ANALYSIS OF THE POTENTIAL FOR DEVELOPMENT OF SME PURCHASE ORDER FINANCE PRODUCTS

31 March 2007

This publication was produced for review by the United States Agency for International Development. It was prepared by Michael Gold and Greg Jacobs of Crimson Capital with assistance from Chemonics International Inc.

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Contract No. EEM-E-00-05-00006-00, Task Order 2
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EXECUTIVE SUMMARY

This trip report summarizes Crimson Capital's in-country visit to USAID's Financial Services for SMEs Program (SME Finance Program). The trip focused on meeting with partner financial institutions (FIs) to explore the development of appropriate working capital finance and/or leasing products, and meeting with representative SMEs to assess their financing needs. Of special interest to the SME Finance Program was the potential introduction of Purchase Order Finance (POF) to the El Salvador market.

POF is a transaction specific form of pre-shipment working capital finance that Crimson Capital has successfully introduced in several other emerging markets. It is not a general loan or line of credit for operations of the business. Rather, it is used to finance the costs of inputs, raw materials, packaging, components, etc., to produce and deliver products on a confirmed contract or purchase order or to purchase trade goods for resale. It can be used for domestic sales as well as export and import in virtually any sector. It works especially well for SMEs because it provides them with the missing finance they need to help them fill bigger and more frequent orders, the lifeblood of any enterprise if it wants to grow. POF also works well without real estate collateral, which most SMEs don't have or have already committed.

Crimson's team interviewed partner banks and SMEs, and reviewed existing information on the SME Finance Program's activities as well as the overall SME finance sector. Several major challenges to lending to SMEs were identified by partner banks as well the SMEs themselves. Some of the issues commonly raised include a limited range of products appropriate for the SME market, lack of alternative forms of collateral, limited experience lending to SMEs, and a heavy focus on collateral-based instead of cash flow based lending. According to those interviewed, both banks and the SMEs themselves see working capital financing to fill orders as the biggest unmet need in the market today.

Crimson introduced the POF concept to partner banks and other parties that the team met. The reaction was overwhelmingly positive to the product, with all six banks expressing an interest to develop the product, with one calling it "fabulous" and another stating they were "extremely interested" in introducing POF in El Salvador. Perhaps the strongest endorsement was received from the Superintendencia de Sistema Financiero (SSF) itself, with its representative stating that POF "is a very good idea and is a product that can help our country move forward, improve the economy, and create jobs. I hope it can be introduced here." SME clients of the USAID EXPRO Program stated that this type of finance would be particularly helpful for them to increase their sales and exports.

Based on these findings as well as other information covered in the body of the report, Crimson recommends that the SME Finance Program proceed with 1-2 partner banks to introduce POF as a formal product to the Salvadoran economy. This is the best place for the project to start as everyone agrees that it is needed, it is not being done yet, and it will create jobs, plus increased profits and exports. Leasing is another product that can help banks successfully access the SME market. It is already being used on the market to a

limited extent and could be rapidly expanded with additional technical assistance and training to targeted institutions.

Section 2 provides a brief introduction to contextualize this report within the SME Finance Program. Section 3 examines the SME Finance market in general, focusing on the demand and supply of SME finance, key challenges and barriers, and legal and regulatory issues related to SME lending. Section 4 offers more information on Crimson Capital's experience and POF programs in other countries. Section 5 discusses POF and leasing in more detail and Section 6 contains our recommendations and proposed next steps to introduce POF to El Salvador through a targeted assistance program with one or two selected partner banks (Pilot POF Program). Initiation of the Pilot POF Program in June/July 2007 could result in the partner banks making POF loans by the fourth quarter and rolling out the program thereafter. Clients of the EXPRO Program would be among the first SMEs to be considered for pilot loans under the Pilot POF Program.

INTRODUCTION

SMEs in El Salvador face a number of challenges to reach new markets and grow their businesses. USAID/El Salvador has identified two major developmental challenges in the financial sector, namely that SMEs lack access to appropriate financial products and services, and non-bank financial institutions (NBFIs) lack access to adequate commercial sources of funds and savings for on-lending.

USAID's SME Finance Program is addressing these problems by working with commercial FIs to increase access to credit and other financial services for small and medium enterprises as well as to further strengthen the provision of microfinance in El Salvador by assisting two microfinance institutions (MFIs) to become regulated NBFIs under the Superintendencia de Sistema Financiero.

The specific objective of the SME Finance Program is to enable FIs to expand lending and other financial services to underserved markets and to introduce viable loan products that can better serve the financing needs of SMEs. The SME Finance Program is expected to increase the number of new SME borrowers by at least 10 percent for its client FIs. In addition, the program will increase the volume of loans to SMEs by at least 20 percent.

A. Summary of Scope of Work

The program is currently beginning to implement its second year work plan and is ramping up its activities with partner banks, especially in terms of product development. These entities have requested support developing new working capital finance products for SMEs. This is a specialty of Crimson Capital, which has developed new trade and working capital finance products for banks and NBFIs in several countries.

As a result, a Scope of Work (SOW) was designed to initially explore potentially appropriate products that can be developed for and/or adapted to the El Salvador market. Crimson Capital especially targeted exploring the potential for introducing purchase order financing (POF), an innovative form of working capital finance that Crimson has pioneered in several emerging markets with great success.

During the week of March 12th, Crimson Capital's consultants Michael Gold and Greg Jacobs visited El Salvador for this purpose. This report summarizes the information collected during their visit as well as an initial gauge on the interest and potential commitment of partner banks to develop and successfully implement new or enhanced products to support increased SME lending.

B. Methodology

During Crimson's visit, the team met with partner banks, a selection of SMEs in need of finance, regulators, and other appropriate parties such as BMI, CONAMYPE, and the USAID supported Export Promotion (EXPRO) project. Crimson's consultants also met with the SSF to examine specific issues related to SME lending such as the utilization of soft asset collateral to secure loans and to present the POF concept. In addition, the team also reviewed available information on partner banks and the Salvadoran SME sector, utilizing both SME Finance Program documents and outside sources. Appendix A contains a list of people interviewed during the trip and Appendix B contains a list of sources consulted.

It is important to stress that this report is by no means a comprehensive look at the general SME Finance sector in El Salvador. The Crimson team was only in country for a week, and met with the parties listed in Appendix A only a single time each. Rather, the SOW focused on collecting specific information on the current state of the supply and demand for SME Finance in El Salvador to explore potential product development that could address key relevant gaps and opportunities in the SME lending market. The goal being that selected products could be piloted during the second year of the SME Finance Program by partner banks to increase and improve their SME lending activities.

During each meeting with partner banks and other institutions, Crimson Capital listened to the specific challenges and opportunities as described by both SME lenders and borrowers. Crimson then introduced the concept of purchase order financing, describing it in detail as well as answering any questions raised by the individuals met. The goal was to familiarize the banks and other actors with POF and to help them understand how this type of financing could be utilized in El Salvador to better overcome the complexities of successfully lending in the SME market.

The Crimson team also discussed other potential finance products that could be utilized for the SME market such as factoring, warehouse receipts and leasing. The latter is a product currently growing in use in El Salvador and is discussed in more detail later in the report. All partner banks requested additional information about purchase order finance as introduced by Crimson Capital in other markets. Crimson's PowerPoint presentation on POF was distributed as a follow up to these institutions and is attached as Appendix D.

SME FINANCE SECTOR IN EL SALVADOR

In several ways, the timing for the SME Finance Program by USAID is ideal. Lending to large corporate clients has become increasingly saturated as the banking sector in El Salvador has evolved during the last ten years. The ongoing purchases of local banks by international and regional players such as GE Capital, Citicorp and HSBC suggest increased levels of competition in the coming years for the prime corporate and larger businesses. This leaves the dynamic and entrepreneurial SME sector in El Salvador as a major area of opportunity for market growth in these tightening conditions. From the perspective of SME borrowers, increased and better access to capital and investment can help them generate increased sales, increased competitiveness and employment—vital to the overall success and long term stability of El Salvador's economy.

According to SME Finance Program documents, the SME segment makes up less than 20 percent of the total Salvadoran credit portfolio. Yet, SMEs in El Salvador account for approximately 33 percent of GDP and 50 percent of total employment. Recent studies have stated that more than 90 percent of SMEs in El Salvador lack appropriate access to bank credit. With greater access to appropriate credit to expand their businesses, the SME sector in El Salvador could easily grow to contribute over 50 percent of GDP and 75 percent of employment in the medium term.

There are approximately 17,055 small, medium and large enterprises in El Salvador. The small segment makes up 93 percent of all these businesses, accounting for 15,777 of the total number. This is important to note, as many of the banks felt they were making progress in successfully lending to medium businesses but still were having difficulties reaching this small business segment of the SME market where the majority of businesses are – and where the maximum economic and employment growth potential lies. According to this survey, there are less than 400 large enterprises in El Salvador and 988 medium enterprises currently active. Clearly, it's critical for El Salvador's future economic prosperity to dramatically increase the amount of credit extended to small businesses.

The largest sector for SMEs in El Salvador is commerce. With the heavy trade imbalance towards imports in El Salvador, this means that many SMEs are involved in various capacities with importing. The services sector is also an important segment for the SME market and seems poised for further growth. Manufacturing and agribusiness are important SME sectors, though dollarization and other factors have made it increasingly difficult for Salvadoran businesses in these areas to be competitive with other regional players. Access to appropriate finance can help SMEs in the commerce, service and manufacturing sectors all become more competitive both domestically and internationally.

A. Demand for Pre-Export Finance

According to the demand market survey completed for the SME Finance Program in October 2006, small businesses cited several major problems with accessing credit.

Extensive information required by lenders, lack of adequate collateral requested of borrowers, lack of flexibility in payment terms, and high fees and interest rates are just some major issues mentioned. While formalization was not a problem for most medium enterprises surveyed, the lack of flexibility in products and payment terms, lack of speed in processing loan applications (resulting in lost opportunities) and the other issues noted above for small businesses were also identified.

These problems are common to SMEs in emerging markets worldwide. Many SMEs' needs are too big for MFIs to start with or the needs have simply outgrown the capacity of the MFIs -- yet the SMEs are not fully prepared to successfully borrow from banks with stricter requirements. Yet banks, focused on profit maximization and risk mitigation, are usually much too hesitant to increase lending exposure to the SME market. They think it is too costly, too risky and not profitable enough to lend to the SME sector. This is the classic Catch-22 that many experts refer to as the "missing middle" phenomenon of SME lending. There is simply not enough access to finance for the vast majority of active businesses with the potential to grow, increase sales and hire more workers.

SMEs need larger and/or more frequent orders to grow, but they cannot get the funding to finance the costs of filling the orders for the variety of reasons described above. This problem is even more acute for companies that export, because there are usually additional costs associated with exports including transport, packaging, customs duties, taxes, insurance, testing and meeting new standards.

According to the staff of USAID's Export Promotion Program (EXPRO), this is commonly seen in the inability of Salvadoran SME businesses to finance the "soft costs" associated with exports such as packaging, marketing, insurance and shipping of products. Many SMEs have to export through brokers or middlemen to try and access the lucrative North American market, paying high fees, losing control over their export sales, missing direct contact with customers and the changing market needs, and reducing their overall profit margin. SMEs directly reported to us that they already have and can get more orders for their products in the local and export markets, but they cannot fill the orders because they can't secure the necessary financing to prepare and ship these orders.

Our preliminary findings in El Salvador show that SMEs usually do not have the working capital needed to buy the raw materials, packaging, sub-assemblies, semi-finished goods and/or trade goods to be able to fill the purchase orders for their products and then wait 60-180 days to receive payment from the customer, and that banks are not providing the appropriate and properly structured trade and working capital financing instruments to fill this market need.

B. Supply of Pre-Export Finance

Despite the interest of partner banks to increase their SME lending activities, interviews and documents reviewed suggest a number of challenges from the supply side. Many SMEs are agile, fast thinking business people, able to capitalize on quick opportunities that they identify. Many have tapped into trade flows connected with Diaspora communities in locations in Central and North America, and are successfully exporting their value added niche products. Although many of the SMEs have long term plans and goals, they are forced by lack of finance to focus short term. They have to draw on personal assets and savings and borrowing from family or friends (or worse – middlemen or loan sharks) to continue operating their businesses.

Banks have financed a few purchase orders in the past, though only for long term, large scale customers with extensive mortgage coverage, such as in the case of large-scale coffee operations. There is a heavy emphasis in the El Salvador banking market on real estate and fixed asset collateral in terms of weighting of loans. There has been some movement of banks towards increased use of the cash flow of the borrowers in credit analysis, but the taking of hard asset collateral still seems to be paramount in most loan decisions. This is a critical barrier for SMEs as many simply do not have the necessary hard asset collateral that the banks require, or their assets are already pledged as collateral for other loans.

From the lenders' perspective, many SMEs (especially small) in El Salvador are not fully formalized, are family run enterprises, and do not correctly or fully account for all businesses activities. The lenders believe, sometimes quite wrongly, that many of these enterprises lack necessary management capabilities to drive increased growth and product development.

Banks are also concerned about "payment risk." The experience of the banks is that many SMEs are not exporting directly to Walmart and Target, but rather to informal businesses or small scale brokers in the US and regional markets. Understandably, it is difficult if not impossible in many of these cases for banks to fully assess the credit worthiness of these clients, which leads to additional collateral requirements and high interest rates and fees for SMEs, if financing is provided to them at all. The Multilateral Investment Bank's (BMI) guarantee program through partner banks like Wells Fargo is an approach intended to help reduce the payment risk for export sales to the US. However, the banks interviewed stated that the BMI program was too slow, too costly, and too bureaucratic for their needs, and it effectively requires that the buyer be a very large US company.

Banks such as Banco de America Central (BAC) have tried using letters of credit with SMEs, but have found them to be costly and time consuming. Also, BAC reported difficulties working with corresponding banks in the US, where they do not have direct branches. Other banks are using overdrafts, lines of credits, and basic products such as term loans and credit cards to finance SME operations to some extent. Yet these offerings often limit the amounts that SMEs can borrow and tie up real estate or other fixed assets as collateral.

While all are challenging problems to address, several banks interviewed were receptive to the Program's proposal to use purchase orders and other forms of alternative collateral to help minimize lending risk. Still, they also want to be sure that any new products or forms of collateral conform to the requirements of the Superintendency of Financial Systems (SSF).

They were also receptive to proposed approaches to help them take greater advantage of their regional banking presence to verify the credit worthiness of buyers of their SME clients' products. This would not only reduce risk and increase lending to Salvadoran SMEs, but it would also increase bilateral (reciprocal) and regional trade, and allow the banks to dramatically increase their cross selling of products and services at both ends of the trade transactions.

C. Legal and Regulatory Environment for Pre-Export Finance

Overall, the El Salvador banking sector is still behind other emerging markets in coming into compliance with Basel II standards. The SME Finance Program has already identified and is addressing several relevant issues with regards to the legal and regulatory environment for SME lending. These include the definition of creditor categories, the $100,000 ceiling for non-application of corporate credit requirements, reactive versus anticipatory borrower classification, and an excessive reliance on guarantees or physical collateral for credit extension and provisioning. More emphasis needs to be placed on determining a specific company's creditworthiness through comprehensive risk analysis, including economic viability, cash flow, etc.

While the focus of the SSF like all regulators is to "monitor, evaluate and control" risks, they are also interested in the development and diversification of the financial sector as a whole. The issue of payment risk, especially for exporters, was raised by the regulatory body—stressing that the SSF is trying to move towards risk guidelines for how to better measure the risk of non-payment.

Crimson also raised the issue of utilization of alternative forms of collateral, specifically the barriers, if any, to the utilization of instruments such as bills of exchange, cross checks, or working capital assets such as accounts receivables, letters of credit, etc. The SSF explained that these were legal instruments in El Salvador as defined and explained by the commercial code. The SSF stressed that these were valid forms of collateral in El Salvador and could be effectively used to secure POF loans. The determination of which form of collateral to take was a decision for each specific bank and the core concern from the SSF's perspective was to make sure that overall risk was effectively controlled and mitigated.

In discussing the potential introduction of the POF product to El Salvador, the SSF referred to it as a "very good idea" that could help develop the financial markets in El Salvador if risk could be properly evaluated and measured. Furthermore, the SSF indicated that there were no legal impediments to POF in El Salvador as long as the banks would develop and/or adapt appropriate policies and procedures for the new product. Further, the SSF requested additional information from the Program regarding other markets where POF had been introduced so that they could be in line with the best practices with regards to risk supervision.

The extremely receptive response of the SSF towards POF is a very positive sign. It indicates a desire of the SSF to help nurture new products as well as increased utilization of alternative forms of collateral on the market.

PURCHASE ORDER FINANCE PRODUCT DEVELOPMENT

There are a variety of products and approaches that can be used to address the working capital finance gaps for SMEs. Traditional instruments such as documentary credits and lines of credit are often available only for the bank's larger, established corporate clients, but it is difficult for many SMEs to meet the lending criteria of banks for these products. Letters of credit are often onerously expensive and time consuming for SMEs, if they can even get them at all. Factoring (post-shipment finance), bridge financing, and warehouse receipts are just some of the other products that can be used and that have a variety of benefits and challenges associated with each.

A specific type of working capital financing that addresses some of the challenges discussed above is pre-shipment finance. Clearly defined, this is financing that is provided to a company before a good is shipped in order for the company to prepare the order in the first place. The financing is provided to enable the company to prepare and ship the product—a crucial barrier to growth for many SMEs in El Salvador. Companies need financing to buy raw materials, packaging, etc., to produce goods or they need financing to buy trade goods for resale. Either way, having access to working capital before shipping the product is critical. For any company, being able to offer attractive payment terms to buyers is often crucial in getting a contract and requires access to finance for the seller. Without necessary financing, businesses are forced to turn down new, more frequent or larger orders that they simply cannot fill without additional financing. The following section looks at how POF specifically can address these types of constraints in more detail.

A. Purchase Order Finance

One of the fastest, easiest and most effective ways to provide working capital financing to SMEs is through purchase order finance. POF can also generate the fastest growth in sales, profits, exports and employment for SMEs. Importantly, all partner banks interviewed as well as the SSF are extremely enthusiastic about introducing this new product to the market place. This is because the Salvadoran banks recognize POF's win-win potential for both lenders and borrowers and its ability to overcome current key obstacles in the SME lending market.

POF is short-term funding provided by a bank or NBFI that is used as working capital by an SME to produce agricultural commodities, manufacture products, or purchase trade goods for resale. In all cases, the products have been pre-sold by the SME to a credit worthy buyer. Each transaction is considered on its own merit with the terms of the agreement requiring the seller to use the bank's funds for the purchase of certain materials and/or services needed to deliver goods to the buyer. POF covers two types of goods:

- Finished Goods, referring to transactions where the goods are procured by the seller for resale to a customer with little or no value added by the seller, except perhaps packaging; and

- Non-Finished Goods, referring to when the seller takes possession of the goods in a raw state or semi-finished state and adds value through manufacturing or processing before selling.

POF is easier to qualify for than many other types of financing since it is very short term and the collateral to secure the loan can be in the form of the purchase order itself: inventory, receivables, personal guarantees, bills of exchange, etc. Real estate or other hard assets are rarely required as collateral. As collateral requirements are often the number one constraint to lending to SMEs in emerging markets, this feature of POF is of particular importance. Banks in El Salvador normally require at least a 140 percent or higher collateral-to-loan ratio. The required collateral is primarily real estate, which many SMEs have already pledged or do not have.

The POF mechanism works in the following way:

- The buyer/customer submits a purchase order to the seller with all documents.
- The seller/bank client submits the purchase order to the bank for POF.
- The bank makes a partial advance to the seller on the value of the purchase order. The advance is made to the seller or directly to the seller's supplier to cover the costs of materials, trade goods and/or services. (This allows the seller to receive funds far sooner than if it had to wait for the buyer to pay on the invoice and even sooner than if the invoice is factored/discounted. POF allows the seller to receive funds even before the goods are shipped and the invoice is issued.)
- The supplier delivers the materials, goods and/or services to the seller for production of the product or assembly of the trade goods to fill the order.
- The seller produces or assembles the goods and ships the products to the buyer.
- The seller prepares and submits an invoice for the sale. Depending on the agreement, the invoice will go to the buyer or directly to the bank (or factoring company).
- The buyer pays the invoice according to the payment terms, usually directly to the bank.
- When the bank receives payment on the invoice from the buyer, the bank withholds the amount it advanced to the seller as repayment on the POF loan, and also deducts the agreed amount of interest and fees. The balance is then remitted to the seller.

POF enables SMEs to fill orders and realize expanded profits and revenues that would not be possible with standard financing. For example, in Macedonia where Crimson developed an SME Fund to do POF lending, clients have realized a substantial increase in profits because loans received have enabled them to drastically increase their amount of orders, turn around time, and development of new customers, without significant increases in fixed costs. Why? The SMEs have been able to increase their utilization of existing production capacity. The end result is a company that realizes significant new sales, experiences growth and increases employment – all while becoming much more profitable and competitive.

For banks, there are several benefits to utilizing POF and similar products. Foremost, it allows them to better access and tap into lending markets such as the SME sector by offering existing and new clients a broader portfolio of lending products, thereby increasing their own profits. By using alternative forms of collateral for POF and other products, banks can open a whole new window of lending opportunities and manage their risks. The short terms of POF coupled with the transaction specific nature of this type of financing, the high leverage (typically with POF, only 10-40 percent of the total transaction value is advanced), and the resulting diversification of the lending portfolio help lower overall risk and provides greater flexibility.

Loans can be structured in a variety of ways including to match payments to the borrower's cash flow cycle. Ultimately, POF can help banks build more bankable clients from whom they capture substantial fees and interest income and to whom they can cross sell other bank products and services. Bottom line: POF helps both lenders and borrowers make more money and grow.

RECOMMENDATIONS AND NEXT STEPS FOR PURCHASE ORDER FINANCE PRODUCT DEVELOPMENT

POF does not exist to any appreciable extent in the Salvadoran market, all SMEs need working capital finance, and there is an expressed strong demand by the partners for proven working capital finance products. Therefore, we recommend that the USAID Financial Services for SMEs Program start by introducing purchase order finance, which seems to have the highest potential for impact in helping the SMEs achieve greater sales, profits, exports and employment. POF will directly contribute to helping the SME Finance Program achieve its targeted results.

We recommend that the SME Finance Program proceed quickly to work with 1 to 2 partner banks to help them introduce POF. The SME Finance Program would develop pilot programs with the partner bank(s) to introduce POF. The SME Finance Program would provide technical assistance and training, and the bank(s) would commit management and staff time and actual funds to make pilot POF loans using their own lending resources. The bank(s) would commit to introducing POF as an official product and formalizing the necessary policies and procedures.

A. Pilot Purchase Order Finance Program

POF offers a proven method to catalyze exports, sales, and job creation—key components of the SME Finance Program's results framework. Through Crimson's experience in implementing POF in other markets, this product can be rapidly introduced and rolled out (often in only six months) with local banks. Our recommended approach is to select one or two of the Program's partner banks and help them launch POF. This can be quickly done by requesting informal expressions of interest (EOI) from partner banks to gauge their seriousness and commitment to develop POF as a formal product and their willingness to use their own resources to make pilot POF loans.

Since bank partners have already been chosen for the Program, Program staff with guidance and assistance from Crimson Capital will conduct interviews with partner banks interested in rolling out POF to determine their real commitment and capability to successfully introduce POF. We have prepared a list of recommended eligibility criteria that the Program should use in selecting one to two partner banks for the POF pilot program. This will help the SME Finance Program best utilize its resources, and to select partners that are most ready, willing and able to successfully introduce POF. This also provides for a fair selection process, as all the interviewed partner banks expressed interest in working with Crimson to develop POF. Criteria for selecting partners should include the bank's commitment to increasing their SME lending portfolio, the amount of their own money they are prepared to commit for making pilot loans, their willingness to track and report the required data on the pilot loans, and a demonstrated readiness to introduce new products to the marketplace. We anticipate that this selection process can be completed quite quickly and that the detailed technical assistance and training could begin in full force as early as August of 2007.

Once partners are selected, we will all assist selected banks to start identifying potential clients or sources of clients through programs such as EXPRO, FUNDES, CONAMYPE and other relevant organizations working with SMEs that have a need for this type of financing.

Below, we lay out a proposed scheduled for the pilot POF program. Once partners are selected, policies and procedures can be drafted and reviewed by the SSF that incorporate alternative forms of collateral as well as increased focus on elements such as cash flow in lending decisions. Getting the buy in from the SSF on new products and new forms or usages of collateral on POF can then be expanded and applied to other banking products.

	Activity
June	Approval of USAID for Pilot POF Program
July	Collect Expression of Interest (EOI) for participation of partner institution(s)
	Select 1-2 partner banks
	Establish links to sources of SME client referrals
	Develop initial calendar and outline of needs for technical assistance and training with partner banks
August	Conduct assessment of training needs for POF as well as assessment of policies and procedures of partner banks
	Design and prepare roll out plan for technical assistance and training for pertinent partner personnel
	Develop a pipeline of prospective SME clients for pilot POF loans (with EXPRO, FUNDES, CONAMYPE, CO-EXPORT, or other partners)
	Begin training of partner bank personnel in POF mechanism and utilization
	Begin development or adaptation of policies and procedures for POF
September	Hold further discussions with SSF on issues related to introduction of POF and utilization of alternative collateral instruments as needed
	Preparation of POF policies and procedures manual along with bank counterparts
	Develop POF marketing materials
	Continue POF training and technical assistance program
October - November	Review potential POF transactions with partner bank staff and begin execution of transactions with SMEs
	Receive approval for utilization of POF policies and procedures manual from bank management
	Roll out of printed marketing materials
December	Develop plan for wider product roll out following evaluation of pilot program

As indicated above, Crimson's experts and the Program team can provide on the job training to help management and loan officers better use cash flow analysis in lending decisions, and to analyze and complete POF loan transactions. Crimson's team will also work with selected partners to help them successfully pilot and market the POF product and adapt it to the Salvadoran environment. Annex A includes two draft SOWs for the proposed next two visits of Crimson experts to begin to implement this pilot POF program once bank partners have been selected.

Experience in other markets have shown that once one to two banks have introduced POF and increased usage of alternative forms of collateral, competition will drive other banks to follow suit. This has been true in all the countries where Crimson has introduced POF to date, and ultimately can help benefit SME borrowers plus help to develop the overall financial markets in El Salvador. The SME Finance Program could rapidly add additional bank partners to the program once the first ones have introduced the product.

If these initial steps can be completed in the near term, Crimson can quickly begin to implement a program with partner banks to introduce POF to El Salvador in compliance with SSF standards. Assuming that activities described above can be speedily completed, partner banks should be able to begin extending pilot POF loans during the fourth third quarter of this calendar year.

ANNEX A. PROPOSED SCOPES OF WORK FOR NEXT STEPS OF PILOT PURCHASE ORDER FINANCE PROGRAM

Scope of Work
Technical Assistance and Training Plan to Introduce POF in El Salvador
USAID Financial Services for SMEs Program
Contract No. EEM-E-02-05-00006-00

A. Background

SMEs in El Salvador face a number of challenges to reach new markets and grow their businesses. USAID/El Salvador has identified two major developmental challenges in the financial sector: SMEs lack access to appropriate financial products and services and non-bank financial institutions (NBFIs) lack access to commercial sources of funds and savings.

USAID's Financial Services for SMEs Program (SME Finance Program) is addressing these problems by working with commercial financial institutions to increase access to credit and other financial services for small and medium enterprises as well as further strengthen the provision of microfinance in El Salvador by assisting two microfinance institutions (MFIs) to become regulated non-bank financial institutions (NBFIs) under the SSF.

The program is currently ramping up its activities with partner banks. Partner banks in the program have requested support developing new working capital finance products for SMEs. This is a specialty of Crimson Capital, which has developed new trade and finance products for banks and NBFIs in several markets.

During March 2007, Michael Gold and Greg Jacobs of Crimson Capital completed an in country assignment to assess the potential development for new working capital financing products, especially Purchase Order Finance (POF). Due to the strong interest of all partner banks in introducing this type of financing, an expedited Expression of Interest (EOI) has been prepared to best determine which partner banks are most committed and able to roll out this project. This SOW as detailed below focuses on moving forward with selected partners to begin to introduce POF to El Salvador.

B. Objective

The primary objective of this scope of work is to launch the introduction of POF through selected partner banks, and to lay out the framework for a technical assistance and training program over five to six months to successfully introduce POF to the El Salvador market.

C. Tasks

This scope of work will undertake a series of activities:

- Complete selection process of one to two partner banks through a clear and measurable selection process.
- Establish links to sources of SME client referrals such as USAID EXPRO, FUNDES, CONAMYPE, etc.
- Scope initial calendar and needs for training and technical assistance program with partners

D. Reporting Instructions

The consultants will report to the Chief of Party, Michael McNertney or his designee, who will be responsible for supervising the consultants' performance.

E. Deliverables

- Definitive criteria for selecting one to two partner banks
- Prepared list of potential referrals for SME clients to the Pilot Program
- Concise presentation to Program detailing proposed next steps for each bank
- Detailed scopes of work for required technical assistance with each bank to successfully launch a POF pilot

The final report will be due within two weeks after completing the in-country portion of the assignment, which will take place on/about July 15, 2007.

F. Level of Effort

The anticipated Level of Effort (LOE) in days needed for this assignment is:

Consultant	Affiliation	In-country LOE	Home/ US LOE	Travel	Total
Greg Jacobs	Crimson Capital Corporation	5	0	2	**7**

The assignment will be performed by Mr. Greg Jacobs who completed the initial SOW for this program along with Mr. Gold and also took part in the work planning process for Year 2 activities for the SME Finance Program. He has worked on SME Finance programs in Macedonia, Armenia, Kosovo, Bolivia and Moldova to analyze the SME financial arena from both the supply and demand sides and to develop appropriate new financial products. Mr. Jacobs has more than a decade of experience in international development and his work with Crimson Capital over the last three and half years has focused on private sector development programs including market and business linkages, MSME finance, competitiveness, trade, enterprise development and economic development. He currently manages Crimson's Washington D.C. operations, and has played a major role in the expansion of Crimson's portfolio in Latin America, Africa, and Asia for USAID, the IFC, and other clients. Mr. Jacobs speaks French, Armenian, Czech and Spanish.

Scope of Work
Assessment of Trainings Needs of Banks and Initial Training to Roll Out Purchase Order Finance (POF)
USAID Financial Services for SMEs Program
Contract No. EEM-E-02-05-00006-00

A. Background

SMEs in El Salvador face a number of challenges to reach new markets and grow their businesses. USAID/El Salvador has identified two major developmental challenges in the financial sector: SMEs lack access to appropriate financial products and services and non-bank financial institutions (NBFIs) lack access to commercial sources of funds and savings.

USAID's Financial Services for SMEs Program (SME Finance Program) is addressing these problems by working with commercial financial institutions to increase access to credit and other financial services for small and medium enterprises as well as further strengthen the provision of microfinance in El Salvador by assisting two microfinance institutions (MFIs) to become regulated non-bank financial institutions (NBFIs) under the SSF.

The Program is currently ramping up its activities with partner banks. Partner banks in the program have requested support developing new working capital finance products for SMEs. This is a specialty of Crimson Capital, which has developed new trade and finance products for banks and NBFIs in several markets. During March 2007, Michael Gold and Greg Jacobs of Crimson Capital completed an assignment to assess the potential development for new working capital financing products, especially POF. This SOW as detailed below focuses on moving forward with selected partners to begin to introduce POF to El Salvador.

B. Objective

The primary objective of this scope of work is to complete an initial assessment of bank training needs for POF and to begin initial training of partner banks in POF mechanism and utilization.

C. Tasks

This scope of work will undertake a series of activities:

- Conduct initial assessment of trainings needs for POF as well as assessment of policies and procedures of partner banks
- Finalize a roll out plan for technical assistance and training to launch POF
- Begin initial training of partner bank personnel in POF mechanism and utilization

D. Reporting Instructions

The consultants will report to the Chief of Party, Michael McNertney or his designee, who will be responsible for supervising the consultants' performance.

E. Deliverables

- Presentation with findings of initial assessment of training needs
- Presentation with findings from review of policies and procedures and recommended changes for introducing POF
- Finalized training and technical assistance plan with partner banks for the following five months
- Development and presentation of initial training modules in POF
- Detailed scopes of work for additional training required

F. Level of Effort

The anticipated Level of Effort (LOE) in days needed for this assignment is:

Consultant	Affiliation	In-country LOE	Home/ US LOE	Travel	Total
Stewart Cole	Crimson Capital Corporation	13	1	2	**16**

The assignment will be performed by Mr. Stewart Cole. Fluent in Spanish, Mr. Cole is a seasoned international banker with extensive experience in diverse geographies, principally Latin America and Asia, in the areas of trade finance, syndicated and project lending, portfolio risk management, credit and compliance, private and branch banking, consulting and development finance. His consulting work has focused on credit and risk management, including teaching related topics such as SME Lending Techniques, Working Capital Finance, and Trade Finance. He has recently worked for Crimson Capital in Bolivia helping a partner financial institution introduce POF to the Bolivia market. This assignment involved extensive training and technical assistance to management and senior loan officers.

Mr. Cole banking development finance experience includes recent USAID assignments in Bolivia the Balkans, Iraq, and Armenia involving technical assistance to non-bank financial institutions in projects requiring support for issuance of commercial paper, MIS development, capacity building in credit and documentary trade finance, and purchase order finance lending. Also, negotiated a DCA guarantee and related documentation, designed and presented extensive training curricula in credit (SME lending, documentary term lending and risk mitigation, source and applications of funds analysis) and international trade finance related subjects.

ANNEX B. RECOMMENDATIONS FOR SELECTION OF PARTNERS FOR POF PILOT PROGRAM

Partner banks interested in participating in the POF pilot program will be required to confirm their interest and commitment to working with the Financial Services for SMEs Program to develop and successfully launch this new product.

Partner banks must demonstrate:

- Commitment to developing trade and working capital finance products and experience developing these types of products to date, especially for the SME Sector.

- Brief explanation of the bank's interest in developing POF and how it plans to incorporate this product into the banks overall and SME lending portfolio.

- Good working relationship with the Financial Services Program to date and demonstrated responsiveness to Program staff.

- Commitment to sharing fifty percent of the costs of the technical assistance and training.

ANNEX C. PURCHASE ORDER FINANCE PRESENTATION

SME Financing

- In developed countries, SMEs generate majority of economic activity and employment
- SMEs in the United States employed 60% of non-farm workers, produced 55% of GDP and created 80% new jobs between 1992-00
- But,it is sometimes difficult even in the United States for SMEs to obtain traditional bank financing
- Bank financing to SMEs in transition and emerging market economies is even more difficult and SMEs lose growth opportunities due to lack of financing

Financing Obstacles for SMEs in El Salvador

- Owners/Managers lack required skills
- Small cadre of professionals at managerial level
- Very poor financial statements
- Registered vs. unregistered sales
- Lack of IAS accounting standards
- Lack of understanding of “trade finance” vs. revolving lines of credit
- Lack of borrowing experience
- Lack of necessary collateral / already highly leveraged

Further Obstacles to Growth for Salvadoran SMEs

- Lack working capital to buy raw materials and packaging
- Lack credit experience and track record with commercial banks
- Inexperience in preparing adequate business plans and credit applications
- Not sophisticated in producing and delivering competitive quality goods to the export market

Introducing Purchase Order Financing to Address these Issues

- Purchase Order Financing is a transaction specific form (Trade Finance) of pre-shipment working capital financing
- It is used to pay job-specific vendors and other costs associated with completing production and delivery of a confirmed purchase order
- It is NOT a general loan or line of credit for operations of the business

Loan Purposes

Purchase Order Financing can pay for:

- purchase of raw materials and direct overhead costs
- payment of project-designated labor, payroll and other taxes
- custom duties, VAT, insurance and other taxes and export-related fees
- payment for subcontractors and assemblies

- purchase or preparation of packaging and graphics, testing, inspection and shipping costs

Why POF and Pre-Export Financing?

- Businesses in El Salvador can obtain needed raw materials, packaging, etc, to fill orders by obtaining money prior to shipping
- Allows increased size and frequency of orders, thereby increasing sales, profits and employment
- Doesn't tie up collateral, especially real estate
- Transaction and market driven
- Tenure and interest on loan limited to transaction
- Creates jobs and promotes sales and exports
- Flexible instrument that can be easily introduced and applied to several sectors (business cycles)
- Appropriate and realistic for challenges to lending in El Salvador

Additional POF Loan Benefits

- Trade financing available nationwide and connects with regional trade flows
- Attractive and competitive terms and conditions
- Direct financial support to SMEs
- Higher fees earned by banks from increased business activity from SMEs
- New/improved clients for banks: SMEs are now more "bankable"

How Does a POF Loan Work?

- Company obtains verified Purchase Order from buyer (customer) for a product
- Company breaks down costs (R/M, direct labor, overhead, profits, etc.) to produce and deliver product to the buyer
- Banks reviews the Purchase Order, cost breakdown, analyzes the credit of the company, and performance record of the buyer

How Does a POF Loan Work?

- If financing approved, bank pays directly to the supplier (of the raw materials) or to the company
- Company produces the product, delivers them and invoices the buyer. The A/R is assigned to the bank and the buyer pays the bank
- The bank receives payment from the buyer, deducts all costs advanced for the financing and remits the balance to the seller

Two Questions

- Is the Purchase Order from a credit-worthy customer or government entity? Or is it backed by an L/C from a reliable bank?
- Can the company produce the products and complete the Purchase order on time and to the satisfaction of the buyer?

Collateral Requirements

POF loans can accept the following collateral, if in compliance with Salvadoran banking regulations:

- Assignment of Working Capital Assets (Inventory, Accounts Receivables and Other Liquid Assets)
- Irrevocable (Confirmed) Letters of Credit
- Cross Checks
- Bills of Exchange
- Bank Guarantees
- Export Credit Insurance
- Personal and Corporate Guarantees
- Other

Loan Terms and Conditions

- Loan size:
- Interest rates:
- Fees:
- Application Fee
- Processing Fee
- Management Fee
- Tenor: Minimum 30 days and maximum 180 days
- Repayment: Interest and principal is paid monthly
- Currency: Loans are denominated and repaid in Dollars

Loan Terms and Conditions
(Example from Crimson's Macedonia Fund)

Loan Application and Approval Procedure

- Submission of the Credit Application
- Credit analysis by Loan Officer
- Client visits
- Approval of the Credit Application
- Signing of Loan Agreement
- Disbursement

Crimson's Introduction of POF in other markets

- Macedonia SME Commercial Finance (Provided $9.5 million in working capital finance, $14 million in exports, 820 new jobs)
- Armenia Micro Enterprise Development Initiative ($5.8 million in new loans from 6 commercial banks)
- Programs in development:
  - Moldova - 3 banks rolling out POF products, one already has extended POF pilot loans with the Central Bank's approval

- Bolivia - Leading NBFI introducing pilot POF program and opening four new branches in two rural economic corridors
- Kosovo – Three banks introducing POF as an official product with Central Bank Approval

What our Clients say about Macedonia's SME Fund

- "The SME loan allowed us to introduce a new product"
- "We were able to increase our exports to Australia"
- "We purchased raw materials before the season at a lower price---this increased our profits!"
- "Our sales increased, our financial situation is stabilizing and we are reaching our goals"

Summing Up -
Why POF and Pre-Export Financing?

- Businesses in El Salvador can obtain needed raw materials, packaging, etc, to fill orders by obtaining money prior to shipping
- Allows increased size and frequency of orders, thereby increasing sales, profits and employment
- Doesn't tie up collateral, especially real estate which may/may not be available.
- Employs collateral alternatives to mitigate risk, provides greater access to credit
- Transaction and market driven
- Logical approach to financing the various steps in value chains to sustain economic processes
- Tenure and interest on loan limited to transaction
- Creates jobs and promotes sales and exports
- Flexible instrument that can be easily introduced and applied to several sectors (business cycles)
- Appropriate and realistic for challenges to lending in El Salvador

Summing Up -
Why POF and Pre-Export Financing?

- Development and enhancement of appropriate working capital financing products such as POF. Broaden the range of products that a bank can offer
- Products that are flexible and meet the special requirements of emerging markets requirements in El Salvador
- Possible integration of leasing and warehouse finance products in the context of structured finance to meet special client needs
- Increase competition and opportunity in lending market
- Sustainable development of new products and services
- Generate finance and investment opportunities for the bank's clients

ANNEX D. INDIVIDUALS INTERVIEWED FOR ASSIGNMENT

BANK/INSTITUTION	CONTACT TO MEET WITH	POSITION
ABACO	René Quan	SME Representative
ABANSA	Lic. Carlos Cáceres & Lic. Melida Pérez Castillo	Director Ejecutivo, Economista Senior
A2F Program	Mike McNertney and team	COP
Banco Agrícola	Lic. Silvia de Gutiérrez	Gerente Área Banca Comercial
Banco Cuscatlán	Lic. Lorena Rubio	Gerente Banca Empresarial
Banco de América Central	Lic. Patricia de Rivera & Lic. Douglas Fuentes	Jefa Banca Comercial/ Inteligencia de Mercado- Gerencia Corporativa
Banco Hipotecario	Lic. Manuel Rivera Castro & Lic. Marlene Deras De Amaya	Gerente de Negocios, Gerente Banca Empresarial PYME
Banco Promérica	Lic. Emilio López & Lic. Ana Vilma de Bolaños	Gerente Banca Empresarial/ Banca Regional
Banco Salvadoreño	Lic. Patricia de Pastore, Lic. Cesar Barahona & Lic. Nohemy de Flores	Subgerente Negocios Minorista, Gerente Banca Comercial, Riesgos Negocios minoristas
BMI+CONAMYPE	Lic. Alfredo Alfaro Lic. Haydeé de Trigueros	Gerente Banca Desarrollo/Directora Ejecutiva
G&G Factible & Latin Trade	Ricardo Guevara	SME Representative
Jaleas Glo	Silvia de Cuenca	SME Representative
Productos La Canasta	Rosario de Barriere & Claudia Barriere de Melara	SME Representative
Programa de Promoc de Exp	Sr. Phil Rourk & Sr. Federico Aguilar	COP, Deputy Director
Superintendencia del Sistema Financiero (SSF)	Lic. William Durán	Intendente de Supervisión
USAID	Lic. Sandra Lorena Duarte & Lic. Carlos Arce	Gerente del Programa, Gerente de Comercio y Desarrollo Empresarial

ANNEX E. RESOURCES REVIEWED

Internal Project Documents

- Evaluación deL Banco y Su Atención al Cliente PYME: Banco Agrícola
- Evaluación deL Banco y Su Atención al Cliente PYME:Banco Promérica
- Evaluación deL Banco y Su Atención al Cliente PYME:Banco Salvadoreño
- Evaluación deL Banco y Su Atención al Cliente PYME:Banco de America Central
- DIAGNÓSTICO integral del área de atención a las PYME EN EL BANCO CUSCATLÁN
- INFORME FINAL CONSULTORÍA SOBRE CULTURA DE ATENCIÓN A LAS PYME: BANCO HIPOTECARIO
- Estudio del mercado PYME: Necesidades y demanda para los servicios financieros
- Importancia de contar con información integral del financiamiento a la PYME, PowerPoint Presentation, Francisco Armando Hernández, March 2007
- First Year Work Plan
- Draft Second Year Work Plan
- Project Quarterly Reports

Outside Sources

- Más créditos a la exportación Proyecto. El BMI prepara una nueva línea de capital de trabajo para el sector, Publicada 19 de agosto 2005, El Diario de Hoy
- Proposal for Preparation of SME Fund, USAID's Export Promotion Project, 2006
- Commercial Code, El Salvador, Articles 701 – 827 (regarding usage and definitions of instruments such as cross checks, bills of exchanges, etc.)
- Leyes de Sistema Financiero (taken from SSF Website below)
- World Bank Data Profile, El Salvador, 2004 - 2005
- Doing Business Survey, IFC, El Salvador, 2005 - 2006

Websites

Superintendecia del Sistema Financiero	www.ssf.gob.sv
ABANSA:	www.abansa.org.sv
CONAMYPE:	www.conamype.gob.sv
BMI:	www.bmi.gob.sv
EXPRO:	www.usaidexpro.org
Banco Hipotecario:	www.bancohipotecario.com.sv
Banco de América Central:	www.credomatic.com
USAID El Salvador:	www.usaid.gov/sv