, to be refined and issued in final form in the next quarter;
- the design of a 4-module training program for Superintendency staff on the basics of microfinance and the role of supervisors in regulating the industry; and
- completion of a major 2-day seminar (first module), featuring leading experts from the U.S., Peru and Bolivia on all facets of microfinance, attended by over 70 Superintendency officers and co-led by Superintendent Miguel Davila, USAID and SALTO

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As for IR 1.A, the SALTO Project effort in IR 1.B was led by Fernando Fernandez, again in close collaboration with USAID/Ecuador's Senior Microfinance Advisor. During this quarter, they were joined by DAI STTA expert Jorge Daly, who was contracted to provide intensive intermittent support for the Superintendency program over a six-month period beginning in June 2002.

The starting point of work was the formal issuance of the norms for microfinance operations by all regulated financial institutions, be they banks, <u>financieras</u> or cooperatives. While microfinance credit, preliminarily defined in the norms as credits under $20,000, currently represents no more than 2%-3% of total credit operations in the country, a majority of borrowers fall into this category and regulation of the sector has become a high priority for the Superintendency. The norms drafted in May 2002 – the first-ever to be applied in Ecuador – were based to a significant degree on the Bolivian model that Superintendency staff had been exposed to during the previous quarter. Following quick approval by the banking authority (<u>Junta Bancaria</u>) in early June, a dissemination program was then carried out in June and July in seven cities by Superintendency staff with SALTO participation and funding to explain the norms in detail. A total of over 400 participants from banks, cooperatives, NGOs and other interested parties attended these one-day workshops. The subject matter covered definitions of microcredits, microfinance methodologies (including use of personal and/or hard collateral guarantees), generic as well as portfolio-based (overdue loans) provisioning requirements, and deadlines for adjusting operations to comply with the new regulations.

In addition, special explanatory sessions were held in Quito with the Association of Regulated Cooperatives and with the leading banks and financieras engaged in microfinance, resulting in detailed feedback on the norms. Jorge Daly worked closely with Superintendency counterparts to translate this feedback into a set of recommended modifications to the norms, both substantive and technical, that are now being readied for formal adoption (and acceptance by the MFI community). He also worked in tandem with STTA advisor Michael McMertney to draft a new Supervision Manual for use by bank supervisors in both off-site and on-site reviews of microfinance operations by the different types of MFIs. The Manual has been delivered to the Superintendency and, following refinements and pilot testing in the next months, it will become the standard reference for supervision operations.

Formal training for Superintendency staff also began during the quarter. A 4-module in-country training program was approved, to be completed during the balance of 2002. The first module was a major seminar co-hosted by SALTO and the Superintendency during August 23-24 at Hacienda Rumipamba de las Rosas, two hours south of Quito, attended by over 70 Superintendency officers and co-led by Superintendent Miguel Dávila and SALTO staff. The program included 17 speakers who presented papers addressing microfinance best practices, specific experiences of MFIs in Peru and Bolivia, the current state of play on norms and the draft Supervision Manual, the role of private credit information bureaus in credit risk management, the special role of cooperatives in the microfinance industry, and other topics. Robert Dressen, DAI's Practice Manager for Banking and Finance, was one of two keynote speakers. The seminar presentations are being edited for inclusion in a SALTO publication to be issued next quarter.

The remaining modules are focused on field visits by teams of supervisors to observe and study operations of selected MFIs (the SFE will be a principal site), and pilot tests of the new norms and Supervision Manual. In addition to in-country training, several overseas training and study tours are being carried out. Two Superintendency officers participated in the INCAE senior management training program in Costa Rica in mid-August, alongside the leaders of the four cooperatives (reported above). Plans were also completed for senior staff to attend an international microfinance conference in Brazil, to participate in additional study tours to Peru and Bolivia, and (two staff) to complete a two-week seminar at Harvard University, all of these events to take place in September 2002.

IR 1.C: Financial Services Infrastructure

Microfinance institutions operate within the context of the broader financial system, and growth of the microfinance sector will depend to an important degree on the existence and performance of other elements of the financial infrastructure. Factors largely external to the microfinance industry – and not being directly addressed by the SALTO Project – include the stability of the overall financial system, the roles of public sector banks (first and second tier), improvements in the supervision of commercial banks to prevent new rounds of bank failures, implementation of policies to restructure debt or initiate liquidation actions with borrowers defaulting on loans, and other structural reforms in the financial sector. More narrowly, IR 1.C focuses on financial services and institutions that will have direct impacts on the effectiveness and growth of MFIs.

During the past quarter, IR 1.C work accomplishments included:

- completion of a comprehensive assessment of the existing Central de Riesgos (credit reference system) operated by the Superintendency of Banks, and a detailed report on the rationale and legal requirements for private credit reference bureaus to operate in Ecuador;
- further work on the promotion of "second-tier" MFI organizations to serve the financing requirements (expansion capital, other services) of the MFI sector; and
- continued progress by the Red Financiera Rural in its programs to establish a "self-regulation" system for cooperatives not currently under formal regulation by the Superintendency of Banks.

There is a clear need (demand) by MFIs for access to a credit reference system that provides accurate information on the debt history and repayment performance of current and potential borrowers, particularly in the case where a borrower seeks loans from more than one MFI. The Superintendency of Banks currently administers a credit reference facility that contains risk information on all clients of the regulated financial system. Commercial banks (and a few cooperatives) are the principal users of this system, and it is geared primarily to credit risk information on borrowers with credit portfolios well in excess of the amounts typically involved in micro-credit operations.

As reported in the previous quarter, it became apparent that there is an unmet need for access to credit information on micro-borrowers, and that the existing Central de Riesgos operated by the Superintendency is itself not functioning as efficiently or effectively as desired. The quality and timeliness of credit reference information is not adequate, not only on microborrowers but for mainstream commercial borrowers, housing and consumer borrowers, etc. We also reported last quarter that there was uncertainty within the government on how best to encourage the entry of private credit reference bureaus into this sector as a means to improve and broaden services to financial institutions and other lenders. No private credit reference bureau exists at present in Ecuador.

The principal step forward in this quarter was a three-week STTA consultancy by SALTO consultants Reese Moyers and Raúl Tapia. They completed a comprehensive diagnostic of the existing system in the Superintendency including a detailed set of recommendations for improving its efficiency and responsiveness to client users. While there is no question, at present, that the existing Central de Riesgos will continue to function – the information received from the participating regulated financial institutions is important for internal Superintendency analysis and reporting on the financial sector as well as for external users seeking credit reference information on borrowers – the SALTO report also included a thorough review of the rationale and legal requirements for the establishment of private credit reference bureaus.

Specifically, the report contains very useful case study information on how private bureaus were established in other Latin American countries, and advice on how to replicate the best models and not repeat mistakes. For example, a primary recommendation is that the licensing of private bureaus allow for "non-specialization" of services, i.e., bureaus that provide services to all lending institutions. In certain countries, licenses have been provided for specialized services (e.g., information limited to microborrowers); this limitation has resulted either in inefficient bureaus with low profit levels or simply no new bureaus. The report contains an analysis of the legal requirements for licensing and operation of private bureaus, together with a suggested outline of the norms (regulations) that need to be issued and utilized by Superintendency officials in regulating the bureaus. The relationship between the existing Central de Riesgos and new private bureaus is addressed, with various options for interchange of information. The report also provides practical advice on how the Superintendency could lead a promotion ("marketing") effort to attract international as well as domestic private investors to establish new bureaus in Ecuador.

Work will continue on this objective in the next quarter, and the goal of the Superintendency is to have the legal, regulatory and marketing work for private bureaus completed prior to the end of 2002. Top Superintendency officials will participate in a study tour to Peru in September to examine the two leading private bureaus in Peru, one of which is INFOCORP, a highly successful (non-specialized) bureau whose Director was among the key speakers at the August 23-24 seminar in Rumipamba de las Rosas. Meanwhile, attention continues to be paid to the separate project for creation of a new credit reference bureau initiated by the Corporación Financiera Nacional-CFN, reported on last quarter. The firm recommendation of the SALTO project is that, whatever becomes the outcome of the CFN initiative (which would specialize in microfinance services), the Superintendency's policy on licensing of private bureaus provide for competition (multiple licenses to qualified companies) and an emphasis on non-specialized services.

Work this quarter on "segundo piso" (second-tier) MFIs was also focused on regulatory issues. In July, the Superintendency issued a preliminary version of regulations for FINANCOOP, a central cooperative facility established to provide financial services to its member cooperatives. Flaws in these regulations were identified, and the preliminary norms are now being re-examined. STTA advisor John Magill reviewed the norms in August, and his report provided relevant texts for regulation of second tier cooperatives in the United States. We will continue to assist the Superintendency is this area, coupled with further analysis of the specific roles of second-tier MFIs in Ecuador that will be needed to support cooperatives as well as other MFIs.

SALTO collaboration with the Red Financiera Rural-RFR in this quarter included the RFR's co-hosting of the software Exposition in late June (see Section I.A) and continued support for the RFR self-regulation project for non-regulated MFIs. The latter included a visit to Ecuador in July by a senior manager of COPEME-Consorcio de la Pequeña y Micro Empresa (Small and Micro Enterprise Consortium), the Peruvian counterpart agency serving as the principal model for the RFR program here. Methodologies and procedures for self-regulation drawing on Peruvian experience have been developed by the RFR and a pilot project applying self-regulation rules to seven RFR member NGOs and cooperatives is now underway under the leadership of SALTO STTA long-term advisor Jessica Herrera.

B. Intermediate Result 2 (IR 2): Improved Macroeconomic Environment

IR 2 currently consists of three fiscal reform activities with the common objective of achieving improvements in the planning and management of government revenues and expenditures. Improved fiscal discipline, aimed at generating surpluses or manageable deficits in government spending, is an essential requirement for macro-stability, which in turn is a critical factor in encouraging investment, economic growth, and reductions in poverty levels. With the dollarization of the economy, even more emphasis is placed on fiscal measures as the key elements of macroeconomic policy. Within IR 2, activities in the approved Year One Work Plan were prioritized (per discussions with USAID) to emphasize assistance on the revenue side of fiscal reform, aimed specifically at the Servicio de Rentas Internas-SRI (Internal Revenue Service) and the Corporación Aduanera Ecuatoriana-CAE (Ecuadorian Customs Authority). Work on the expenditure side of fiscal reform (budget transparency and fiscal analysis), was postponed to later in Year One.

The principal new development in the current quarter was the start of intensive work on budget reforms. In June 2002, a sweeping change occurred with the resignation of the Minister of Finance and Economy (MEF) and the entire team of MEF vice-ministers and sub-secretaries, triggered by alleged corruption practices. A new Minister and new MEF team assumed office in late June. SALTO then initiated discussions with the MEF on support for implementation of the Fiscal Reform Law passed – ironically – in May 2002 in the tenure of the previous group. The new work stemming from these discussions is reported under IR 2.B and 2.C below.

It is important to again reiterate the "targets of opportunity" approach inherent in IR 2. In addition to "macroeconomic" fiscal reforms, reforms in the financial sector and other structural reform areas are being addressed for possible SALTO support. An example reported in the previous quarter involved support for workshops promoting the adoption of a first-ever competition (anti-monopoly) law in Ecuador. In the present quarter, similar support was provided for a three-day workshop on trade policy, "Risks and Opportunities for the Ecuadorian Private Sector in the Free Trade Area of the Americas," sponsored by CORDES-Corporación de Estudios para el Desarrollo, a private think tank. Also during the present quarter, significant effort was spent in investigating possible support for one or more high-priority activities linked to the National Competitiveness Agenda. For example, SALTO and USAID/Ecuador staff met with the leadership of the CORPEI-Corporación de Promoción de Exportaciones e Inversiones (mixed private/public sector National Export and Investment Promotion Corporation) to consider institutional strengthening of CORPEI in trade policy analysis. Another example was consideration of direct support for one or more private sector "clusters" in addressing critical policy and other bottlenecks – the tourism cluster is one where SALTO support may be applied, pending further thinking. Finally, on financial sector reforms beyond those directly related to microfinance, SALTO has been approached by the Superintendency of Banks to work on broader requirements, beginning with a review of risk analysis tools used by supervisors in examining all regulated financial institutions – the central task of the Superintendency and a critical one following the financial crisis in 1998-1999 from which the country is still recovering. New developments on these fronts will be reported in the next quarter.

IR 2.A: Revenue Generated

Work on IR 2.A continues to be focused on both the Internal Revenue Service (Servicio de Rentas Internas-SRI) and the Ecuadorian Customs Authority (Corporación Aduanera Ecuatoriana-CAE). The principal accomplishments during the past quarter were:

- for the SRI, formal receipt of a request from SRI Director General Elsa de Mena to proceed with a "Phase 2" technical assistance and training program (up to five new tasks) and the contracting of additional STTA services of DAI tax expert Fuat Andic to help implement the Phase 2 tasks; and
- for the CAE, receipt of a similar request for one new activity, involving a detailed assessment of the CAE's new "zero paper" automated customs information system.

The new SRI tasks were defined following a series of discussions with the SALTO Chief of Party, based on the twelve recommendations for further support listed in the initial comprehensive assessment of SRI capacities completed in May 2002 by Fuat Andic and Arthur Mann. Five of the twelve recommendations are included in the Phase 2 assistance request. They represent the highest near-term priorities to build tax policy and tax administration capacities that the SRI would like to see consolidated prior to the end of the current government administration (presidential elections will be completed in November 2002 and a new administration will be inaugurated in January 2003). The specific tasks address: (1) analysis of the fiscal sacrifice (taxes foregone) attributable to zero rates of value added taxes as well as other major tax exemptions or exonerations; (2) design of a reliable methodology to project expected tax collections and infer (measure) levels of likely tax evasion in the system; (3) improve the effectiveness as well as efficiency of internal controls used by the audit department through the acquisition of Audit Common Language (ACL) software and training in ACL applications; (4) strengthening control processes in the examination of tax declarations; and (5) review of the existing internal and external security systems used to protect the SRI's computerized tax records and related information.

To help provide technical guidance and support for each of these tasks, the services of DAI tax expert Fuat Andic have again been retained. Dr. Andic will provide precise definitions of all work to be done and consultant qualifications of experts needed to carry out each individual task, and then provide technical guidance and quality control of final work products prior to delivery to the USAID/Ecuador and the SRI. Dr. Andic will also work with SALTO and USAID staff to define both quantitative and qualitative indicators of improved SRI performance for incorporation into Results Frameworks used by both organizations. Work on at least two of the five tasks is scheduled to begin in September. Cost sharing by the SRI will include some or all of costs related to software purchases (obviating needs to seek waivers should software be of non-U.S. origin).

With regard to the CAE, a request for very specific technical advisory services was defined in mid-August, to conduct an in-depth review by a team of experts on the CAE's recently installed "zero paper" automated customs information system. The objective has a timetable similar to the Phase 2 SRI work, i.e., to complete work prior the end of the current government in order to pass along to the incoming political administration (and possible new leadership at the CAE) a system that has been fully validated, where it is functioning well, or in the process of further improvements, where changes are found to be needed. The CAE system is highly complex as it integrates data from customs information (goods entering country, tariffs paid, etc.) into other tax records of the SRI and into the foreign trade statistics and other macroeconomic data bases of the Ministry of Foreign Trade, other line ministries, and the Central Bank. As the quarter ended, SALTO was working with its local subcontractor, BDO Stern, to refine the terms of reference for this activity and to proceed with recruitment of the appropriate consultant team.

IR 2.B: Improved Budget Transparency
and
IR 2.C: Improved Fiscal Analysis

The previous report summarized the new Fiscal Reform Law, in many ways a true landmark law in that it has the potential to change radically the way in which fiscal policy and, particularly, government management of budget resources, have been handled in the past. The new law, entitled the "Ley Orgánica de Responsabilidad, Estabilización y Transparencia Fiscal" (Fiscal Responsibility, Stabilization and Transparency Law), was passed by Congress in late May 2002. In the ensuing three months, certain modifications to the law as passed have also been passed by the Congress, pursuant to conditions of the International Monetary Fund related to Ecuador's application for an IMF stand-by agreement. The final modifications were pending approval by the President, and the implementing regulations for the new law were being finalized, as the quarter ended.

As these positive developments were unfolding, there was a serious crisis in June 2002 involving allegations of corruption by the (now former) Minister of Economy and Finance (MEF) and senior officials in the ministry. The Minister resigned, and by the end of June a new Minister was appointed along with a complete new team of vice-ministers and sub-secretaries. The new group was charged with the job of quickly reestablishing the credibility of the ministry, with pursuing a much needed stand-by agreement with the IMF, and with moving forward with the implementation of the new fiscal reform law. The SALTO Chief of Party approached the MEF at this juncture with an offer of support, resulting in a request by senior MEF staff in August for SALTO to undertake a two-part task. The first part is to compile up-to-date information on the external donor support that is already in place or "on hold" to strengthen MEF capacities, including both loan and grant support by the Inter-American Development Bank, the World Bank, the Andean Development Corporation (Corporación Andina de Fomento-CAF), the United Nations agencies, and several bilateral donor programs including other USAID-financed projects. A special concern of the new MEF group is to reduce reliance on loan finance in preference of grant finance wherever possible, consistent with the government's determination to reduce external debt. The second part of the assignment involves a thorough review of the full range of capacity-strengthening requirements faced by the MEF as it undertakes its responsibilities in implementing the new fiscal reforms. Matching the demands of the MEF and the supply of external support by donors is expected to provide a "map" for the MEF on how to prioritize short, medium and long-term capacity building activities and take best advantage of donor collaboration offers.

By the end of August, a two-person SALTO STTA team was recruited for this work – DAI budget expert George Guess and local economist Margarita Andrade. Their four-week assignment will be completed in September. In addition to the report addressing the tasks summarized above, the team will work with the MEF to draft a "transition plan" that the current MEF group can hand over to the incoming Minister of Economy and Finance when the new government takes office in January 2003. For SALTO and USAID consideration, the team will also provide specific recommendations (with draft scopes of work) for one or two immediate short-term initiatives of high priority to the MEF that could be completed before the end of 2002 using SALTO resources. Overall, this assignment should provide a framework for SALTO work on IR 2.B and 2.C for at least the next two years.

III. Project Management

The most important Project Management tasks undertaken during the quarter again centered on urgent needs for modifications to the SALTO contract. The two proposed modifications to the SALTO contract, prepared in late May, were further refined in discussions with USAID/Ecuador. Modification No. 1 reallocates resources within the existing 2-year contract budget to reflect changes in staffing requirements and other factors. Modification No. 2 outlines an expanded budget and a 3-year extension of the contract to a new end date of September 30, 2006. At the end of August, actions had not yet taken place on either modification, but it is fully anticipated that both modifications will be negotiated and signed prior to September 30, 2002, the end of the current Fiscal Year.

Other noteworthy accomplishments during the quarter were the issuance of new employment contracts to local SALTO employees, and the receipt of formal approval from the SRI for SALTO project refund claims on value added tax (VAT) expenses. The new employment contracts, replacing earlier contracts that had been written under U.S. law between DAI/Bethesda and each employee, are consistent with Ecuadorian law and, in particular, with requirements to register the contracts with the Ecuadorian Social Security Administration and to pay monthly contributions (both employee and employer portions). The approval for SALTO as a tax-exempt international assistance project to receive refunds on VAT expenses represents a significant breakthrough – it appears to be the first time that a U.S.-financed contactor has received this approval. At this point, the SRI has stated that all VAT expenses incurred since the inception of the contract can be refunded, on a staggered basis, which could represent a substantial refund. However, we caution that the paperwork requirements for these claims appear cumbersome, and we cannot be sure that the refunds will be easily processed.

Total Project Expenditures to date: Annex 1 summarizes SALTO Program Expenditures as of August 31, 2002. Expenditures accelerated significantly in the current quarter.

IV. Priorities for Next Quarter

For the next quarter, ending November 30, 2002, actions requiring high-priority attention are:

- Negotiation and signature of both Modification No. 1 and Modification No. 2 of the SALTO contract, reallocating and expanding resources to carry out SALTO Project objectives over a new five-year period (vs. the current two-year timeframe);
- Implementation of the next round of IR 2 tax and customs activities, as well as fiscal reform initiatives for the MEF pending results of the diagnostic now underway;
- Continued intensive implementation of activities with the Superintendency of Banks, aimed at completing actions on norms and procedures for regulation of MFIs, second-tier institutions, and private credit reference bureaus prior to the end of 2002; and
- Preparation and approval of the SALTO Project Year Two Work Plan.