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Report No: PAD3630

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROJECT APPRAISAL DOCUMENT
ON A
PROPOSED LOAN

IN THE AMOUNT OF US$260 MILLION

TO THE

CORPORACIÓN FINANCIERA NACIONAL B.P.

WITH A GUARANTEE FROM THE REPUBLIC OF ECUADOR

FOR A

PROMOTING ACCESS TO FINANCE FOR PRODUCTIVE PURPOSES FOR MSMES PROJECT

JUNE 8, 2020

Finance, Competitiveness And Innovation Global Practice
Latin America And Caribbean Region

CURRENCY EQUIVALENTS

Exchange Rate Effective April 24, 2020

Currency Unit = US$

FISCAL YEAR

January 1 - December 31

Regional Vice President:	J. Humberto Lopez (Acting)
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ABBREVIATIONS AND ACRONYMS

BCE	Central Bank of Ecuador
CFN	National Finance Corporation (*Corporación Financiera Nacional B.P.*)
COMYF	Monetary and Financial Code (*Código Orgánico Monetario y Financiero*)
ESMS	Environmental and Social Management System
ESRS	Environmental and Social Review Summary
ESS	Environmental and Social Standards
E&S	Environmental and Social
FM	Financial Management
FY	Fiscal Year
GDP	Gross Domestic Product
GRM	Grievance Redress Mechanism
GRS	Grievance Redress Service
IBRD	International Bank for Reconstruction and Development
IMF	International Monetary Fund
IPAM	Indigenous Peoples and Nationalities, Afro-Ecuadorians and Montubians
LAC	Latin America and the Caribbean Region
M&E	Monitoring and Evaluation
MEF	Ministry of Economy and Finance
MFD	Maximizing Finance for Development
MSME	Micro, Small, and Medium Enterprise
NGF	National Guarantee Fund
NPL	Non-performing loan
PCT	Project Coordination Team
PDO	Project Development Objective
PFI	Participating Financial Intermediary
SB	Superintendence of Banks
SEP	Stakeholder Engagement Plan
SME	Small and Medium Enterprises
US$	Unites States Dollars
WB	World Bank

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DATASHEET

BASIC INFORMATION

Country(ies)	Project Name
Ecuador	Promoting Access to Finance for Productive Purposes for MSMEs

Project ID	Financing Instrument	Environmental and Social Risk Classification
P172899	Investment Project Financing	Moderate

Financing & Implementation Modalities

[ ] Multiphase Programmatic Approach (MPA)	[ ] Contingent Emergency Response Component (CERC)
[ ] Series of Projects (SOP)	[ ] Fragile State(s)
[ ] Performance-Based Conditions (PBCs)	[ ] Small State(s)
[✓] Financial Intermediaries (FI)	[ ] Fragile within a non-fragile Country
[ ] Project-Based Guarantee	[ ] Conflict
[ ] Deferred Drawdown	[ ] Responding to Natural or Man-made Disaster
[ ] Alternate Procurement Arrangements (APA)	

Expected Approval Date	Expected Closing Date
02-Jul-2020	31-Dec-2025

Bank/IFC Collaboration
No

Proposed Development Objective(s)

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

Components

Component Name	Cost (US$, millions)
Strengthening the Institutional Capacity of CFN	3.00
Development and Improvement of Financial Products to Promote Access to Finance for MSMEs	42.00
Credit Line Intermediated by CFN to PFIs for On-Lending to MSMEs	213.00
Project Management	2.00

Organizations

Borrower:	Corporación Financiera Nacional B.P.
Implementing Agency:	Corporación Financiera Nacional B.P.

PROJECT FINANCING DATA (US$, Millions)

SUMMARY

Total Project Cost	260.00
Total Financing	260.00
of which IBRD/IDA	260.00
Financing Gap	0.00

DETAILS

World Bank Group Financing

International Bank for Reconstruction and Development (IBRD)	260.00

Expected Disbursements (in US$, Millions)

WB Fiscal Year	2020	2021	2022	2023	2024	2025	2026
Annual	0.00	98.00	67.00	60.00	34.00	1.00	0.00
Cumulative	0.00	98.00	165.00	225.00	259.00	260.00	260.00

INSTITUTIONAL DATA

Practice Area (Lead)

Finance, Competitiveness and Innovation

Contributing Practice Areas

Climate Change and Disaster Screening

This operation has been screened for short and long-term climate change and disaster risks

SYSTEMATIC OPERATIONS RISK-RATING TOOL (SORT)

Risk Category	Rating
1. Political and Governance	High
2. Macroeconomic	High
3. Sector Strategies and Policies	Substantial
4. Technical Design of Project or Program	Moderate
5. Institutional Capacity for Implementation and Sustainability	Substantial
6. Fiduciary	Substantial
7. Environment and Social	Moderate
8. Stakeholders	Moderate
9. Other	
10. Overall	Substantial

COMPLIANCE

Policy

Does the project depart from the CPF in content or in other significant respects?

[ ] Yes [✓] No

Does the project require any waivers of Bank policies?

[ ] Yes [✓] No

Environmental and Social Standards Relevance Given its Context at the Time of Appraisal

E & S Standards	Relevance
Assessment and Management of Environmental and Social Risks and Impacts	Relevant
Stakeholder Engagement and Information Disclosure	Relevant
Labor and Working Conditions	Relevant
Resource Efficiency and Pollution Prevention and Management	Relevant
Community Health and Safety	Relevant
Land Acquisition, Restrictions on Land Use and Involuntary Resettlement	Not Currently Relevant
Biodiversity Conservation and Sustainable Management of Living Natural Resources	Not Currently Relevant
Indigenous Peoples/Sub-Saharan African Historically Underserved Traditional Local Communities	Not Currently Relevant
Cultural Heritage	Not Currently Relevant
Financial Intermediaries	Relevant

NOTE: For further information regarding the World Bank's due diligence assessment of the Project's potential environmental and social risks and impacts, please refer to the Project's Appraisal Environmental and Social Review Summary (ESRS).

Legal Covenants

Sections and Description
The Borrower will establish the ESMS no later than 90 days after the Effective Date, and in any event prior to carrying out any activity under Parts 2 (b), 2(c) and 3 of the Project according Schedule 2. Section I.F.4. of the Loan Agreement.

Sections and Description
The Borrower shall, no later than thirty (30) days after the Effective Date, and in any event prior to carrying out any activity under Parts 2 (b), (c) and 3 of the Project, adopt the Operational Manual in a form and substance acceptable to the Bank according Schedule 2. Section I.B.3. of the Loan Agreement.

Conditions

Type	Description
Disbursement	Subcomponent 2(c): No withdrawal shall be made under Part 2(c) for transfers to the National Guarantee Fund unless the National Guarantee Fund adopts the NGF Strengthening Plan in a manner satisfactory to the Bank according Schedule 2. Section III.B (b).

Type	Description
Disbursement	No withdrawal shall be made for payments made prior to the Signature Date, except that withdrawals up to an aggregate amount not to exceed $26,000,000 may be made for payments made prior to this date but on or after May 20, 2020, for Eligible Expenditures under Categories (1), (4) and (5) according Schedule 2. Section III.B (a).

I. STRATEGIC CONTEXT

A. Country Context

1. **Starting from an already challenging macro-fiscal situation, Ecuador has been hit by two major simultaneous shocks in the first half of 2020: the COVID-19 outbreak and the collapse of international oil prices.** While the COVID-19 crisis is still unfolding and its duration and depth is unknown, it is clear that Ecuador will be severely affected. According to the latest International Monetary Fund (IMF) projections[1], Gross Domestic Product (GDP) is expected to contract by 6.3 percent in 2020, the second largest output fall among countries in Latin America. As of May 21, 2020, 35,306 cases – including 4,819 deaths – were recorded in Ecuador. The COVID-19 crisis further complicated a challenging economic situation. The government had to respond quickly at the first signs of the crisis by implementing austerity measures to free up resources for priority spending, introducing strong containment measures, and responding with stimulus programs to support firms, jobs, and vulnerable households. However, Ecuador's reduced fiscal buffers, limited monetary policy tools, and restricted access to financing contains the size, scope and impact of the said measures. In fact, spending pressures associated with health, social and economic support measures and lower tax revenues due to economic contraction will further compress the available fiscal space. At the same time, necessary crisis response efforts will temporarily divert attention from the medium-term reform agenda, which is further complicated by the oil price collapse – oil accounts for 39 percent of Ecuador's exports and 22 percent of its fiscal revenues. The sharp drop in international oil prices in the first months of 2020 has aggravated external and fiscal imbalances faced by Ecuador's dollarized economy.

2. **After sustaining more than a decade of robust growth on the back of high oil prices, Ecuador has seen a marked slowdown in GDP growth since oil prices plummeted in mid-2014.** The remarkable episode of stable growth experienced during 2001-2014, where annual GDP growth averaged 4.5 percent, marked a break with two decades of booms and busts. Initially driven by stabilization reforms and the decision to adopt the US dollar as the legal tender in the early 2000s, growth was later fueled by high oil prices. However, this boom hid the accumulation of large macroeconomic imbalances and some structural problems such as an inefficient public sector, a lack of stabilization mechanisms in a dollarized economy, loss of competitiveness due to persistent inflation differentials with the US and limited private investment. These deficiencies became further evident when oil prices fell in 2014, exposing the inconsistency of the fiscal path with the dollarization framework. The ensuing fiscal consolidation combined with declining oil revenues and feeble private demand brought down GDP growth to an average of just 0.6 percent between 2015 and 2018.

3. **Ecuador now faces the challenge of adjusting its economy to low and volatile oil prices and to tightened external financing, while navigating the impacts of the COVID-19 crisis.** Due to its dollarized economy and limited fiscal buffers, Ecuador could neither rely on currency depreciation nor undertake countercyclical fiscal policies to respond to shocks such as the oil price drop in 2014. As revenues plummeted in 2014, the Government cut spending (mainly public investment), which accentuated the economic deceleration in 2015-16. Despite these efforts, fiscal deficits widened, arrears accumulated, and the public debt increased swiftly, from 27 percent of GDP in 2014 to 48 percent in 2019. External imbalances have led to a sharp decline in Ecuador's international reserves since 2015, with temporary relief when Ecuador managed to mobilize costly external financing. Poverty reduction lost momentum during this time, with the poverty rate increasing slightly between 2014 and 2019. This reversal trend is expected to intensify in 2020 due to the effects of the COVID-19 health crisis, with almost 1.5 million people who could fall back into poverty during the year. While initial reform efforts introduced in 2018 and 2019 improved Ecuador's fiscal profile, the COVID-19 health crisis

[1] World Economic Outlook, April 2020

adds unforeseen pressures to the economy. Adapting to this challenging context requires the combination of quick crisis response measures and a solid medium-term reform program to continue addressing macro-fiscal imbalances while shifting from an economic model that is state-led to one that is balanced and productivity-driven. Increasing private investment and non-oil exports while creating employment in the private sector are crucial to maintain consensus for the reform program and ensure its sustainability.

4. **In addition to the above-mentioned challenges, the country's ability to support measures as a response to COVID-19 is exacerbated by climate change.** The country is vulnerable to several natural induced hazards, including floods, landslides and droughts, which are expected to be exacerbated by climate change. In addition to floods, which are often associated with the El Niño phenomenon, landslides are the most frequent natural hazards in Ecuador. These and other climate change impacts, in particular rising temperatures and changes in precipitation patterns and severity, also result in an increase in the transmission of vector-borne and other respiratory diseases, making the affected population increasingly vulnerable. Lastly, observed and anticipated climate change impacts, also pose challenges to micro, small and medium enterprises (MSMEs) [2] as their financial and physical ability to continue in business can be threatened by impacts in the health of their workforce, but also through damages to infrastructure.

B. Sectoral and Institutional Context

5. **Like countries with similar levels of development, Ecuador's financial sector is dominated by banks.** The banking sector accounts for nearly 80 percent of the system's assets. Yet unlike many peer countries Ecuador's banking system presents a rather atypical structure. While twenty-two private banks account for about two thirds of financial system's assets and about half of total banking sector assets[3], five public banks have gained importance in the provision of financial services over the past decade, and account for just under 20 percent of credit operations of the financial system.[4] In addition, about 450 financial cooperatives also play an important role, accounting for about a quarter of total banking assets and serving more than 7 million clients/members. Capital markets remain underdeveloped compared to countries in Latin America, with limited participation of institutional investors. This partly reflects the lack of a liquid and transparent market for government bonds, which is a key building block for capital market development and for influencing the marginal cost of funding of financial intermediaries.

6. **Recent macroeconomic instability has had a negative impact on the operations and financial performance of the banking system, which however remains *prima facie* stable** (Figure 1)**.** This can rapidly change as the unfolding of the COVID-19 crisis exacts its toll on the Ecuadorian economy. Deposit and credit aggregates have recently shown diverging growth trajectories, putting pressure on liquidity and squeezing interest rate margins, and spurring volatility in key credit metrics. Banks reduced markedly the provision of credit in the wake of the 2015 economic contraction to only bounce back in 2017-18, though signs of slowdown have recently emerged, especially in the segment of credit to firms. Despite these developments, the financial system appears stable. The reported financial metrics suggest that the financial system remains solvent, profitable, and liquid. However, it is essential that the authorities remain vigilant and closely monitor the evolution of key indicators, especially given the expected impact of the COVID-19 crisis, while the regulatory and supervisory framework is being upgraded. In this context, the World Bank is discussing the opportunity to provide technical assistance to strengthen the credit risk surveillance framework of the Superintendence of Banks (SB), the

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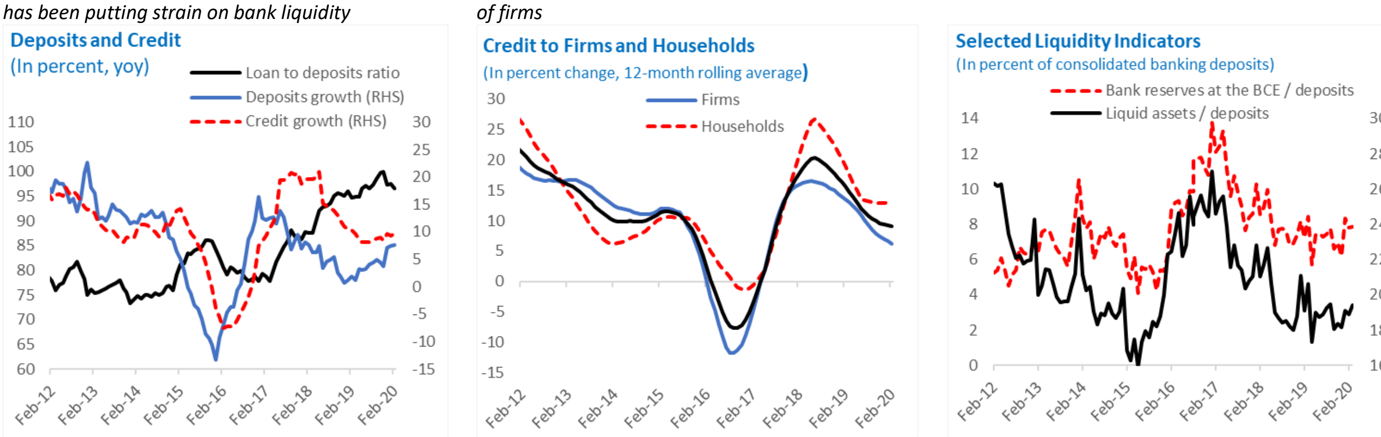
[2] MSMEs are defined according to domestic regulation.
[3] Superintendence of Banks (SB)
[4] Public banks include: *Corporación Financiera Nacional B.P.* (CFN), *Banco de Desarrollo*, *BanEcuador* and CONAFIPS. *Banco Pacífico*, while officially classified as a private bank, is 100 percent state-owned through CFN. An institution managing the funds of the social security system, BIESS, completes the list of public banks.

supervisory authority, especially in the higher risk segments. As part of its program, the IMF envisions technical assistance to develop a macroprudential policy framework while strengthening banking supervision and streamlining liquidity requirements.

7. **The banking sector's role in supporting private sector-led growth has substantially been constrained due to restrictive government interventions.** The sector is shallow, with private credit to GDP standing at 29 percent versus 48 percent in Colombia, 37 percent in Peru and 49 percent on average in the region[5]. Limited financial deepening is partly explained by the crowding out of the private sector by the public sector. Excessive liquidity requirements on banks have contributed to crowd out private sector financing. Moreover, central bank financing of the public sector has been particularly significant since the 2014 decline in oil prices, which adversely impacted government revenues. Central bank financing has been historically complemented by the pervasive presence of interest rate caps across all credit segments, limiting private banks' involvement due to the binding nature of the ceilings in several markets (Box 1). In 2018, legislative and other steps were taken to put an end to new central bank financing of the government and to the quasi-fiscal activities of the central bank. As part of the package of reforms agreed with the IMF, the authorities intend to go further in the coming months to bolster the central bank's autonomy and governance arrangements. As a part of the current Development Policy Financing (DPF)[6] discussions, the World Bank is providing support to the authorities to revise the current interest rate management policy to make lending ceilings more flexible and more responsive to cyclical and structural developments in the different components of the lending rate. These upstream reforms can contribute to unlock private sector solutions in the future, other things being equal.

Figure 1: Financial System Developments

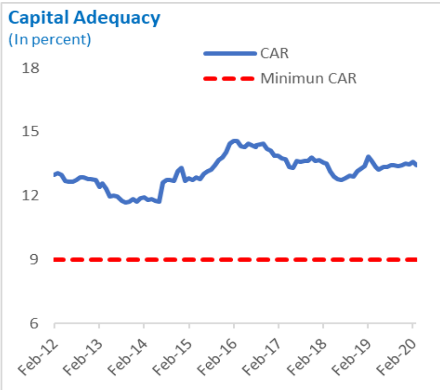
The divergence between credit and deposit growth has been putting strain on bank liquidity | *Household credit growth has been outpacing that of firms* | *Banks' liquidity appears still adequate*



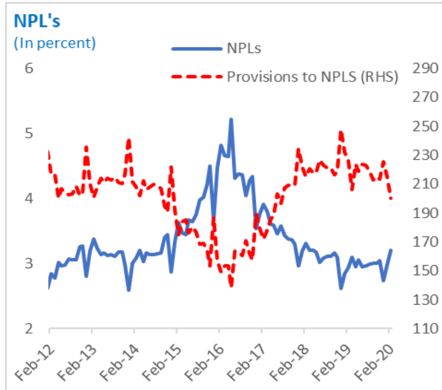
[5] World Development Indicators, 2019

[6] Second Inclusive and Sustainable Growth (P171190)

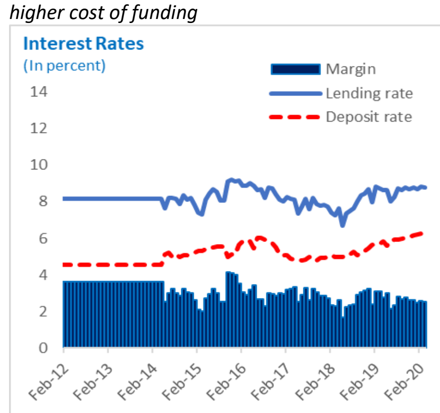
Capital ratios are above the regulatory minimum



NPLs appear low and adequately provisioned



Lending rates have begun to rise ad a result of higher cost of funding



Source: Authors' elaboration;SB.

8. **Businesses, particularly MSMEs, struggle to grow and create adequate and stable employment.** Evidence suggests that smaller firms in Ecuador seem to be the most affected by input market distortions, with government restrictions to market-based financial intermediation being an important potential culprit.[7] This leads to resource misallocation, negatively impacting output and labor demand. Private firms in Ecuador are overwhelmingly young and small, and they struggle to grow over time. More than 18 percent of firms in 2015 were new entrants and nearly 40 percent were less than five years old.[8] There are about 900,000 firms in Ecuador: 91 percent of firms are micro enterprises, 7 percent are small, and the remaining 2 percent are split between medium and large firms.[9] Only a few firms grow to any significant degree during their life cycle. Between 2010 and 2015, only 1.7 percent of micro firms were able to grow beyond the US$100,000 sales threshold. Most of these micro firms remain the same size and many exit the market; a similar pattern holds for small firms. Perhaps due to the economic downturn in 2015, the survival rate of firm cohorts has declined between 2012 and 2016. The one-year survival rate of entrants fell from 84 percent in 2010 to 77 percent in 2014. Similarly, the three-year survival rate for the 2010 cohort was 65 percent and fell to 53 percent by 2012.

Box 1: Interest Rate Controls in Ecuador

Interest rate controls in Ecuador were introduced at the time of the adoption of the US dollar as legal tender in 2000. First, there were limits to the maximum lending rates based on the London Interbank Offered Rate (LIBOR), augmented by a spread considering country risk and a 4 percent operating margin. Subsequently, in 2007 the authorities introduced absolute interest rate ceilings on four credit portfolios while prohibiting the charging of fees and commissions. Since then, the number of credit segments has increased to the current 19 with 22 administered interest rates ceilings.

The credit portfolio segmentation appears to be excessive. Credit segmentation reflects different criteria, namely the purpose of the loan with a clear separation among production, consumption and real estate, difference in the economic agents (firms versus households), in the economic segments (e.g., agriculture and farming), and in size (e.g., microenterprises versus other firms). This segmentation appears excessively convoluted, entailing a high degree of complexity in terms of administration and management. Moreover, it might involve arbitrage. For example, within a certain segment banks may be tempted to shift from one sub-segment to another to profit from more favorable (i.e. less binding) lending ceilings.

[7] Ho et al. (2019), Productivity and Reallocation: Evidence from Ecuadorian Firm-Level Data, mimeo.
[8] World Bank (2019), Country Private Sector Diagnostic.
[9] In terms of sectoral distribution, about 43 percent are firms from the service sector, 35 percent from commerce (both economic sectors generate more than 60 percent in annual sales), 10 percent from the agriculture sector, 8 percent from manufacture, 3 percent from construction, and 1 percent extractive sector.

Interest rates caps vary by sub-segment but tend to remain constant over time. It is not clear whether variation by credit grouping reflects appropriately the underlying risk in each segment. In the absence of money markets that influence banks' marginal cost of funds, it is unlikely that these caps have a direct relationship with credit risk. Moreover, for three microcredit segments there is a differentiation in the ceilings depending on the type of credit institution providing the loan. Finally, except for *microcredito* and *consumo prioritario*, which have seen their interest rate caps revised in 2018, lending rate ceilings have not changed during the past five years, largely as a result of the lack of a transparent and reliable methodology.

Lending rate ceilings appear to be binding in some segments. There are different explanations for this. One argument is that rates offered are below market level, implying a distortion that may have multiple consequences such as mispricing of credit risk and inefficient allocation of credit. Another option is that banks tend not to compete on pricing because their behavior is anchored to a binding interest rates ceiling (i.e., coordination point for interest rates). The observation that the mass of the distribution is close to the interest rates cap may also suggest that there is lack of differentiation of business strategies due to the existence of a binding constraint.

9. **Access to finance, especially credit, is an important obstacle to investment and innovation by MSMEs.** According to the 2017 Enterprise Survey, access to finance is among the top three business environment obstacles for firms in Ecuador. The use of banks by Ecuadorian firms to finance investments is lower than the average for the region and for similar income country groups, while access to long-term finance is low even for large companies. Limited access to finance for MSMEs reflects the interaction of demand and supply factors. Small firms have limited collateral to offer to banks. For example, the value of collateral needed for a loan is estimated at more than 200 percent of the loan amount. Moreover, MSMEs face several nonfinancial barriers related to their own capacities, including a lack of financial education. On the other hand, private banks' participation in MSME credit markets remains limited. The tenors offered by private sector banks are short, usually less than two years, and few products are tailored to small businesses, as higher administrative costs lead banks to prefer to devote their efforts to large corporate clients. Moreover, there are no MSME-focused banks in Ecuador. Large corporations are catered to by private banks and some micro firms are served by financial cooperatives, leaving most micro firms and the SME segment underserved. Interest rate caps on loans to MSMEs add to the reluctance of banks to work with smaller firms, as the high transaction costs and the high risks associated with this segment make it non financially viable in most cases. All the above combined generated an estimated financing gap of US$17 billion in 2018 or 17 percent of GDP.[10] Ensuring adequate access to financing for MSMEs is, therefore, critical for restoring growth and for job creation as MSMEs account for about 60 percent of formal employment in Ecuador[11].

10. **Access to credit seems to be more limited for businesses headed by women and by indigenous peoples and nationalities, Afro-Ecuadorians and Montubians (IPAM).** On gender, although the percentage of women with an account in a financial institution was 40 percent in 2014, only 23 percent of firms where the top manager is female had access to a credit.[12] IPAM-owned MSMEs are concentrated in municipalities with less financial infrastructure (i.e. fewer bank branches and financial cooperatives), operate in sectors that are often not well-served by financial institutions (e.g., smallholder farming, forestry, retail trade), may be less likely to have fixed assets to use as collateral, and may face discrimination and unfair business practices by financial institutions.

11. **The COVID-19 crisis will exacerbate traditional challenges while new, supply-side and demand-side difficulties will soon become apparent, disproportionately affecting MSME financing.** Several interrelated stress factors are expected to impact MSME and entrepreneurship financing in Ecuador:

[10] IFC, MSME Finance Gap Database.
[11] National Institute of Statistics and Censuses (INEC, for its acronym in Spanish), 2019.
[12] World Bank, 2018, Gender Gaps in Ecuador: An Overview, Washington DC.

(a) Reduced activity or business closure will result in less sales revenue. At the same time, costs can increase due the restrictive availability of raw materials, limited transportation routes and increased transportation costs.
(b) A depletion of working capital may entail liquidity or even insolvency problems. The decline in sales and the contemporaneous rise in inventories can be compounded by an increase in payment delays on receivables, leading to a rapid reduction of working capital.
(c) Financial intermediation may be curtailed. Normal banking hours can be reduced, and, in some cases, branch operations can be temporarily halted. Nonperforming loans (NPLs) are expected to rise while significant deposit outflows cannot be rule out, which would put pressure on bank liquidity. All this can result in tightened credit conditions, negatively affecting the availability of credit for MSMEs.

12. **Dealing with the cash flow problems of MSMEs while enhancing access to bank financing will be critical to contain the fallout from the coronavirus crisis while preparing for the recovery.** International experience shows that MSMEs are more vulnerable to business cycle fluctuations and more susceptible to credit rationing. Ecuadorian MSMEs risk being caught in a vicious cycle of supply shock, demand shock, decline in working capital and an increase in insolvencies. At the same time, tightened credit conditions may affect their ability to access liquidity, setting in motion a downward spiral that can significantly impair the backbone of the economy and employment. Ecuador's ability to deal with the crisis is severely constrained by the absence of fiscal space, low international reserves and limited control over monetary policy in a dollarized framework. Therefore, to alleviate the effects of the twin shock of falling sales and more difficult access to finance, the authorities are left with mobilizing MSME credit through public banks and credit guarantees. These approaches have been widely used during the global financial crisis in many economies to restart the flow of credit to MSMEs and have been recently announced, *inter alia*, by Germany, Italy and the UK as a part of the policy toolkit to respond to the COVID-19 crisis. Public banks and credit guarantees not only can be used to provide emergency support to Ecuadorian MSMEs but also to prepare for the recovery and spur greener and innovation-led growth. In addition to fresh resources, this will require parallel interventions to strengthen the institutional framework and expand the range of products they can offer.

13. **Public banks have traditionally responded to the gaps left by the private banks in the MSME segment, yet they are facing structural funding problems.** The government has historically provided incentives for public banks to address the needs of sectors of the economy that are financially underserved. This incentive has mostly come in the form of implicit subsidies. Public banks were the main beneficiary of funding from official sources and mandatory contributions from commercial banks. As of June 2019, CFN held liabilities with the public of US$1.81 billion[13], of which US 961 million were with the central bank, US$434 million with commercial banks (mandatory allocations), and US$416 million with the deposit insurance fund. The average funding rate from these obligations is 2.6 percent, which is approximately one quarter of the government's cost of funding with international bondholders before recent developments. In other words, the government was borrowing at 10 percent and lending to CFN at 2.6 percent, with the subsidy not covered by public banks' returns on their assets, which averaged 2.1 percent in 2018. With Central Bank financing exhausted and other forms of funding increasingly in scarce supply as a result of recent legislative and regulatory reforms, public banks in the medium term will need to be financed either from internal resources or from commercial sources.

14. **Public banks will need significant restructuring to remain relevant and play a more effective role in supporting the real economy.** A problem faced by public banks in a fully dollarized economy is that most of their funding comes from domestic debt. However, in the presence of fiscal constraints, government financing of public banks is expected to be modest at best in the future. Under most scenarios, including that of financing from multilaterals, public banks will

[13] As of March 2020, the total liabilities with the public were US$1.46 billion.

have fewer and more expensive resources and, consequently, will need to redesign their business models and strategies by creating incentives for more active participation of private financial institutions. Instead of trying to compete with commercial banks, public banks should play a more catalytic role by supporting private sector financing in key sectors of the economy. For example, currently *BanEcuador* and CONAFIPS compete in the same segment of the rural market. They also compete with financial cooperatives and some commercial banks that serve this sector. Public banks' mandate and strategy will need to be replaced by one, whereby public banks promote participation of the privately-owned commercial banks in priority sectors, including through second-tier lending and guarantees. In the MSME segment, for example, CFN could complement commercial banks by supporting the development of commercial platforms in commercial banks to help understand and promote their MSME business.

15. **The public banks' new role will require a more adequate corporate governance structure.** Among all distortions originating from the poor design of the public banking system, corporate governance is probably the most significant. The basis can be found in the Monetary and Financial Code (COMYF) that was never clear about the roles of public banks, subordinating them to the central government and putting in place a corporate governance framework that eliminated the independence of these banks and the accountability of directors and senior managers. The boards of directors of public banks are chaired by a delegate from the President of the Republic, with other board members including several ministers, without any independent directors and no specific qualifications and relevant experience requirements in finance or banking. Moreover, directors are often conflicted about the multiple objectives assigned to public banks, making difficult to balance financial performance with the mandate to fulfill vaguely defined social objectives. Lending targets of public banks are expressed in terms of volumes, without enough regard for quality, resulting in lax or poor credit underwriting standards and recovery process, and exposing these financial institutions to political capture and focus on socio-political – electoral and regional – objectives. Without clarity of objectives and clear guidelines for performance the results of public banks have probably been poor on both fronts. To reduce government interference in the business of public banks, government officials should not be members of their boards of directors. Public banks' mandates should address clearly identified market failures with explicit financial targets to ensure financial sustainability and accountability.

16. **Leveling the regulatory and supervisory playing field will also be essential if public banks are to contribute to expand financial access opportunities.** Public banks unduly benefit from several regulatory exemptions compared to private banks, from licensing criteria to minimum liquidity requirements and contributions to the deposit insurance fund. Moreover, SB has been often conflicted, as it has no regulatory powers (those are with the *Junta de Política y Regulación Monetaria y Financiera* under the COMYF) and has faced conflicts of interest by not being independent while supervising high level government officials (cabinet members) that are running the public banks and who have decision-making powers over the SB in terms of appointments and budget. For these reasons, the oversight function for public banks has been generally weaker than that for private banks and possibly not credible. However, even under those constraints, signs of significant operational problems, inefficiency, high but probably underestimated NPLs, poor IT systems and weak internal controls, and in general poor risk management practices, have been highlighted by the SB and the public banks' external auditors.

17. **The authorities are eager to reform the public banks to turn them into modern development finance institutions with a clear mandate and sustainable business model.** With World Bank Group support, the authorities have prepared a reform of the COMYF, which includes a profound revision of the corporate governance framework of public banks to bring it in line with international best practices (expected to be submitted to Congress in the first half of 2020). At the same time, the authorities have requested World Bank Group technical assistance to undertake a financial viability diagnostic of public banks followed by the design of a new strategy based on second-tier lending. In the interim, public

banks need fresh resources to be intermediated to the productive sector to stimulate investment, create jobs and mitigate the negative effects of ongoing fiscal consolidation, particularly for the bottom forty percent of the population. This Investment Project Financing (IPF) forms part of this broad reform agenda supported by the World Bank Group.

18. **The *Corporación Financiera Nacional* B.P. (CFN) is the largest public bank in Ecuador with an institutional focus on the productive sector, including MSMEs, and as such is the ideal partner for this Project.** Established in 1964, CFN is the oldest and largest public bank in Ecuador. CFN is authorized, regulated and supervised by SB. The Central Bank of Ecuador (BCE) is CFN's sole shareholder following a debt-for-equity swap deal between the Ministry of Economy and Finance (MEF) and BCE, which led the latter – which had lent to MEF via CFN – to exchange the outstanding debt with equity in CFN. However, the authorities are planning to transfer CFN's, as well as other public banks', ownership back to MEF. CFN mostly focuses on financing fixed assets and working capital as first-tier lender, but it has designed a strategy to gradually transition to a modern second-tier bank to complement private lenders and crowd in commercial financing. In this context, CFN is already working with a number of private banks and large financial cooperatives, which would act as participating financial institutions (PFIs) for this Project. CFN also acts as a merchant bank, with equity participations in several companies including *Banco Pacífico*, the second largest commercial bank in the country. While well-capitalized, similar to other public banks in Ecuador, CFN presents some key challenges that require immediate attention, including: (i) unsustainable funding structure, with an estimated funding gap of US$210 million in 2020; (ii) poor corporate governance; and (iii) conflicting performance targets and poor asset quality – as of June 2019, the NPL ratio was 13 percent compared to an average of 3 percent for private bank.

19. **CFN manages the *Fondo National de Garantía* (NGF), a public credit guarantee scheme, which represents an important, though underused, tool to increase availability of credit for MSMEs, especially in the context of the COVID-19 crisis.** Established in 2013, NGF is a public policy tool widely used in the region and in the rest of the world to facilitate access to finance for MSMEs that have limited collateral to post to banks when applying for loans. In line with an institutional model adopted especially in the Latin America and the Caribbean region (LAC), NGF is established as a "trust", whose constituent and manager is CFN through a dedicated unit. NGF has its own corporate governance framework and is supervised by SB. It issues individual or loan-by-loan partial guarantees to banks willing to lend to MSMEs, taking 50 percent of the loss in case the MSME defaults on its loans. With a capital of US$26 million and outstanding guarantees of US$79 million at end-2019, NGF presents significant potential to scale up MSME financing through private financial institutions. An assessment conducted as a part of the preparation of this Project has found broad compliance of NGF with the Principles for the Design, Implementation and Evaluation of Public Credit Guarantee Schemes for SMEs, a set of international best practices developed by the World Bank in 2015.[14] Yet there are key areas that require strengthening if NGF is to play a greater role in mobilizing financing for MSMEs. These include: (i) undeveloped risk management system; (ii) lack of risk-based pricing model; and (iii) business model solely based on individual guarantees (i.e. need to develop portfolio guarantees). Nonetheless, a special guarantee program to assist MSMEs with access to bank credit can be established and implemented soon.

C. Relevance to Higher Level Objectives

20. **The Project is fully congruent with the Country Partnership Framework (CPF) for FY19-FY23 discussed by the Board on June 11, 2019 (Report No.135374-EC) – Result Area I: Supporting Fundamentals for Inclusive Growth – as well as with Ecuador's national strategies.** Specifically, this Project contributes towards Objective 3 – Improve financial sector

[14] See http://documents.worldbank.org/curated/en/576961468197998372/Principles-for-public-credit-guarantee-schemes-for-SMEs.

inclusion and intermediation – as it will promote a more efficient allocation of resources while crowding in commercial bank financing and including a larger number of SMEs in the formal financial sector. This IPF also contributes to Objective 1 – Enhance efficiency of public spending – as it will help remove a potential source of contingent liability for the government thus increasing fiscal efficiency. Finally, the Project contributes indirectly to Objective 2 – Improve conditions for private sector development – as it will stimulate private investment in the productive sector. This Project is also aligned with Ecuador's National Development Plan 2017–21 which aims to increase the number of productive loans channeled through the domestic financial sector by improving the coordination between public banks, the private financial sector, and the financial cooperatives.

21. **Ecuador is among the countries supporting the 'Helsinki Principles', a set of six aspirational principles that promote national climate action, especially through fiscal policy and the use of public finance.** One of these principles relates to mobilizing private sources of climate finance by facilitating investments and the development of a financial sector which supports climate mitigation and adaptation. In that regard, this Project is aligned with these principles since it will support actions and investments (through technical assistance and on-lending to MSMEs) that would contribute to increased awareness of and reduced exposure to climate change risks.

II. PROJECT DESCRIPTION

A. Project Development Objective

PDO Statement

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

PDO Level Indicators

23. **The key results expected for the proposed Project will be measured by three PDO indicators:** (i) Number of loans for productive purposes disbursed to MSMEs under the Project; (ii) Number of partial credit guarantees provided to MSMEs with Project funds; and (iii) Share of second-tier financing of CFN.

B. Project Components

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

25. **Component 1 – Strengthening the Institutional Capacity of CFN (US$3 million, IBRD).** This component will provide technical assistance and capacity building to CFN. Under this component the Project will finance, *inter alia*:

(a) Design of a corporate governance strengthening plan for CFN to incorporate international best practices in terms of mandate definition, and board appointment and composition, among others, and to align with the expected legislative and regulatory changes;

(b) Assessment of the financial viability of CFN to ascertain the net present value of its assets. Accordingly, this activity will also include the design of an NPL resolution strategy that would reflect the macroeconomic context, the legal and judicial systems, the fiscal capacity of the government and the type of assets in the NPL stock;

(c) Assessment of the current strategy of CFN and development of an updated business plan to align with the results of the corporate governance reform and the financial viability assessment;

(d) Design and implementation of a monitoring and evaluation strategy to measure the effect of access to credit on final borrowers, including female-owned enterprises and first-time borrowers;

(e) Design and implementation of an environmental and social management system and standards for CFN's second-tier lending; and

(f) Technical assistance to strengthen the capacity of financial intermediaries accessing second-tier financial products, including the strengthening of their environmental and social management systems.

26. **Component 2 – Development and Improvement of Financial Products to Promote Access to Finance for MSMEs (US$42 million, IBRD).** This component will support CFN to develop new or improve existing financial products to promote access to finance for productive purposes, especially for MSMEs. Specifically, under this component the Project will finance:

(a) **Subcomponent 2a – technical assistance (US$2 million, IBRD**). Under this subcomponent, the Project will finance a technical assistance to, *inter alia*: (i) strengthen NGF, especially its risk management system and pricing policy; and (ii) design, test and evaluate new financial products for MSMEs with potential to be scaled up or improve the existing ones (e.g. risk sharing facilities, alternative financial instruments, climate resilience financial products, specialized products for female-owned MSMEs and IPAM-owned MSMEs, FinTech solutions).

(b) **Subcomponent 2b – capitalization of NGF for special COVID-19 program (US$20 million, IBRD).** This subcomponent will support the activation of a special emergency guarantee program to alleviate the economic effects of the COVID-19 crisis on productive MSMEs, guaranteeing liquidity and covering their working capital and investment needs to maintain productive activity and employment. Under this subcomponent, the Project will capitalize a special guarantee program, which will be part of NGF's capital and will be extended to PFIs that will lend to beneficiary MSMEs.

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

27. **Component 3 – Credit Line Intermediated by CFN to PFIs for On-Lending to MSMEs (US$213 million, IBRD).** This component will support CFN to establish and expand second-tier lending operations to serve MSMEs through the commercial and the cooperative banking sector. Under this component, the Project will finance the provision of lines of credit to eligible private PFIs, which in turn will on-lend to eligible private MSMEs. CFN will assume the credit risk of the PFIs, while the latter will take on their books the credit risk of the MSMEs. Beneficiary MSMEs will get access to finance for working capital and investment purposes. It is expected that final borrowers will include firms from sectors with high

potential for productivity growth as well as female-owned enterprises, IPAM-owned MSMEs and first-time borrowers.

28. **CFN and the PFIs will follow their respective pricing policy according to market conditions.** Pricing would cover all PFIs' costs and allow a profit margin adequate to encourage lenders to compete in this market. The cost of on-lending financing through PFIs will include, at a minimum, the cost of IBRD funds to CFN plus an on-lending margin reflecting CFN's administrative costs, a credit risk margin (or risk markup) associated with the PFI, and an expected profit. Ultimate borrower cost will add, at a minimum, the PFI's administrative costs, a credit risk margin associated with the beneficiary MSME, and an expected profit. The presence of interest rate caps on SME loans and microcredit, currently at 11.83 percent and ranging from 21-28.50 percent (depending on the subsegment), respectively, is not expected to affect the implementation of the Project.[15]

29. **PFIs, MSMEs and subloans will comply with eligibility criteria.** Clearly defined eligibility criteria detailed in the Project Operations Manual will be followed during the implementation of the Project. These criteria will ensure that the loan proceeds are used for the intended purposes following the obligations described in the Loan Agreement, including fiduciary procedures, environmental and social standards, and anticorruption guidelines. The eligibility criteria will ensure that the PFIs are commercially oriented, financially sound, and well-managed. Likewise, the eligibility criteria for lending operations will incorporate appropriate measures, where feasible, to address climate change-related risks and aspects. In addition, eligibility criteria for productive investments (e.g. new equipment and machinery, vehicles, etc.) to be financed by MSMEs will include the use of best available technology (BAT), energy efficiency, and low-carbon considerations as defined in the Operations Manual.

30. **The Project will support CFN towards increasing PFIs' ability to provide access to finance to women entrepreneurs.** Female entrepreneurship in Ecuador is among the highest in the world yet access to finance seems to be more constrained for women-led firms than for men[16]. Only 23 percent of businesses headed by women had access to a credit in 2014 – latest available data[17]. To address the gender gap identified in the financial sector, this Project promotes a gender equality approach within this component and includes a specific gender indicator in the results matrix to measure the number of MSMEs owned and/or led by women receiving subloans with Project funds.

31. **Component 4 – Project Management (US$2 million, IBRD).** This component will focus on supporting CFN to effectively execute the Project. Under this component, the Project will finance, inter alia:

(a) Recruitment and training of the Project Coordination Team (PCT) members including, if necessary, specialists responsible for procurement procedures, financial management, environmental and social management, and the overall execution of the Project;
(b) Acquisition of equipment and furniture for the PCT;
(c) Monitoring and evaluation activities;
(d) Study tours for relevant CFN staff;
(e) Stakeholder and citizen engagement plan, including implementation of a Grievance Redress Mechanism (GRM);
(f) Communication strategy; and

[15] Analyses and simulations conducted as a part of the technical assistance aimed to revise the current interest rate control framework has shown that effective lending rates for loans to SMEs and microcredits have been historically set below the respective caps, implying that caps are not binding for these credit segments.
[16] Country Partnership Framework (CPF) for FY19-FY23 (Report No.135374-EC)
[17] World Bank, 2018, Gender Gaps in Ecuador: An Overview, Washington DC.

(g) Project's financial audits.

C. Project Beneficiaries

32. ***Corporación Financiera Nacional B.P.* (CFN):** The Project will assist CFN in strengthening its institutional capacity and developing a new business strategy based on second-tier lending. A reoriented and strengthened CFN is expected to improve the allocative efficiency of its lending, increase its productivity, and improve the quality of its assets and its financial sustainability. Moreover, the Project will support CFN to maximize finance for development by crowding-in private financial institutions to serve MSMEs. This operation will support CFN to restart second-tier operations after several years the institution has focused only on first-tier lending. The operation will also strengthen and capitalize NGF, which is an important tool to expand access to finance for MSMEs. The Project will help CFN expand its activities and loan portfolio through PFIs. CFN will be able to reach more MSMEs and cover more locations without incurring high operating costs or increasing the credit risks of its portfolio.

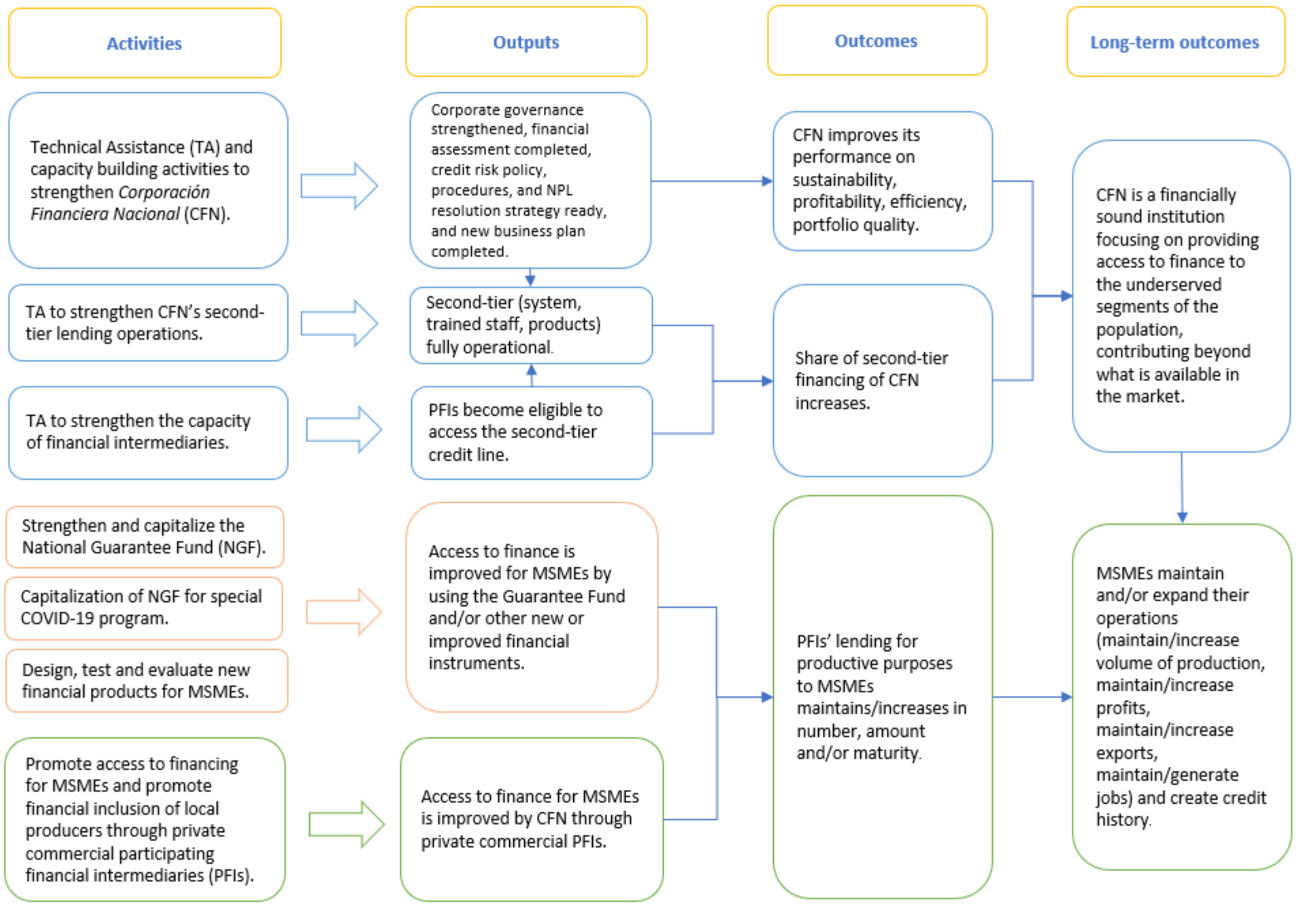
33. **Participating Financial Intermediaries (PFIs):** The project will provide financial products to PFIs to help them reach more MSMEs and grow their activities in sectors and areas underserved or not served before. PFIs will benefit from getting access to credit lines, and new or improved financial instruments offered by CFN to promote access to finance for MSMEs through financial intermediaries (e.g. partial credit guarantees). Moreover, PFIs will benefit from technical assistance. Under the Project, technical assistance will be provided to strengthen the capacity of financial intermediaries to make them eligible to access the second-tier credit line, including support to help them create or improve their environmental and social management systems and conduct a climate vulnerability assessment, when applicable.

34. **Micro, Small and Medium Enterprises (MSMEs):** MSMEs are the main project beneficiaries. MSMEs will benefit from the Project by getting access to finance for productive purposes through PFIs. MSMEs will also benefit from new or improved financial instruments offered by CFN to promote access to finance for MSMEs through financial intermediaries (e.g. risk sharing facilities, alternative financial instruments, climate resilience financial products, specialized products for female owned MSMEs, Indigenous peoples MSMEs, FinTech solutions). MSMEs will benefit by getting access to finance for working capital and investment needs. In addition, MSME will be able to reduce their exposure to climate-related risks or recover from damages incurred by impacts of climate change and natural or man-made disasters by getting access to finance from PFIs that have the capacity to be closer to the population and reach marginal areas nationwide in times of emergency to help them overcome economic shocks (e.g. earthquake 2016 and COVID-19 pandemic).

D. Results Chain

Figure 2: Theory of Change

Development Challenge: MSMEs have limited access to finance for productive purposes.



Critical Assumptions: (i) CFN implement institutional capacity activities; (ii) financial institutions comply with eligibility criteria and use financial instruments offered by CFN, (ii) MSMEs demand loans for productive purposes.

E. Rationale for Bank Involvement and Role of Partners

35. **This Project marks a re-engagement of the World Bank Group in the Ecuadorian financial sector.** This Project will be the first Financial Intermediary (FI) IPF in the country after more than 15 years and following re-engagement through analytical and advisory assistance that started in 2018. The Project comes at an unprecedented time for the country and its small businesses, which are expected to be hit hard by the COVID-19 crisis. The World Bank Group brings important global expertise in financial sector development to Ecuador and more specifically in access to finance for productive purposes for MSMEs, having supported for many years similar initiatives in the region and around the world. The role of the World Bank Group in this Project is also to accompany CFN in its transition to second-tier lending, which is historically one of the most effective and less distortionary forms of direct government intervention in credit markets,

and to strengthen NGF, which is a widely used public policy tool to mobilize MSME financing.

36. **The proposed Project complements and builds on several World Bank Group projects in Ecuador.** The proposed IPF aligns with and builds on the Second Inclusive and Sustainable Growth (P171190) DPF, which includes indicative triggers on reform of public banks' corporate governance framework under the COMYF. The Project also complements the Territorial Economic Empowerment for the Indigenous, Afro-Ecuadorians and Montubian Peoples and Nationalities Project (P173283) under preparation, whose development objective is to increase income generation opportunities for targeted IPAM in accordance with their vision and priorities for development. Finally, the Project aligns with IFC's current and prospective operations in Ecuador. As of December 2018, the IFC had an outstanding portfolio of US$265 million, mostly concentrated in tier 1 financial institutions and food industry. In response to the COVID-19 crisis, the IFC is also discussing with existing bank clients to include them in the Working Capital Solutions program and increase limits of trade lines, while in the real sector, it is working with several large firms to grant access to the Real Sector Crisis Response Facility. Besides, it is expected that one important complementary benefit of the Project will be to support the graduation of large firms currently served by CFN towards more market-based financing, where the IFC could play an important role.

37. **The Project is also part of a package of coordinated financial assistance from international partners, including the IMF, IDB, and CAF.** The staff of the four institutions have met regularly to coordinate efforts and align messages. There are strong complementarities in selected areas of support, especially in coordinated technical assistance activities. For example, the IMF is assisting the authorities in strengthening banking supervision, including that of public banks, which would contribute to ensure that the restructuring of public banks, including CFN, will proceed safely. More recently, the Asian Infrastructure Investment Bank (AIIB) expressed interest in exploring the possibility of providing separate financing to CFN for promoting access to finance for MSMEs through PFIs, based on the design of this Project.

F. Lessons Learned and Reflected in the Project Design

38. **The Project will leverage the World Bank's comparative advantage in offering competitively priced long-term funds, coupled with international experience in designing line of credit interventions and facilitating institutional reforms.** The Project follows and reflects lessons learned from the successful FI operations by the World Bank across the LAC region and worldwide, donor projects, international best practices in MSME finance, and the World Bank OP on IPF Guidelines on FI Financing. It also incorporates good practices identified in the 2006 Independent Evaluation Group's (IEG) evaluation of World Bank Lending for Lines of Credit and 2009 IEG's evaluation of World Bank Group Support for SMEs. Overall, lessons learned point to: (i) simple and flexible design, allowing for operational adjustments, and avoiding sectoral or regional targets; (ii) inclusion of technical assistance components to strengthen the institutional capacity of the borrower; (iii) intensive monitoring of key indicators that measure the quality of the loan portfolio; (iv) use of quantified eligibility criteria for selecting PFIs; (v) availability and use of sound analysis and data on the financial performance of PFIs, and external audit for verification; and (vi) importance of leveraging lines of credit with other Bank operations, such as Development Policy Finance. In addition, one key lesson learned from successful FI operations is the World Bank's prominent leadership role as a promoter of environmental and social responsibility. The preparation of this IPF has already facilitated CFN's institutional reform – e.g. CFN's management is advancing in strengthening the institution's risk management framework – while the World Bank team is providing advisory and technical assistance for the reform of other public banks. Reform of the corporate governance for public banks is a prior action under the Programmatic DPL under preparation. This IPF is also expected to play a crowding in role for private investors for CFN in the medium-term thus maximizing finance for development. By strengthening its institutional capacity, CFN expects to improve its conditions for mobilizing private commercial financing to support the expansion of its operations.

39. **Transparent reporting, sound governance arrangements, and independent and effective regulation and supervision, as well as wholesale business models, are key lessons learned in developing sustainable public development banks**. Accurate and detailed financial and performance reporting is essential in maintaining a self-sustaining institution. Independent regulation and supervision by the financial sector regulator, rather than a line ministry with conflicts of interest, further enforces the disciplined prudent management of a public bank. International experience suggests the importance of tightly defined mandates, clear performance targets, transparent reporting, and insulation from political interference. Public banks that apply strong corporate governance standards generally perform better. International experience relating to public bank reform, e.g. in Mexico, confirms that wholesale public banks (second tier institutions) that provide incentives to private sector banks to enter new markets perform better than public banks that engage in retail operations (first tier institutions).

III. IMPLEMENTATION ARRANGEMENTS

A. Institutional and Implementation Arrangements

40. **CFN will be the Borrower and Project Implementing Agency.** CFN is authorized, regulated and supervised by SB. It has written policies, manuals and procedures for the management of its financial and operational risks. CFN has a management information system that allows the monitoring of its financial and risk situation, including the preparation of various reports (weekly, monthly, quarterly and annual) addressed to internal (CFN) and external (SB, credit risk rating agency, external auditors) stakeholders. The organizational structure of CFN is in line with what is required by regulation, observing separation of functions and internal control systems (see Annex 2).

41. **The Republic of Ecuador, represented by MEF, will guarantee the obligation of the Borrower in respect to the Loan Agreement. The IBRD will enter into a Loan Agreement with CFN.** For implementation of the credit line, CFN will enter into a Subsidiary Financing Agreement with eligible PFIs to on-lend to eligible MSMEs through Subloan Agreements. For the provision of partial credit guarantees, the NGF will enter first, into a Participation Agreement with the relevant eligible PFI; then, into a Partial Credit Guarantee Agreement with the eligible PFI and the respective eligible MSME.

42. **CFN will maintain a Project Coordination Team (PCT) throughout Project implementation.** The PCT will be responsible for coordinating the implementation, supervision, completion, and documentation of all the activities related to the Project. The responsibilities of the PCT will include, among others: (i) coordinating the implementation of project activities; (ii) coordinating the procurement, financial management, disbursements, and environmental and social aspects of the Project in accordance with the provisions of the Loan Agreement; (iii) coordinating the preparation, adjustments, and use of the project management tools, including the Operations Manual, working annual plan, Procurement Plan, and disbursement projections; (iv) coordinating with key stakeholders all the technical aspects of the Project; (v) monitoring the progress of the PDO and intermediate results indicators of the Results Framework; (vi) preparing project reports; and (vii) acting as the main point of contact for the World Bank team.

43. **The PCT will be composed of key staff from CFN at central and regional levels with functions, experience, responsibilities and qualifications acceptable to the World Bank.** CFN staff will be trained and equipped to manage the Project activities. Based on CFN's organizational structure, the PCT will be integrated by representatives from key departments within CFN. These staff members will act as focal points and will comply with the roles and responsibilities set in the operations manual for a core team, including: (i) project coordinator, (ii) procurement officer, (ii) financial management and disbursement officer, and (iv) E&S specialist.

B. Results Monitoring and Evaluation Arrangements

44. **A monitoring and evaluation (M&E) strategy will be developed and implemented to measure the results of Project activities.** This strategy will ensure that key information is regularly collected and tracked so CFN can measure the progress towards the Project objectives. CFN, in line with the stakeholder engagement plan, will work with PFIs to implement an M&E strategy to measure the effects of sub-loans granted to eligible MSMEs. Baseline information of firms will be collected through subloan applications by PFIs and reported semiannually.

45. **This Project will include a set of additional indicators to monitor its advancement**. In addition to the PDO and intermediate level indicators included in the Results Framework (section VII), this Project will include a set of additional indicators in the Operations Manual that will help CFN measure aspects such as the contribution to local economic development by monitoring the economic sector, the geographic areas, and size population where the beneficiary MSMEs are executing their activities; or the financial additionality by monitoring the number of MSMEs getting access to finance for the first time or with improved financial terms (disaggregated by gender). Likewise, information about number of IPAM-owned MSMEs getting access to finance for productive purposes will be collected. The progress of these indicators will be measured periodically and reported as part of the semiannual progress reports.

46. **The M&E strategy will be supported by a communication strategy that will be implemented during the life of the Project.** As part of the communication strategy, CFN will be in permanent contact with MSMEs and PFIs during the implementation phase which will facilitate the monitoring and evaluation activities promote the dialogue with key stakeholders and increase the level of engagement MSMEs. CFN will be responsible for defining and implementing a broad communication strategy. In a first phase, the communication strategy will be used to make information available to MSMEs and PFIs about the improved or new developed financial products that will be available for their access. Communication material will be prepared, including material in native languages as needed. The material will be used to provide information about the characteristics of the products, how to apply, who can apply, what kind of activities can be financed. In addition, education material on climate co-benefits and climate change mitigation and adaptation aspects and the application best practices on environmental and social risks management will be part of the strategy. In a second phase the communication strategy will be used to carry out site visits to the final borrowers to assess their satisfaction with the financial products offered under the Project and evaluate and document the progress achieved by MSMEs after receiving access to finance. Finally, the strategy will be used to showcase how MSMEs got access to financial products and to disseminate the results achieved by those borrowers.

47. **A quantitative impact evaluation would be conducted to assess the effects of second-tier lending.** CFN, with the support of the World Bank, would conduct a randomize control trial (RCT) where the impact of the second-tier-lending program will be identified by comparing differences in outcomes between first-tier-lending and second-tier-lending in the post-program periods. It will examine how second-tier-lending affects borrower selection, number of borrowers and the performance of loans issued by PFIs and CFN. Moreover, subject to availability of firm-level information at the municipality level, the evaluation could also study the impact of second-tier-lending on real outcomes and growth of firms.

C. Sustainability

48. **The sustainability of the project is based on CFN acting as a catalyst by encouraging greater intermediation by the financial sector in currently underserved market segments.** Although the IBRD loan amount is relatively small

relative to the potential demand for credit from MSMEs, a multiplicative effect will be achieved through CFN channeling any subloan repayments to other eligible MSMEs through PFIs for the same purpose. Moreover, World Bank's financing support to MSMEs will go hand in hand with further institutional strengthening of CFN. The instruments deployed by CFN — on-lending and partial credit guarantees to PFIs — will be designed based on market-conforming terms. Rather than replacing credit markets, CFN will enhance them by providing financing to PFIs to on-lend to MSMEs, including at maturities that are otherwise unavailable to this segment.

49. **A rigorous accreditation procedure for borrowing from CFN —as well as for technical assistance to both CFN and PFIs — will help improve their governance, risk management, and operational processes.** The World Bank will be tracking progress throughout Project implementation. While the World Bank can play an important catalytic role at this stage by providing the sector with long-term financing that is currently scarce, it is expected that, in the long run, Ecuador will return to macro-financial stability and alternative sources of finance will be mobilized. Finally, as previously mentioned, activities under this Project form an integral part of an overall initiative, supported by the IMF and the World Bank Group, to strengthen and further develop the financial sector in Ecuador and are closely aligned with the government's structural reform agenda and its financial sector development strategy.

50. **To avoid market distortions, CFN and the PFIs will follow their respective pricing policy according to market conditions.** The cost of on-lending subsidiary financing through PFIs will include, at a minimum, the cost of IBRD funds to CFN plus an on-lending margin reflecting CFN's administrative costs, a credit risk margin associated with the PFI, and an expected profit. Ultimate beneficiary cost will add, at a minimum, the PFI's administrative costs, a credit risk margin associated with the beneficiary MSME, and an expected profit. The only significant market advantage from the World Bank funds is in terms of maturity, facilitating the provision of long-term finance to MSMEs without taking on a significant maturity mismatch. The presence of interest rate caps on SME loans and microcredits, the two main types of subloans expected to be mobilized as a part of this Project, is not expected to affect the sustainability of the Project. Effective lending rates on SME loans and microcredits have been historically set below the respective caps, implying that caps are not binding for these credit segments. The expected reforms of the interest rate control framework will strengthen the sustainability of the Project.

IV. PROJECT APPRAISAL SUMMARY

A. Technical, Economic and Financial Analysis

Economic and Financial Analysis of the Project

51. **The expected Net Present Value (NPV) of component 3, which accounts for the bulk of the funds allocated under the Project, is estimated at US$47.7 million while the Economic Rate of Return (ERR) is estimated at 14.1 percent over the term of the loan (15 years).** The analysis estimates the benefits based on the difference in cash flows between the borrowing scenario versus the without borrowing scenario. The baseline scenario projects that 20 percent of the loan volume under component 3 will be directed to relatively large loans to purchase machinery and equipment, with an average of US$500,000 per loan and a total of 85 loans to 68 enterprises over the course of the project. These loans are projected to have a significant impact on the economic performance of SMEs, increasing their annual sales growth rate from baseline 2 percent up to 7 percent (as in 2012-15). The remaining 80 percent of the loan volume under component 3 will provide for 3,408 working capital loans averaging US$50,000 to 2,562 enterprises. These loans are expected to add a smaller yet still significant boost to the annual sales growth rate from 2 percent to 4 percent. In both cases, the target beneficiary enterprise is the weighted average of small, medium "A" and Medium "B" enterprises as defined by the

National Institute of Statistics and Censuses (INEC, for its acronym in Spanish): firms with average sales of US$584,000, and a mean of 13 registered employees, who earn an annual gross salary of US$7,400 per person.[18]

52. **Component 2 includes two capitalizations of the National Guarantee Fund (NGF). These have expected NPV of US$107.9 million and US$36.8 million thanks to the leveraged nature of the credit guarantee scheme, respectively.** The ERR of the capitalization under component 2 (b) is estimated at 116.3 percent. The analysis assumes that the fund will allow participating enterprises to avoid a large 10 percent decrease in sales, with zero growth in the first year and then grow at 2 percent in subsequent years. The result critically depends on the leverage ratio of the scheme, which is assumed to be 3 times, the same as the NGF. A sensitivity analysis shows that a reduction in the leverage ratio from 3 to 2 would bring the ERR of subcomponent 2 (b) down from 116.3 to 73.1 percent. Subcomponent 2(b) is expected to provide 2,000 guarantees to 1,724 enterprises, covering 80 percent of the loan values. Moreover, the ERR of the capitalization of the NGF subcomponent is estimated at 67.2 percent. The latter is expected to be disbursed in the third year of the project, having a similar (though more leveraged) impact to the working capital loans under component 1. The NGF subcomponent is expected to provide additional 2,500 guarantees to 2,155 enterprises, covering 60 percent of the loan values. This subcomponent assumes that technical assistance embedded in it would allow NGF to further increase the leverage ratio up to 5 times. If that increase in leverage did not materialize and leverage remained at 3 times, the expected ERR of subcomponent 2 (c) would come down from 67.2 to 31.7 percent.

53. **For the remaining components of the Project, evidence from the literature and past experience is offered, given the indirect nature of the benefits.** CFN has already taken steps towards capacity strengthening with remarkable results in terms of overhead cost reduction. Moreover, the relationship between access to finance and firm performance is well-supported the in literature.[19] The latter also supports that the provision of capacity-building programs to financial institutions contributes to increase the number and customization of products offered to MSMEs.

54. **The financial analysis of CFN's cash flows should also consider the repeated on-lending of the funds to the PFIs until maturity of its obligations with the World Bank.** CFN would borrow at LIBOR plus a spread, and the majority of the funds will be lent to PFIs through component 3. Given that PFIs would be able to charge up to 11.83 percent for MSME loans and between 21-28.50 percent for microcredits (and maybe more in case interest caps are partially revised), respectively, and that swap rates are at historical lows (i.e. the 15-year swap rate was at 0.85 percent as of April 2020), there is scope for both CFN and the PFIs to generate profits by providing access to finance to MSMEs.

B. Fiduciary

(i) Financial Management

55. **The Financial Management (FM) team conducted a FM assessment (FMA) to CFN in its capacity of proposed project implementing entity for the project.** The FMA was conducted following Investment Project Financing (IPF) Policy which requires that for each operation supported by a World Bank loan, the borrower needs to maintain FM arrangements that are acceptable to the Bank and that, as part of the overall arrangements for implementing the operation, provide reasonable assurance that the proceeds of the loan are used for the intended purposes.

56. **The FM residual risk is Substantial**, considering: (i) This is the first time CFN will be implementing a WB-financed project, which may impact implementation until the project team gets acquainted with Bank procedures; (ii) the project

[18] For further reference, please see "*Directorio de Empresas*" at *https://www.ecuadorencifras.gob.ec/directoriodeempresas/*
[19] See, for example, Demirguc-Kunt and Klapper 2012.

involves decentralized arrangements and requires a robust financial management system to effectively monitor implementation of subloans; (iii) CFN is gradually transitioning to the second-tier lending operations market, and some processes need to be strengthened for controlling and financial reporting of subloans; (iv) additionally, the project involves the capitalization of the National Guarantee Fund (NGF) for Special COVID-19 Program and for Standard Programs where although the capitlization of funds will be considered elegible expenditures for disbursement purposes, it will be important to ensure capitalized funds will used for the intentended purpose; and (v) given the country's fiscal constrains, getting timely approval of budget funds for the implementation of the project will be a challenge[20] as in other projects in the portfolio.

57. **The main mitigation measures include**: (i) CFN Financial Business and Deposits Management (*Gerencia de Negocios Financieros y Captaciones*) is adequately staffed and have experience implementing projects financed by CAF[21] and AFD[22]; (ii) CFN needs to enhance monitoring of sub-loans provided to PFIs; (iii) for capitalization of the the NGF, CFN will be required to open exclusive bank account for each fund (Special COVID-19 Program and for the fund Standard Programs); to provide financial reporting on the use of the capitalized funds; and, to describe in the project operational manual the criteria and mechanisms to operate both funds; (iv) the project budget will be approved by CFN's Board and any potential budget delays will be monitored; and (v) financial mangement arrangements will be reflect in the chapter of the project operational manual.

58. **On the basis of the above mentioned, the proposed FM arrangements are acceptable.** CFN will ensure to include in the operational manual the financial management and disbursements arrangements specific to this project that are acceptable to the Bank.

(ii) Procurement

59. **Procurement will be carried out in accordance with "World Bank Procurement Regulations for IPF Borrowers"** (July 2016, revised November 2017 and August 2018) ("Procurement Regulations"). A Procurement Plan covering the first 18 months of project implementation was prepared by the Borrower based on the results of the Project Procurement Strategy for Development (PPSD) and will be agreed with the Bank as part of the negotiations.

60. **Procurement will be carried out by the *Gerencia Administrativa* (GA),** which does not have prior experience in procurement under the Bank Procurement Regulations; however, it has qualified staff with significant experience in national procurement procedure, which added to the features/low complexity of procurement included in the Project, and the related market conditions, no significant issues could be expected. In terms of procurement record system, internal controls, and roles/responsibilities, they were found acceptable by the World Bank.

61. T**he key procurement risks are lack of experience in World Bank financed projects, and coordination between technical units and procurement.** The agreed mitigating measures are: (i) the World Bank will deliver procurement training, and, if necessary, a part-time procurement experienced consultant on Procurement Regulations could be strengthen the GA, and (ii) the Project Operational Manual will set appropriately, roles and responsibilities of the

[20] The most recent Public Financial Management assessments of Ecuador (most notably the PEFA report 2019) pointed out various deficiencies including, inter alia, the need to strengthen transparency of public finances, the budget preparation, management and control framework, and improving internal control and external oversight of the public sector. Such deficiencies may impact this project (as it is the case of other projects in Ecuador) and reflect in delays in getting the budget approved in time.
[21] *Corporación Andina de Fomento*
[22] French Development Agency – *Agence Francaise de Développement*

technical and procurement units.

62. **Frequency of Procurement Supervision.** In addition to prior review supervision, an annual mission will be carried out and the procurement post review will cover at least 10 percent of contract not prior reviewed by the World Bank. The periodicity and the percentage of the post review processes to be reviewed based on the Borrower procurement performance.

C. Legal Operational Policies

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

D. Environmental and Social

(i) Environment

63. **The environmental proposed risk classification for the Project is Moderate under the World Bank Environmental and Social Framework (ESF).** Considering the nature and magnitude of the potential environmental risks and impacts of financial intermediary (FI) subprojects they would be: (i) predictable and expected to be temporary and/or reversible; (ii) low in magnitude; (iii) site-specific, without likelihood of impacts beyond the actual footprint of the project; (iv) low probability of serious adverse effects to human health and/or the environment (e.g., do not involve use or disposal of toxic materials, routine safety precautions are expected to be sufficient to prevent accidents, etc.). The activities of the FI subprojects will not increase water and energy consumption due to the manufacturing of new products, increment air pollution because of industrial process, e-wastes from computer hardware upgrades, among others. Also, no loans that would lead to significant adverse impacts on biodiversity and habitats, or on cultural heritage, would be supported.

64. **CFN has created an exclusion list to delineate the subprojects that will not be subject to investment with this credit line with the World Bank.** Ultimately, only low and/or moderate risk investments will be financed. CFN will design and implement an ESMS for subcomponents 2b., 2c. and Component 3, which will include a categorization process for assessing the E&S risk level of each of the proposed loans This ESMS will be commensurate with the nature and magnitude of environmental and social risks and impacts of FI subprojects, the types of financing, and the overall risk aggregated at the portfolio level, in line with paragraph 40 of the E&S Policy. The ESMS will include at a minimum the following: (i) E&S policy; (ii) E&S procedures and capacity to screen subprojects conduct due-diligence to evaluate E&S risk and assign risk category; (iii) systems/processes for due diligence to evaluate, monitor, review and manage E&S risks and impacts of subprojects; (iv) organizational capacity and competence; and (v) external communications and reporting mechanisms on E&S performance.

(ii) Social

65. **The social proposed risk classification for the Project is Moderate under the ESF.** In addition to environmental risks and impacts described in the section above, the Project's design an ESMS considers the nature and scope of the

potential social risks and impacts of FI subprojects that tend to be low and temporal and limited to specific sites. The Project will only support sub-projects with low and moderate social risk and impacts based on the categorization defined in the ESMS. As part of the ESMS, CFN has created an exclusion list and will not support any land acquisition and resettlement and has included specific measure to avoid negative impacts to indigenous peoples. In addition, some social risk and impacts are associated with: (i) CFN's capacity to fully implement the ESMS for second tier lending; (ii) compliance with labor laws, health and safety procedures and community safety; and (iii) capacity of the PFIs to provide information to reach out to vulnerable groups, particularly indigenous groups and women.

66. **To manage these main risks, CFN will strengthen its institutional capacity by hiring environmental and social specialist to support the implementation of the ESMS.** Likewise, CFN will prepare a Labor Management Procedure (LMP) and a Stakeholder Engagement Plan (SEP)[23], including development of a Grievance Redress Mechanism (GRM) for the Project. These two independent instruments will be also part of the Project's ESMS and are included in the Environmental and Social Commitment Plan (ESCP)[24] to ensure implementation and compliance. In addition, the Project will include specific objective to measure gender and citizen engagement activities during implementation.

67. **During Project preparation, CFN carried out several preliminary consultation and information session with key stakeholders.** These consultation and information sessions will be strengthened during project implement as define in the SEP prepared for this operation and capacity building activities that will be supported under Component 1 and 4 of the Project.

(iii) Relevancy of the WB Environmental and Social Standards

68. **Six of ten Environmental and Social Standards (ESS) are relevant for this Project:** ESS1, Assessment and Management of Environmental and Social Risks and Impacts; ESS2, Labor and Working Conditions; ESS3, Resource Efficiency and Pollution Prevention and Management; ESS4, Community Health and Safety; ESS9, Financial Intermediaries; and ESS10, Stakeholder Engagement and Information Disclosure. The Standards that are currently not relevant are: ESS5, Land Acquisition, Restrictions on Land Use and Involuntary Resettlement; ESS6, Biodiversity Conservation and Sustainable Management of Living Natural Resources; ESS7, Indigenous Peoples/Sub-Saharan African Historically Underserved Traditional Local Communities; and, ESS8, Cultural Heritage. More information can be found in the ESRS of the Project[25]. In terms of triggering WB Operational Policies (OP), OP 7.60 "Projects on Disputed Areas" and OP 7.50 "Projects on International Waterways" do not apply and are not triggered for this Project.

V. GRIEVANCE REDRESS SERVICES

Communities and individuals who believe that they are adversely affected by a World Bank supported project may submit complaints to existing project-level grievance redress mechanisms or the World Bank's Grievance Redress

[23] Disclosed by the Borrower on April 14, 2020 (*https://www.cfn.fin.ec/proyecto-de-acceso-a-financiamiento-productivo-para-mipymes-banco-mundial/*) and disclosed by the WB on April 20, 2020 (http://documents.worldbank.org/curated/en/584231587416898991/pdf/Stakeholder-Engagement-Plan-SEP-Promoting-Access-to-Finance-for-Productive-Purposes-for-MSMEs-P172899.pdf)
[24] Disclosed by the Borrower on May 20, 2020 (*https://www.cfn.fin.ec/proyecto-de-acceso-a-financiamiento-productivo-para-mipymes-banco-mundial/*) and disclosed by the WB on June 3, 2020 (http://documents.worldbank.org/curated/en/212881591194627613/pdf/Environmental-and-Social-Commitment-Plan-ESCP-Promoting-Access-to-Finance-for-Productive-Purposes-for-MSMEs-P172899.pdf)
[25] http://documents.worldbank.org/curated/en/522851587416927137/Appraisal-Environmental-and-Social-Review-Summary-ESRS-Promoting-Access-to-Finance-for-Productive-Purposes-for-MSMEs-P172899

Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address project-related concerns. Project affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of World Bank non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service (GRS), please visit http://www.worldbank.org/en/projects-operations/products-and-services/grievance-redress-service. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

VI. KEY RISKS

69. **The overall risk rating associated with the Project is rated Substantial.** The major risk to the Project's ability to achieve its development objectives include political and governance risks as well as macroeconomic risks, which are considered high. In addition, other risks such as sector strategies and policies risks, institutional capacity for implementation and sustainability risks, and fiduciary risks are judged to be substantial.

70. **Political and governance risks are assessed as High.** With parliamentary and presidential elections planned for February 2021, pre-election politics are likely to intensify throughout the year. While this is not expected to directly impact implementation of the Project, post-election results may result in significant changes in key senior management positions within CFN, derailing the attainment of the Project's intended development objectives. This risk is mitigated by having technical staff appointed in CFN's PCT, which can ensure continuity in project implementation.

71. **Macroeconomic risks are assessed as High.** These stem from weak external and internal conditions. Externally, record drops in oil prices and tightening global financial conditions could further complicate financial access for the country. Ecuador's economy is also vulnerable to oil price volatility, with implications for the fiscal and real sectors. Internally, the response of the economy to ongoing fiscal consolidation and structural reforms might take longer than envisaged, and the COVID-19 crisis is expected to significantly derail economic recovery. While this is expected to increase MSME demand for credit, especially for working capital, it can also lead to tightened financial conditions as a result of a deterioration in financial institutions' asset quality and an increase in risk aversion. Financial support, close supervision and technical engagement provided through international financial institutions-supported programs will help mitigate these risks.

72. **Sector Strategies and Policies risks are rated Substantial.** This mostly reflects political uncertainty. Despite the strong commitment of the Government to reform public banks, including CFN post-election results in 2021 may result in a reassessment of the role and function of public banks in the economy away from international best practices. This risk can be amplified by the coronavirus crisis as political pressure to indiscriminately use public banks to hand over cash to households and firms may increase. This risk is however mitigated by the constraints imposed by the dollarization framework, which imposes fiscal discipline, limiting the use of public banks for other than allocative purposes. An additional risk is that the reform of the COMYF, especially the revision of interest rate caps, stalls. However, this risk is mitigated by the observed private banks' practice of charging lending rates on SME loans and microcredits below the respective caps, implying that caps are not binding for these credit segments.

73. **Institutional Capacity for Implementation and Sustainability risks are assessed as Substantial.** Though CFN has experience in implementing projects financed by international financial institutions, it has no capacity in implementing

World Bank projects. CFN is committed to transition to a wholesale business model based on second-tier lending but it has limited experience with this approach. These risks will be mitigated by the technical assistance program that is a critical component of the Project.

74. **Fiduciary risks are rated Substantial.** According to Project nature and institutional arrangements, more than 80 percent of the Project involves decentralized implementation arrangements and significant participation of private financial institutions and MSMEs. For Project purposes, CFN's procedures and internal controls need to be strengthened to enhance follow up and monitoring of sub-loans provided by PFIs to assure loan proceeds are used for the purposes intended. Moreover, arrangements under the capitalization of NGF are not ready yet. On such a basis, the financial management risk is substantial, and the fiduciary residual risks are also substantial. Some mitigation actions are described under the FM implementation arrangement in Annex 1.

VII. RESULTS FRAMEWORK AND MONITORING

Results Framework
COUNTRY: Ecuador
Promoting Access to Finance for Productive Purposes for MSMEs

Project Development Objectives(s)

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

Project Development Objective Indicators

Indicator Name	PBC	Baseline	End Target
Promote access to finance for MSMEs through financial intermediaries			
Number of subloans disbursed under the Project (Number)		0.00	3,500.00
Share of second-tier financing of CFN. (Percentage)		0.00	25.00
Number of partial credit guarantees provided to MSMEs with Project funds (Number)		0.00	4,500.00

Intermediate Results Indicators by Components

Indicator Name	PBC	Baseline	End Target
Credit Line Intermediated by CFN to PFIs for On-Lending to MSMEs			

Indicator Name	PBC	Baseline	End Target
Number of MSMEs receiving subloans financed with project funds (Number)		0.00	2,600.00
Number of MSMEs receiving sub-loans financed with Project funds that are owned and/or led by women. (Number)		0.00	1,300.00
Number of PFIs receiving credit lines with Project funds (Number)		0.00	15.00
Volume of total subloans disbursed under Project (Amount(USD))		0.00	213,000,000.00
NPLs of credit lines used by PFIs with Project funds versus the NPLs of CFN's first tier lending to MSMEs (Text)		0.00	<1/2
Development and Improvement of Financial Products to Promote Access to Finance for MSMEs			
Number of MSMEs receiving partial credit guarantees with Project funds (Number)		0.00	3,800.00
Strengthening the Institutional Capacity of CFN			
CFN's strengthening key actions implemented (Text)		Not adopted	Highly adopted
Project Management			
Beneficiary MSMEs report their satisfaction with the financial products offered under the Project (Percentage)		0.00	75.00

Monitoring & Evaluation Plan: PDO Indicators

Indicator Name	Definition/Description	Frequency	Datasource	Methodology for Data Collection	Responsibility for Data Collection
Number of subloans disbursed under the Project	This indicator measures the total number of subloans provided to MSMEs by	Semiannual	Project Progress Report	Participating Financial Intermediaries	CFN - Project Coordination Team

	participating financial intermediaries with Project funds. It is assumed that 20 percent of the credit line will be allocated for investment loans with an average loan size US$ 500,000, and 80 percent of the credit line will be allocated for working capital with an average loan size of US$50,000.				
Share of second-tier financing of CFN.	This indicators measures the share of second-tier financing of CFN.	Semiannual	Project Progress Report	CFN financial reports	CFN - Project Coordination Team
Number of partial credit guarantees provided to MSMEs with Project funds	This indicator measures the number of partial credit guarantees provided by National Guarantee Fund to eligible MSMEs through eligible PFIs with Project funds under subcomponents 2(b) and 2(c)	Semiannual	Project Progress Report	National Guarantee Fund reports	CFN - Project Coordination Team

Monitoring & Evaluation Plan: Intermediate Results Indicators

Indicator Name	Definition/Description	Frequency	Datasource	Methodology for Data Collection	Responsibility for Data Collection
Number of MSMEs receiving subloans financed with project funds	This indicator measures the number of micro, small and	Semiannua l	Project Progress	Participating Financial Intermediaries reports	CFN - Project

	medium enterprises receiving subloans with project funds through participating financial intermediaries.		Report		Coordination Team
Number of MSMEs receiving sub-loans financed with Project funds that are owned and/or led by women.	This indicator measures the number of MSMEs receving subloans financed with Project funds that are owned and/or led by women.	Semiannual	Project Progress Report	PFIs reports	Project Coordination Team - CFN
Number of PFIs receiving credit lines with Project funds	This indicator measures the number of eligible commercial banks and/or cooperatives receiving credit lines with Project funds to on-lend to MSMEs.	Semiannual	Project Progress Report	Participating Financial Intermediaries	CFN - Project Coordination Team
Volume of total subloans disbursed under Project	This indicator measures the total volume (US$) of funding disbursed by eligible PFIs to eligible MSMEs.	Semiannual	Project Progress Report	PFIs reports	CFN - Project Coordination Team
NPLs of credit lines used by PFIs with Project funds versus the NPLs of CFN's first tier lending to MSMEs	This indicator compares the NPL weighted average ratio of credit lines used by PFIs to provide subloans to eligible MSMEs with Project funds versus the NPLs of CFN's first tier lending to MSMEs. NPLs will be considered those subloans with more than 90 days of arrears.	Semiannual	Project Progress Report	PFIs report	Project Coordination Team - CFN

Number of MSMEs receiving partial credit guarantees with Project funds	This indicator measures the number of MSMEs securing subloans with a partial credit guarantee provided by the strengthened National Gurantee Fund with Project funds under subcomponents 2b. and 2c. Subloans will be provided by PFIs.	Semiannual	Project Progress Report	National Guarantee Fund Report	CFN - Project Coordination Team
CFN's strengthening key actions implemented	This indicator measures the level of implementation of CFN's strengthening key actions identified as part of the TA component in issues related to, inter alia, corporate governance, credit risk policy and procedures, non-performing loans resolution strategy. This indicador has four levels: High, Substantial, Moderate, Low.	Semiannual	Project Progress Report	CFN financial reports	CFN - Project Coordination Team
Beneficiary MSMEs report their satisfaction with the financial products offered under the Project	This indicator measures the satisfaction of beneficiary MSMEs. This indicator will measure the results of surveys conducted as part of the monitoring and evaluation strategy implemented during Project	Annual	Annual site visits, Mid-term review, project completion.	Surveys conducted to beneficiary MSMEs	Project Coordination Team - CFN

	implementation to beneficiary MSMEs about their satisfaction with the financial products offered under the Project.				

ANNEX 1: Implementation Arrangements and Support Plan

COUNTRY: Ecuador
Promoting Access to Finance for Productive Purposes for MSMEs

1. ***Corporación Financiera Nacional B.P.* (CFN) will be the Borrower and Project Implementing Agency.** Founded in 1964, CFN is authorized, regulated and supervised by SB. CFN shareholder is BCE. It has written policies, manuals and procedures for the management of its financial and operational risks. CFN has a management information system that allows the monitoring of its financial and operational risks, including the preparation of various reports (weekly, monthly, quarterly and annual) addressed to internal (i.e. CFN management) and external (SB, credit risk rating agency, external auditors) stakeholders. The organizational structure of CFN is in line with what is required by regulation, observing separation of functions and internal control systems.

2. **The Republic of Ecuador, represented by MEF, will guarantee the obligation of the Borrower in respect to the Loan Agreement. The IBRD will enter into a Loan Agreement with CFN.** For implementation of the credit line, CFN will enter into a Subsidiary Financing Agreement with eligible PFIs to on-lend to eligible MSMEs through Subloan Agreements. For the provision of partial credit guarantees, the NGF will enter first, into a Participation Agreement with the relevant eligible PFI; then, into a Partial Credit Guarantee Agreement with the eligible PFI and the respective eligible MSME.

3. **CFN will maintain, throughout Project implementation, a PCT.** The PCT will be responsible for coordinating the implementation, supervision, completion, and documentation of all the activities related to the Project. The responsibilities of the PCT will include, among others: (i) coordinating the implementation of project activities; (ii) coordinating the procurement, financial management, disbursements, and environmental and social aspects of the Project in accordance with the provisions of the Loan Agreement; (iii) coordinating the preparation, adjustments, and use of the project management tools, including the operations manual, working annual plan, Procurement Plan, and disbursement projections; (iv) coordinating with key stakeholders all the technical aspects of the Project; (v) monitoring the progress of the PDO and intermediate results indicators of the Results Framework; (vi) preparing Project reports; and (vii) acting as the main point of contact for the World Bank.

4. **The PCT will be composed of key staff from CFN at central and regional levels with functions, experience, responsibilities and qualifications acceptable to the World Bank.** CFN staff will be trained and equipped to manage the Project activities. Based on CFN's organizational structure, the PCT will be integrated by representatives from key departments within CFN. These staff members will act as focal points and will comply with the roles and responsibilities set in the operations manual for a core team, including: (i) project coordinator, (ii) procurement officer, (ii) financial management and disbursement officer, and (iv) E&S specialist.

Component 1 – Strengthening the Institutional Capacity of CFN (US$3 million, IBRD)

5. **This component will finance technical assistance and capacity building activities to strengthen CFN and, when needed, the capacity of financial intermediaries to make them eligible to access the second-tier credit line.** To implement this component, the PCT will: (i) coordinate the development of terms of reference for the TA activities with the technical staff within CFN responsible for the areas to be strengthened – the World Bank team will provide guidance and support for the completion of the terms of reference; (ii) coordinate the selection process; (iii) supervise

the implementation and completion of the contract with the firms or consultants selected; and (iv) coordinate with the technical team the review and approval of all deliverables received. It is expected that these technical assistance activities will include as part of their deliverables a set of recommendations or key actions to be taken by CFN to strengthen its institutional setup as well as a working plan and key results indicators for those actions. The PCT in coordination with the technical team will monitor the progress of those plans and will incorporate the findings and results in the Project Progress Report.

Component 2 – Development and Improvement of Financial Products to Promote Access to Finance for MSMEs (US$42 million, IBRD)

6. **Subcomponent 2a – technical assistance (US$2 million, IBRD).** This subcomponent will finance technical assistance to: (i) strengthen NGF, and (ii) design, test and evaluate new financial products for MSMEs with potential to be scaled up. To implement this subcomponent the PCT will follow the same approach as in component 1. The coordination team will work with technical specialists within CFN to carry out these activities and follow up the achievement of the expected results.

7. **Subcomponent 2b – capitalization of NGF for special COVID-19 program (US$20 million, IBRD).** This subcomponent will finance the capitalization of the NGF for a special guarantee program to respond to the liquidity challenges of MSMEs posed by the COVI1-9 crisis. This subcomponent will not include any disbursement condition. Once NGF is capitalized, for the purpose of issuing partial credit guarantees, CFN, through NGF, will enter first, into a Participation Agreement with the relevant eligible PFI; then, into a Partial Credit Guarantee Agreement with the eligible PFI and the respective eligible MSME. The eligibility criteria for MSMEs and subloans for this subcomponent will be described in the Operations Manual.

8. **Subcomponent 2c – capitalization of NGF for standard programs (US$20 million, IBRD).** This subcomponent will finance the capitalization of the NGF for its standard guarantee programs, i.e. not related to the COVID-19 crisis. The amount and tranches for the capitalization will be determined as part of the technical assistance. This subcomponent will include a disbursement condition. No withdrawal shall be made for capitalizing the fund unless NGF has adopted the strengthening plan in a manner acceptable to the World Bank. Once NGF is capitalized, for the purpose of issuing partial credit guarantees, CFN, through NGF, will enter first, into a Participation Agreement with the relevant eligible PFI; then, into a Partial Credit Guarantee Agreement with the eligible PFI and the respective eligible MSME. The eligibility criteria for MSMEs and subloans will be the same applied for final borrowers of the credit line component as described in the Operations Manual.

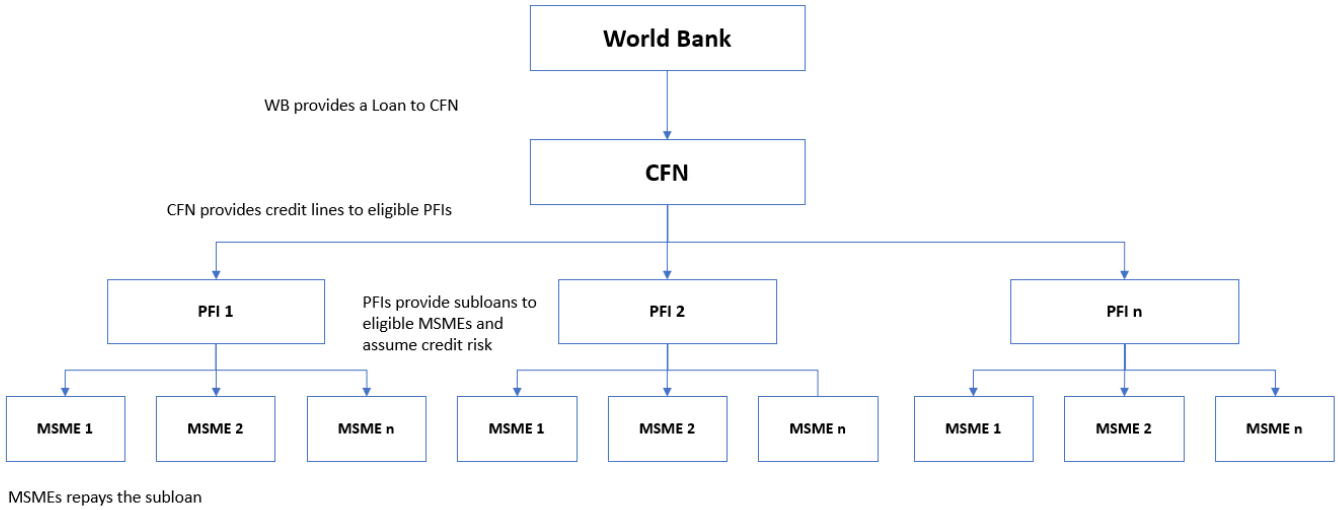
Figure 3: Partial Credit Guarantees Structure

Component 3 – Credit Line Intermediated by CFN to PFIs for On-Lending to MSMEs (US$213 million, IBRD)

9. **Under this component the Project will finance the provision of lines of credit by CFN to eligible private PFIs,**

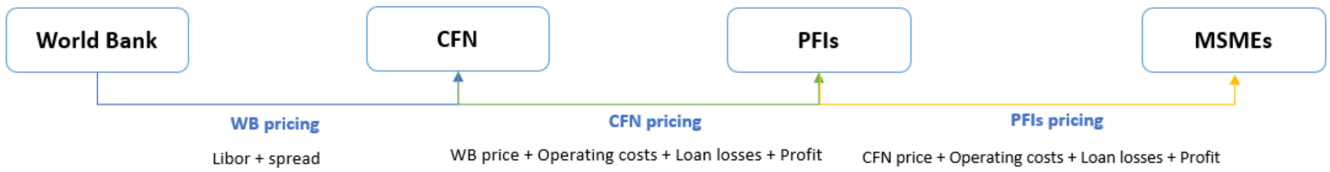
which in turn will on-lend to eligible private MSMEs. CFN will assume the credit risk of the PFIs, and PFIs will assume the credit risk of the MSMEs (see chart below).

Figure 4: Credit Line Structure



10. **CFN and the PFIs will follow their respective pricing policy according to market conditions.** The cost of on-lending financing through PFIs will include, at a minimum, the cost of IBRD funds to CFN plus an on-lending margin reflecting CFN's administrative costs, a credit risk margin (or risk markup) associated with the PFI, and an expected profit. Ultimate borrower cost will add, at a minimum, the PFI's administrative costs, a credit risk margin associated with the beneficiary MSME, and an expected profit. Pricing should be adequate to cover all PFIs' costs and provide a profit margin adequate to encourage lenders to compete in this market.

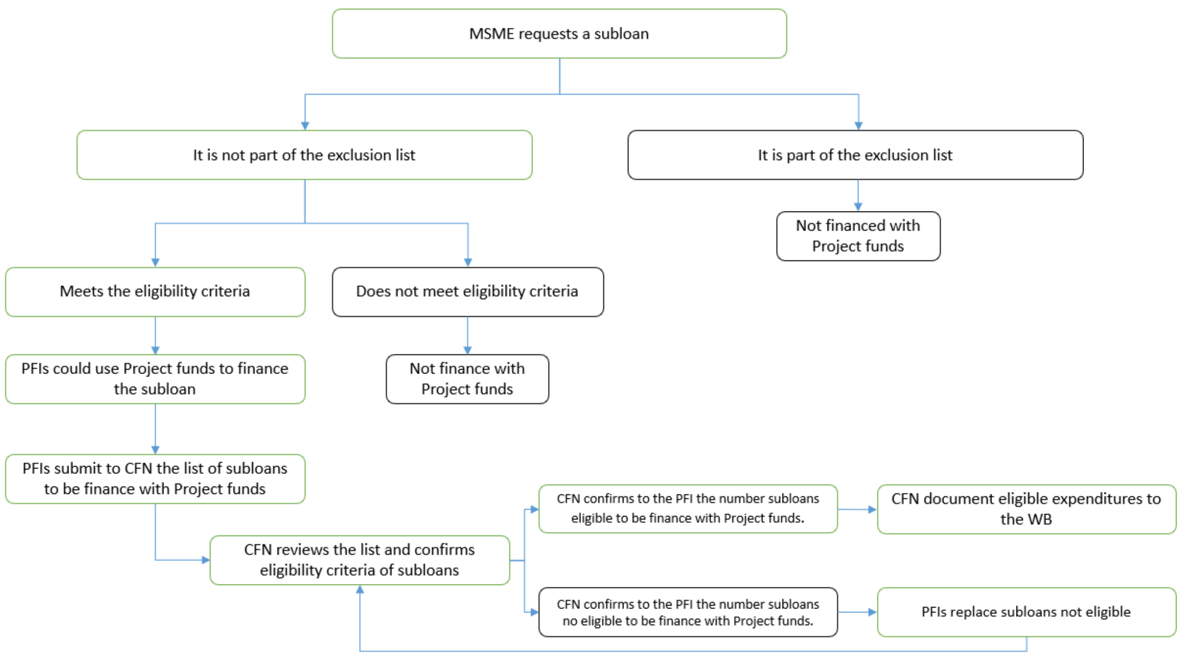
Figure 5: Pricing



11. **PFIs, MSMEs and subloans will comply with eligibility criteria.** A clearly defined eligibility criteria detailed in the project operations manual will be followed during the implementation of the Project. These criteria will ensure that the loan proceeds are used for the intended purposes following the obligations described in the Loan Agreement, including fiduciary procedures, environmental and social standards, and anticorruption guidelines. The eligibility criteria for PFIs will ensure that are commercially oriented, financially sound, and well-managed. The eligibility criteria for lending operations will incorporate appropriate climate co-benefits measures, where feasible, to address climate change-related risks and aspects. In addition, eligibility criteria for the productive assets (e.g. new equipment and machinery, vehicles, etc.) to be financed by the MSMEs will include the use of best available technology (BAT), energy efficiency, and low-carbon considerations as defined in the Operations Manual.

12. **Eligible PFIs, by assuming the credit risk of MSMEs, will be responsible to select final borrowers**. PFIs will provide subloans to MSMEs based on their respective internal policies and procedures. If MSMEs and subloans comply with the eligibility criteria, PFIs will have available the additional source of funding for their credit operations provided by this Project. If the PFIs decide to use the credit line and/or the partial credit guarantees financed with Project funds, then, the PFIs will submit the list of subloans for CFN's review and confirmation. Those subloans confirmed by CFN as eligible will be discounted from the amount allocated to each PFI.

Figure 6:Screening of Subloans



Financial Management

13. **The FM residual risk is Substantial,** considering: (i) CFN a government-owned bank supervised by the Superintendence of Banks (SB) is the first time that will be implementing a WB-financed project, which may impact implementation until the projec team gets acquainted with Bank procedures; (ii) the project involves decentralized implementation arrangements including significant participation of private financial institutions and MSMEs, which will require a robust financial management system in order to effectively monitor implementation of subloans; (iii) CFN is gradually transitioning to the second-tier lending operations market, and as such it needs to strenghten some processes for controlling and reporting reliable and timely financial information of subloans; (iv) additionally, the project involves the capitalization of National Guarantee Fund (NGF) for Special COVID-19 Program and for Standard Programs where although the capitlization of funds will be considered elegible expenditures, it will be important to ensure capitalized funds will be used only for the intentended purposes ; and (v) given the country's fiscal constrains, getting timely approval of budget funds for the implementation of the project will be a challenge[26], as it is the case for

[26] The most recent Public Financial Management assessments of Ecuador (most notably the PEFA report 2019) pointed out various deficiencies including inter alia the need to strengthen transparency of public finances, the budget preparation, management and control framework, and improving internal control and external oversight of the public sector. Such deficiencies may impact this project (as it is the case of other projects

most of the projects in the portfolio.

14. **These risks will be mitigated through the following measures:** (i) CFN Financial Business and Deposits Management (*Gerencia de Negocios Financieros y Captaciones*) is staffed with qualified professionals with experience implementing projects financed by CAF[27] and AFD[28]. Moreover, the project may hire a financial management specialist for the project as required in the future. This unit will be trained in the most relevant FM Bank's policies in order to facilitate the project implementation; (ii) CFN will be required to enhance monitoring of sub-loans provided to PFIs to ensure loan proceeds are used for the purposes intended. In this regard, it will be important to maintain an inter-intstitutional coordintaion between CFN, PFI and MSMEs to establish clear roles and responsibilities of all actors particpiating in the project implementation, along with the design of enhanced financial reporting mechanisms; (iii) for capitalization of the the NGF, CFN will be required to open exclusive bank account for each fund (Special COVID-19 Program and for the fund Standard Programs); to provide financial reporting on the use of the capitalized funds; and, to describe in the project operational manual the criteria and mechanisms to operate both funds; (iv) the project budget will be approved by CFN's Board and any potential budget delays will be monitored; and (v) finanical mangement arrangements agreed during should be reflected in the FM chapter of the project operational manual.

15. **On the basis of the review performed and the actions taken so far by CFN, FM team concludes that proposed FM arrangements are acceptable.** CFN will ensure to include in the operational manual the financial management and disbursements arrangements specific to this project that are acceptable to the Bank.

16. **Implementing Entity and Organizational Structure**. The Financial Business and Deposits Management (*Gerencia de Negocios Financieros y Captaciones*) will be mainly responsible for implementing financial management tasks in coordination with Sub-management of Insitutional Administration (*Subgerencia General de Gestión Institucional*[29] and *Subgerencia General de Negocios*). These Units are adequately staffed; thus, it will not require additional support to implement FM tasks; however, in the future, a FM Specialist might be required for the project during implementation depending on the workloads. In such case, the FM Specialist will be hired under terms of reference agreed with the Bank and could be financed with loan proceeds. A staff member within that unit will act as focal point and will comply with the roles and responsibilities set in the operations manual for a FM Specialist. This focal point to be part of the PCT during project implementation will be mainly responsible for: (i) preparing annual project budget; (ii) follow-up with PFIs as it relates to subproject implementation; (iii) preparing project financial reporting; (iv) processing and submitting withdrawal applications to the WB; and (v) coordinating financial audit.

17. **Programming and Budgeting**. CFN will follow local procedures regulated by COPLAFIP[30], Financial and Monetary Organic Code and Superintendence of Banks for the programming, formulation and execution of annual budgets. CFN's Budget Proforma comprises three budgets: (i) Ordinary Budget, (ii) Extraordinary Budget, and (iii) Policy Budget. A separate budgetary line under the CFN's Policy Budget will be created to allow appropriate monitoring and control of budget resources from different sources and project expenditures. CFN's annual budget (including the project) will be approved by CFN's Board and then by the Policy and Monetary and Financial Regulation Board. Timely recording of approved budget and issuance are managed in the PCIE system, while accruals, payments will be recorded through the COBIS accounting information system.

in Ecuador) and reflect in delays in getting the budget approved in time.

[27] *Corporación Andina de Fomento*

[28] French Development Agency – Agence Francaise de Développement

[29] Comprises *Gerencia de Contabilidad, Gerencia Administrativa*, and Gerencia de Presupuesto y Control

[30] *Código Orgánico de Planificación y Finanzas Públicas.*

18. **Internal Controls.** CFN processes are formalized in existing manuals with detailed procedures for the daily operations undertaken by the entity. Such manuals also include procedures related to implementation of second-tier lending operations; however, some process need to be strengthened for ensuring that loan proceeds will be used for intended purposes and that sub-loans will be effectively controlled and monitored, and they will include: (i) the PCT establishes clear roles and responsibilities for the implementation of this project under inter-institutional agreements between CFN and actors participating in the project implementation; (ii) CFN carries out more frequent control and monitoring to PFIs's through the strengthening of financial reporting on sub-loans amounts provided to eligible MSMEs; (iii) the operational manual describes implementation arrangements to be followed under capitalization of the NGF and ensure funds capitalized will be used for intended purposes under the strengthening plan agreed with the WB; and (iv) CFN, PFIs, and MSME maintain project documentation through the project life for further supervision and audits. All detailed processes will be reflected in the Project Operations Manual.

19. **Accounting, Information System and Financial Reporting.** CFN accounting records are managed in the financial information system COBIS, which has integrated modules for the accounting records, payments, and transfer of funds; however, preparation and execution of budget are managed in a different system named PCIE. Accounting records apply the accrual accounting basis and the chart of accounts for financial institutions issued by Superintendence of Banks. Under those arrangements project transactions will be recorded and accounted for as part of CFN's general accounting system. According to project information needs, COBIS credit module will provide detailed information on the credit lines operations with PFIs; however, it does not provide automatized information on the use of the funds documented by PFIs which will be carried out manually. Regarding capitalization of funds, the NGF uses the CFN's guarantee module to manage and control credit guarantees issued for PFIs. The trustee is regulated by the Superintendence of Companies and will also issue financial reports on the funds to be capitalized by the Bank.

For project purposes, CFN will require to prepare the following reports:

(a) Semiannual project interim financial reports (IFRs) to be submitted to the Bank not later than 45 calendar days at the end of each semester and will include: (i) Sources and uses of funds; (ii) Cumulative investments; (iii) Consolidated report on PFIs and sub-loans[31]; (iv) Reconciliation of the Designated Account; and, (v) Notes to the project financial statements. The IFRs will be also used for disbursement purposes as described in the funds flow and disbursement arrangements.

(b) Annual project financial statements will be also prepared, including (i), (ii) and (v) above, which will be subject to external financial audits.

Financial Auditing Arrangements

20. **Internal Audit.** CFN is subject to internal audit reviews carried out by the Internal Audit Unit. This unit performs reviews based on annual work plans. This unit would conduct reviews with the aim of ensuring that the funds were used for the intended purposes. Based on the assessment performed, it has been determined that the internal audit unit has adequate capacity to perform its work with appropriate independence. The internal auditors are expected to carry out regular reviews of project payments and transfers of funds to PFIs. Internal audit arrangements will be specified in the Project Operational Manual.

21. **External Audit.** The Financial Statements of CFN are audited annually by an external auditor approved by the Audit Committee of CFN's Board. For WB financed project, CFN will be responsible for the selection and appointment

[31] A report comprising: disbursements made to PFI, sub-loans to MSME; and outstanding balances pending to document

of an independent private auditor acceptable to the Bank under audit TORs agreed with the Bank. Annual project financial statements will be audited in accordance with International Standards on Auditing (ISAs) issued by the International Federation of Accountants (IFAC). Audit costs will be financed out of loan proceeds. The audit TORs will also include visits to PFIs and a sample of MSME and a review on the use of the funds capitalized with loan proceeds, under the NGF, for the Special COVID-19 Program Fund and for Standard Programs Fund, all in accordance with the conditions of the loan agreement and process agreed under the project operations manual. The audit report will cover the fiscal year of the borrower (or any other period agreed with the Bank) and will be presented to the Bank no later than six months after the end of each audited period.

Funds Flow and Disbursement Arrangements

22. The Bank will disburse loan proceeds using the disbursement methods of advance direct payment and reimbursement. Under the advance method, a segregated Designated Account (DA) in US Dollars will be opened and maintained by CFN in the Central Bank of Ecuador (BCE[32]). Funds deposited into the DA as advances, will follow Bank's disbursement policies and procedures as described in the Disbursement and Financial Information Letter (DFIL). Withdrawals from the DA will be carried out against payments under sub-loans *(*component 3*)*, and payments under goods and services *(*Components 1, 2 a) and 4*)* and *for* capitalizations of the National Guarantee Fund for Special COVID-19 Program and for Standard Programs (Sub-component 2b and 2c).. Local counterpart funding is not expected for this project All transfer of funds and payments will be made through the interbank payment system (SPI).

(a) Intermediary Financing. CFN will transfer loan proceeds from the DA to eligible PFIs to provide sub-loans to eligible MSMEs. Transfer of funds would follow the terms and conditions established in the financing agreement (CFN-PFI) and forecasts of planned sub-loans prepared by PFIs.

(b) Capitalization of the National Guarantee Fund (NGF). The NGF is a Trust Fund Account[33] (Fideicomiso, by its name in Spanish) whose main objective is to provide credit guarantees to Financial Institutions (FIs) with non-performing loans. For project purposes, the NGF will continue using the CFN's guarantee module to manage and control credit guarantee issued for PFIs. The trustee[34] will also issue financial reports on the funds to be capitalized by the Bank. As part of the project, there are two subcomponents:

(i) For Subcomponent 2 b) Capitalization of the National Guarantee Fund for Special COVID-19 Program, the World Bank will transfer the resources to the NGF only after the following conditions have been met: the operational manual including procedures for the control of funds have been approved by the World Bank, and a bank account for the exclusive use of this guarantee fund has been opened.
CFN envisages to use the disbursement method of advance to DA for capitalization purposes. The capitalized funds will be used to finance partial credit guarantees, in accordance to the conditions of the loan agreement and procedures established under the operational manual. Disbursements for the Capitalization of the National Guarantee Fund for Special COVID-19 Program can be requested in one or more tranches by the Borrower. The capitalization of this fund will be considered eligible expenditure and in order to document the expenditure, the borrower shall provide to the Bank the IFR according Schedule 1 of the DFIL in addition evidence in the form of a copy of a bank statement

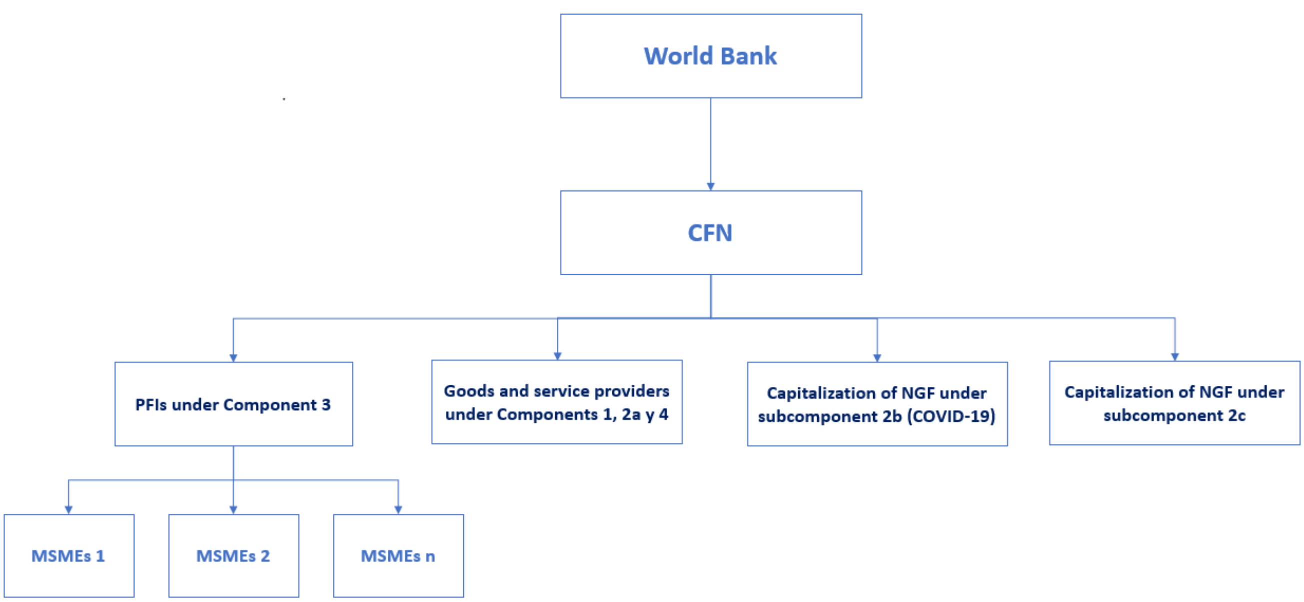
[32] In accordance with local regulations, CFN must open separate special accounts in the Central Bank of Ecuador to manage public resources including those coming from external financing.
[33] Managed by the Trustee (Fiduciary, by its name in Spanish) FIDUECUADOR since 2014.
[34] The Trustee is regulated by the Superintendence of Companies.

for this Fund account under the NGF, showing the respective capitalization of said Fund in regard to Disbursement Category 2 of the Loan Agreement.

(ii) For Subcomponent 2 c) Capitalization of the National Guarantee Fund for Standard Programs, the World Bank will transfer the resources to the NGF only after the following conditions have been met: the operational manual including procedures for the control of funds have been approved by the World Bank, a bank account for the exclusive use of this guarantee fund has been opened and CFN has fulfilled disbursement condition as part of the strengthening plan of NGF. CFN envisages to use the disbursement method of advance to DA for capitalization purposes. The capitalized funds will be used to finance partial credit guarantees in accordance to the conditions of the loan agreement and procedures established under the operational manual. Disbursements for the Capitalization of the National Guarantee Fund for Standard Programs can be requested in one or more tranches by the Borrower as resulted from the strengthening plan of the NGF. The capitalization of this fund will be considered eligible expenditure and in order to document the expenditure, the borrower shall provide to the Bank a report with the IFR according Schedule 1 of the DFIL and in addition evidence in the form of a copy of a bank statement for this Fund account under the NGF, showing the respective capitalization of said Fund in regard to Disbursement Category 3 of the Loan Agreement.

(c) Financing of goods and services will be also eligible under loan proceeds and advances to the DA will be withdrawn to carry out payments by CFN under service providers contracts for component 1, 2 a and 4.

Figure 7: Flow of Funds and Disbursement Arrangements



23. Disbursements will be report based. For Component 1, 2 (a), 3 and 4, the CFN's DA will have a variable ceiling, based on a six-month forecast to cover project implementation needs. Withdrawal applications will be submitted by CFN, duly signed by authorized signatures. Semiannual or more often, as needed, IFRs will be used to document expenditures within client connection. Reconciled bank account as well as other appropriate supporting documentation will be attached to IFRs. Disbursement arrangements will be described in the DFIL of the Project. For Component 2b) and 2c), the capitalization of these funds will be considered eligible expenditures and documented for the World Bank as long as the funds would be deposited into the exclusive bank accounts opened for each Fund (Special COVID-19 Program and Standard Program). Supporting documentation will be maintained by CFN and the Trustee that manages both Funds under the NGF. All other documentation in support of IFRs will be retained by CFN. This information will be maintained for at least two years after the WB has received the audit report for the fiscal year in which the last withdrawal from the loan account was made. This information will be available for review during WB supervisions and for annual audits.

Table 1: Loan Proceeds Table

Category	Amount of the Loan (in US dollars)	Percentage of Expenditures to be financed (inclusive of taxes)
(1) Goods, non-consulting services, consulting services, training for Part 1 and Part 2a of the Project.	5,000,000	100%
(2) Capitalization of the Guarantee Fund under Part 2b of the Project.	20,000,000	100%
(3) Capitalization of the Guarantee Fund under Part 2c of the Project.	20,000,000	100%
(4) Sub-Loans under Part 3 of the Project	213,000,000	100%
(5) Goods, non-consulting services, consulting services, training and operating Costs for Part 4 of the Project	2,000,000	100%
(6) Interest Rate Cap or Interest Rate Collar premium	0	Amount due pursuant to Section 4.05 (c) of the General Conditions
TOTAL AMOUNT	**260,000,000**	

24. Retroactive financing. No withdrawal shall be made for payments made prior to the Loan Agreement Signature Date, except that withdrawals up to an aggregate amount not to exceed $26,000,000 may be made for payments made prior to this date but on or after May 20, 2020, for Eligible Expenditures under Categories (1), (4) and (5).

Procurement

25. Procurement will be carried out in accordance with "World Bank Procurement Regulations for IPF Borrowers" (July 2016, revised in November 2017 and August 2018) ("Procurement Regulations"). A PPSD prepared by the Borrower, which describes how procurement in this operation will support the PDOs and deliver value for money under a risk-based approach. The PPSD will provides adequate supporting market analysis for the selection methods detailed in the Procurement Plan. Mandatory Procurement Prior Review Thresholds detailed in Annex I of the Bank's Procurement Procedure are observed. All procurement procedures, including roles and responsibilities of different units, will be defined within the Project Operations Manual.

26. Procurement Plan. In accordance with paragraph 5.9 of the Procurement Regulations, the Bank's Systematic Tracking and Exchanges in Procurement (STEP) system will be used to prepare, clear and update Procurement Plans and conduct all procurement transactions for the Project. A Procurement Plan covering the first 18 months of the project implementation was prepared by the Borrower in accordance with the results provided by the PPSD and will be agreed with the World Bank as part of the Negotiations. A summary of PPSD, including recommended procurement approach for higher risk/value contracts.

27. Consulting services to be financed under the Project will be focused on CFN's assessments of financial viability, current strategy and business plan, designs and implementation of M&E, and environmental and social standards, external auditing, among other services.

28. Goods to be financed under this Project will include IT equipment, software, office furniture, etc.

29. Non-consulting services to be financed under this Project would include surveys, the organization of events, etc.

30. Civil Works are not foreseen to be financed under the Project.

31. Bidding Procurement Documents. Standard Procurement Documents (SPDs) shall be used for all contracts subject to international competitive procurement and those contracts as specified in the Procurement Plan tables in STEP. For bidding processes with national market approach, bidding and request of quotations documents will be agreed with the Bank.

32. Operating costs. Operating costs refer to reasonable recurrent expenditures that would not have been incurred by the PCT in the absence of the Project. The Project will finance operating costs such as the financing of study tours (air tickets, hotel, per diem), printing material, among others. qualified

33. Capacity assessment. The World Bank carried out the procurement capacity assessment to evaluate the adequacy of procurement arrangements of CFN. The assessment focused on how CFN will be organized to procure using the loan's funds, in terms of staffing structure, procurement record system, internal controls, roles and responsibilities, etc. Procurement will be carried out by the *Gerencia Administrativa*, which does not have prior experience in procurement under the Bank Procurement Regulations; however, it has qualified staff with significant experience in national procurement procedure, which added to the features/low complexity of procurement included in the Project, and the market conditions, no significant issues could be expected. In terms of procurement record system, internal controls and roles/responsibilities, were found acceptable by the World Bank.

34. **The key issues and risks concerning procurement for Project implementation are**: (i) lack of experience in project financed by the World Bank, and (ii) coordination between technical and procurement units.

35. **The agreed corrective measures are**: (i) the procurement staff of GA and other related staff on procurement activities (e.g. lawyers, technical experts, etc.), will be trained on the World Bank Procurement Regulations, and, if necessary the GA could be strengthened by a part-time procurement consultant experienced in World Bank Procurement Regulations, and (ii) the Project Operations Manual will set appropriately roles and responsibilities of the technical and procurement units.

36. **Frequency of Procurement Supervision.** In addition to prior review supervision, an annual mission will be carried out and the procurement post review will cover at least 10 percent of contract not prior reviewed by the World Bank. The periodicity and the percentage of the post review processes to be reviewed based on Borrower procurement performance.

37. **Summary of PPSD (recommended procurement approach for higher value contracts):**

Table 2: Summary of PPSD

Description	Estimated Cost (US$)	Prior / Post Review	Market approach	Procurement method
CONSULTING SERVICES				
Financial assessment, credit risk policy and NPL resolution strategy for CFN	400,000	Post	International	QCBS
Strengthening plan for the National Guarantee Fund	200,000	Post	International	QCBS

Strategy and Approach for Implementation Support

38. The implementation support strategy was developed considering that CFN will be the borrower and implementing agency for the first time of a World Bank project. This strategy includes different channels of communication that will be offered to CFN to allow the institution to receive closer and permanent implementation support, especially during the first year of Project implementation.

(a) Technical and Operational Support – The Project team will provide technical and operational support to CFN, especially to the Project Coordination Team. Weekly calls, monthly meetings, and virtual and *in-situ* missions will be organized with the participation of the TTLs and technical specialists to guide CFN during project implementation.

(b) Financial Management and Procurement – During project implementation, the World Bank will supervise the project's financial management arrangements in two ways: (i) review the project's semi-annual project reports as well as CFN's and the project's annual audited financial statements; and (ii) during the World Bank's implementation support missions, review the project's financial management and disbursement arrangements to ensure compliance with the loan procedures. Likewise, the World Bank will supervise procurement arrangements and review prior and post review procurement processes. As required, a World Bank-accredited Financial Management Specialist and a Procurement Specialist will participate in implementation support and supervision missions.

(c) Environmental and Social Standards –The World Bank Environmental and Social Specialists will guide CFN to develop, update and use the E&S instruments. Also, the team will guide CFN to comply the ESCP. Regarding the ESMS, the team will support CFN during workshops and training sessions organized with financial intermediaries and final borrowers to explain the ESS and how they will be applied in this Project. As required, World Bank-accredited Environmental Specialist and Social Development Specialist will participate in implementation support and supervision missions.

Implementation Support Plan and Resource Requirements

Time	Focus	Skills Needed	Resource Estimate
Year 1	Task Team Leaders	Project management	10 staff weeks (SWs)
	Technical reviews	Financial Sector Specialist	6 SWs
	Fiduciary supervision	FM and Procurement Specialists	6 SWs
	Environmental and social supervision	Environmental and social safeguard specialists	6 SWs
Year 2-4	Task Team Leaders	Project management	8 SWs per year
	Technical reviews	Financial Sector Specialist	4 SWs per year
	Fiduciary supervision	FM Specialist	4 SWs per year
	Environmental and social supervision	Environmental and social safeguard specialists	4 SWs per year

ANNEX 2: Financial Intermediary Assessment

COUNTRY: Ecuador
Promoting Access to Finance for Productive Purposes for MSMEs

1. **The current assessment of CFN took place based on eligibility criteria in accordance to Financial Intermediary Financing**. The criteria for the World Bank assessment and a table with the assessment results are described below.

(a) The bank must be duly licensed and at least two years in operation.
(b) The bank's owners and managers must be considered 'fit and proper'. It must have qualified and experienced management and adequate organization and institutional capacity for its specific risk profile.
(c) The bank must maintain capital adequacy.
(d) The bank must have adequate liquidity.
(e) The bank must have positive profitability and an acceptable risk profile. It must maintain the value of its capital.
(f) The bank must have well defined policies and written procedures for management of all types of financial risks (liquidity, credit, currency, interest rate and market risk, as well as risks associated with balance sheet and income statement structures) and operational risk.
(g) The bank must classify its assets and off-balance-sheet credit risk exposures (at least four times per year) and make adequate provisions. It must have adequate portfolio quality. The bank should not have more than 10 percent of criticized assets (that is, classified as doubtful and at a loss).
(h) The bank must have adequate internal audits and controls for its specific risk profile.
(i) The bank must have adequate management information systems.

Summary of CFN Assessment

Criterion	Comments
1. License	The bank is authorized, regulated and supervised by the Superintendence of Banks of Ecuador (SBE). It was founded in 1964.
2. Owners/managers 'fit & proper', governance quality	CFN shareholder is the Central Bank of Ecuador (BCE). The Board of Directors is composed of representatives from different ministries, while its president is a permanent delegate of the President of the Republic. It could not be verified that all the members of the Board of Directors can be considered "fit and proper" in terms of their experience in financial matters. Its General Manager and the managements that make up CFN are qualified and experienced. The organizational structure of CFN is in line with what is required by regulation, observing separation of functions and internal control systems.
3. Capital adequacy	As of June 2019, the regulatory capital of CFN was US$ 1,004 million, while the assets (and contingents) weighted by credit risk were US$ 2,300 million, reaching a "Capital Asset Ratio" (CAR) of 43.7 percent. (the minimum regulatory ratio is 9.0 percent). This situation has been observed in previous

Criterion	Comments
	years. Although capital requirements for other risks and the constitution of capital cushions are not contemplated, CFN capitalization levels are relatively high.
4. Liquidity	CFN funding structure is highly concentrated and presents challenges for the expansion of its businesses. The majority of its funding (91 percent) comes from time deposits; more than half of these (53 percent) are BCE´s deposits, 24 percent are from the deposit insurance fund trust, 6 percent from the Pacific Bank and the remaining 17 percent from other financial institutions. Due to legal changes, CFN must replace the Central Bank as a source of funding with other sources. Although CFN funding is concentrated in few suppliers, they have shown little volatility and high renewal rates. In the contractual liquidity scenario, CFN presents some liquidity positions at risk that were below regulatory minimums in some months. Most of the investments in CFN bonds are concentrated in instruments that do not have a credit rating and are not considered as computable liquid assets. The available liquid assets of CFN have been declining.
5. Profitability	CFN has been showing stable results, which has allowed it to maintain the value of its capital (although 2/3 of these results come from the profits of the Pacific Bank, of which it owns 100 percent of the shares). During the first half of 2019, it experienced a significant fall in its results, as a result of the increase in loan loss provisions for credit risk (ROE of 0.7 percent as of June 2019). CFN has small financial intermediation margins offset with a low level of expenditures; the main factor that explains the reduced financial margin of CFN is the reduced active interest rate that applies to its credits; operational expenses are low as a result of having average amounts of major loans and having made a rationalization of its structure together with the reduction (10 percent) of the staff.
6. Policies and risk management functions	CFN has written policies, manuals and procedures for the management of its financial and operational risks. Some of them are recent and are in full implementation stage. They include the main aspects for risk management and are (in general terms) aligned with regulatory requirements. The policies and manuals present aspects of improvement, such as the automation and consolidation of processes and the execution of contingency plans.
7. Asset quality and provisions	CFN credit exposures are classified and provisioned monthly, in line with the specific regulations in the matter. They are transmitted to SN on a quarterly basis. CFN shows high rates of problem assets. The loan portfolio with more than 90 days of arrears is around 10 percent (9.8 percent as of June 2019), while the portfolio with more than 30 days of arrears amounted to 13.2 percent. The coverage ratio of the provisions is reasonable, especially when considering the solvency levels presented by CFN (the level of provisions of the loan portfolio covers 80 percent of the portfolio with arrears of more than 30 days and 108 percent of the loan portfolio with arrears greater than 90). The share of restructured and rescheduled loans in the loan portfolio is

Criterion	Comments
	significant, which entails a high probability of turning into NPLs. A detailed analysis of the loan portfolio shows that a significant proportion of the unproductive portfolio was generated several years ago. CFN has modified and is implementing new credit processes and has defined as one of its priority objectives to reduce delinquency levels of its loan portfolio.
8. Internal audit and controls	The Internal Audit Department reports directly to the Board. There is an Internal Audit Committee, with the participation of Board members. The Internal Audit Department consolidates the recommendations to the different areas received from various sources and monitors their degree of compliance.
9. Adequate management information systems	CFN has a management information system that allows the monitoring of its financial and operational risks, including the preparation of various reports (weekly, monthly, quarterly and annual) addressed to internal (i.e. CFN management) and external (SB, credit risk rating agency, external auditors) stakeholders. The external audit identified aspects of improvement in information security and development of a Strategic Information Technology Plan (PETI), which are in the process of being implemented by CFN. Some observations were also made on the Banking Core, for which CFN is evaluating its strengthening or updating.

ANNEX 3: Micro, Small and Medium Enterprises in Ecuador

COUNTRY: Ecuador
Promoting Access to Finance for Productive Purposes for MSMEs

1. **Access to finance is an important obstacle to investment and innovation by MSMEs.** According to the 2017 Enterprise Survey, access to finance is among the top three business environment obstacles for firms in Ecuador. The use of banks by Ecuadorian firms to finance investments is lower than the average for the region and for similar income country groups, while access to long-term finance is low even for large companies. Limited access to finance for MSMEs reflects the interaction of demand and supply factors. Small firms have limited collateral to offer to banks and face several nonfinancial barriers related to their own capacities, including a lack of financial education. On the other hand, private banks' participation in MSME credit markets remains limited. The tenors offered by private sector banks are short, usually less than two years, and few products are tailored to small businesses, as higher administrative costs lead banks to prefer to devote their efforts to large corporate clients. Moreover, there are no MSME-focused banks in Ecuador. Large corporations are catered to by private banks and some micro firms are served by financial cooperatives, leaving most micro firms and the SME segment underserved. Interest rate caps on loans to MSMEs add to the reluctance of banks to work with smaller firms, as the high transaction costs and the high risks associated with this segment make it non financially viable in most cases. All this generates an estimated financing gap of US$ 17 billion in 2018 or 17 percent of GDP. Ensuring adequate access to financing for MSMEs is, therefore, critical for restoring growth and for job creation as MSMEs account for about 60 percent of formal employment in Ecuador.

2. **The COVID-19 crisis will exacerbate traditional challenges while new, supply-side and demand-side difficulties will soon become apparent, disproportionately affecting MSME financing.** Several interrelated stress factors are expected to impact MSME and entrepreneurship financing in Ecuador, with some sectors – e.g. agriculture, hospitality, retail, transport – more exposed than others:

(a) Reduced activity or business closure will result in less sales revenue. At the same time, costs can increase due the restrictive availability of raw materials, limited transportation routes and increased transportation costs.
(b) A depletion of working capital may entail liquidity or even insolvency problems. The decline in sales and the contemporaneous rise in inventories can be compounded by an increase in payment delays on receivables, leading to a rapid reduction of working capital.
(c) Financial intermediation may be curtailed. Normal banking hours can be reduced, and, in some cases, branch operations can be temporarily halted. NPLs are expected to rise while significant deposit outflows cannot be rule out, which would put pressure on bank liquidity. All this can result in tightened credit conditions, negatively affecting the availability of credit for MSMEs.

3. **MSMEs are the main Project beneficiaries.** MSMEs are the main project beneficiaries. MSMEs will benefit from the Project by getting access to finance for productive purposes through PFIs. MSMEs will also benefit from new or improved financial instruments offered by CFN to promote access to finance for MSMEs through financial intermediaries (e.g. risk sharing facilities, alternative financial instruments, climate resilience financial products, specialized products for female-owned MSMEs to promote gender equality, indigenous peoples MSMEs, FinTech solutions). MSMEs will benefit by getting access to finance for working capital and investment needs. In addition, MSME will be able to reduce their exposure to climate-related risks or recover from damages incurred by impacts of climate change and natural or man-made disasters by getting access to finance from PFIs that have the capacity to be closer to

the population and reach marginal areas nationwide in times of emergency to help them overcome economic shocks (e.g. earthquake 2016 and COVID-19 pandemic).

Definition and Classification of MSMEs

4. **MSMEs are defined by the Organic Code of Production, Commerce and Investments (COPCI) and its regulations.** MSMEs are defined as any natural or legal person that, as a productive unit, exercises an activity of production, commerce and or services, meets the number of workers, and gross value of annual sales, indicated for each firm size, in accordance with the ranges established in the Code and its regulation described in the table below.

Table 3: MSME definition

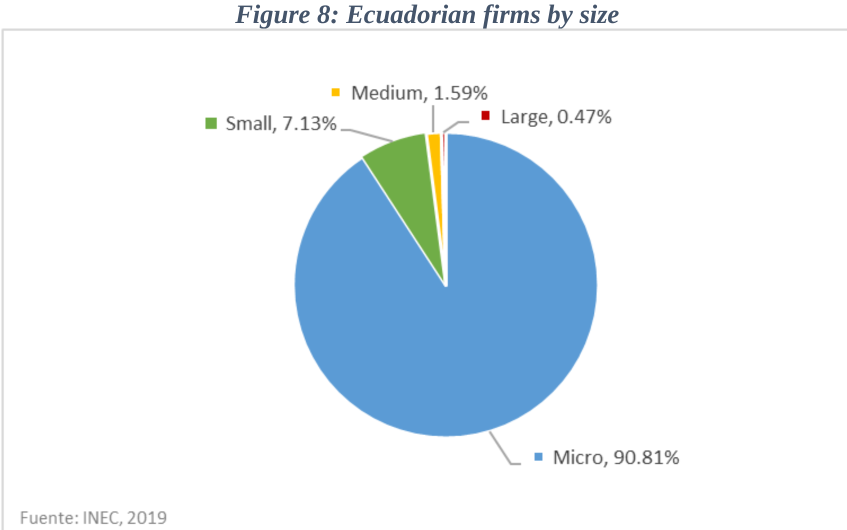
Size	Annual Sales	No. Employees
Micro	<=US$100,000	1 a 9
Small	US$100,001 a 1,000,000	10 a 49
Medium	US$1,000,001 a 5,000,000	50 a 199

Source: COPCI (at appraisal stage)

MSME Structure

5. **Micro, Small and Medium enterprises represent 99 percent of firms in Ecuador.** The National Institute of Statistics and Censuses (INEC) registered about 900,000 firms in the country in 2018. About 90 percent (815,000) are micro enterprises, 7 percent small, 1.6 percent medium, and 0.4 percent large.

Figure 8: Ecuadorian firms by size



6. **Ecuadorian firms concentrate their activities in two economic sectors: services and commerce.** Services stand out as the sector with the largest number of firms, about 380,000 or 43 percent, followed by 35 percent of firms engaged in commerce, mainly wholesale and retail trades; 10 percent involved in agriculture and fishing activities, 8 percent manufacture, 3 percent construction, and 0.2 percent extractive industries.

7. **MSMEs represent about 30 percent of total annual sales in Ecuador.** About US$ 34 billion were sold by MSMEs in 2018. Firms engaged in commerce activities represented 38 percent, followed by 24 percent of firms involved in services, 21 percent in manufacture, 7 percent in extractive industries, 6 percent in agriculture and fishing, and 4 percent in construction.

Figure 9:Number of firms by sector

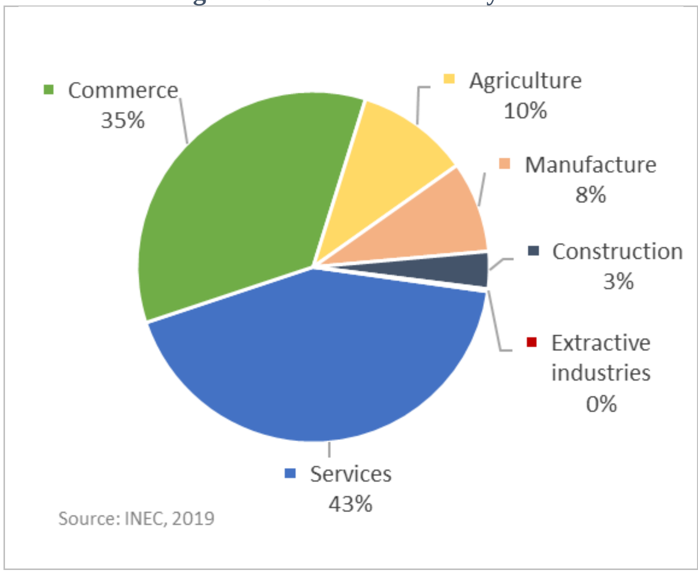
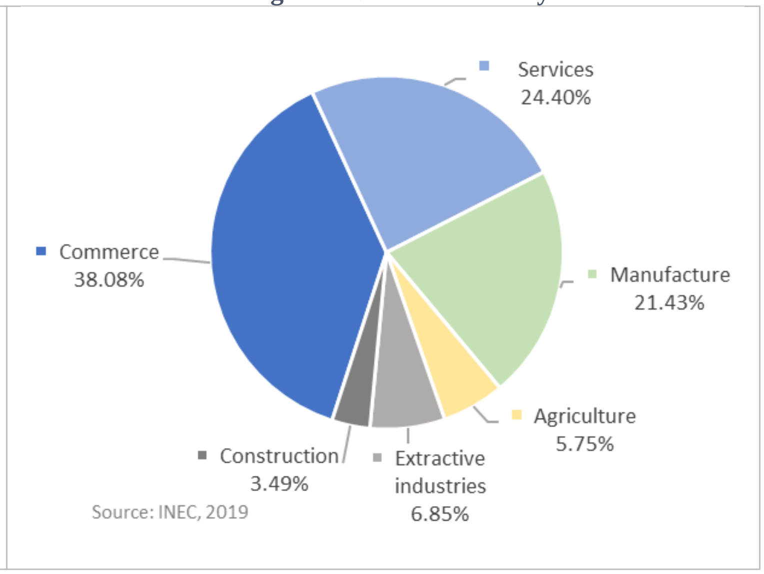
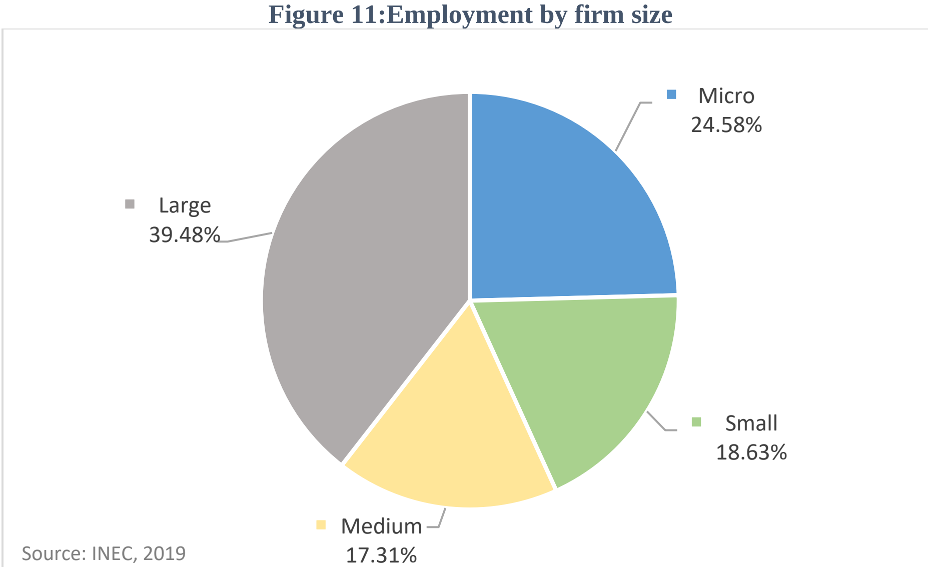


Figure 10: Annual sales by sector



8. **MSMEs generate about 60 percent of employment in Ecuador**. About 3 million employees worked in private sector firms in Ecuador in 2018, from which 1.8 million employees worked in MSMEs. Almost 25 percent of employees worked in microenterprises, 18 percent in small firms, and 17 percent in medium enterprises. Firms involved in the services sector concentrates the largest number of registered employment positions with a 56 percent share; followed by the commerce and manufacturing sector, which have a participation of 18 percent and 13 percent, respectively.

Figure 11:Employment by firm size



9. **Access to financial products, including credit, seems to be more limited for women- and IPAM-owned MSMEs.** On gender, firms with female participation in ownership in Ecuador is among the highest in the region and compared with economies with similar income levels. According to the 2017 Enterprise Survey, about 70 percent of firms have female participation in ownership, 23 percent have a female top manager, 34 percent have permanent full-time workers that are female, 50 percent have permanent full-time non-production workers that are female, and 21 percent have permanent full-time production workers that are female. When it comes to access to financial services, although the percentage of women with an account in a financial institution has increased between 2011 and 2014, it still remains low. In 2014 only 40.8 percent of women had an account at a financial institution compared to 51.9 percent among men. Only 23 percent of businesses headed by women had access to a credit in 2014. Similarly, though data on access to finance are not available, IPAM-owned MSMEs face significant obstacles in their quest for a loan. These firms are concentrated in municipalities with less financial infrastructure (i.e. fewer bank branches and financial cooperatives), operate in sectors that are often not well-served by financial institutions (e.g., smallholder farming, forestry, retail trade), may be less likely to have fixed assets to use as collateral, and may face discrimination and unfair business practices by financial institutions.

10. **MSMEs source of financing for investment purposes comes mostly from internal resources**. According to the 2017 Enterprise Survey, firms in Ecuador identify access to finance as the third biggest business environment obstacle. Although the percentage of firms with a checking or savings account in Ecuador is close to 100 percent, the percentage of firms with a bank loan remains low, with only 18 percent of firms getting access to finance for investment purposes from a financial institution. Instead, about 60 percent of micro and small firms and 53 percent of medium enterprises use internal resources to finance the purchase of fixed assets, 13 percent get financing from the same provider that is selling the products, 8 percent from equity, and 5 percent from other sources such as friends and family.

Table 4: Ecuador's Enterprise Survey 2017, Gender and Finance

	Ecuador2017	Small firms	Medium firms	Large firms	Latin America & Caribbean	Upper Middle Income
Firm Characteristics						
Age of the establishment (years)	18.1	16.1	17.8	31.8	20.0	16.7
Gender						
Percent of firms with female participation in ownership	70.4	70.1	72.7	66.3	42.2	37.4
Percent of firms with a female top manager	22.9	25.4	23.7	5.8	21.4	20.3
Proportion of permanent full-time workers that are female (%)	34.2	40.2	24.2	23.6	37.6	36.4
Percentage of permanent full-time non-production workers that are female.	50.4	65.1	43.5	39.8	45.0	44.2
Percentage of permanent full-time production workers that are female.	20.8	28.9	17.2	16.4	23.5	28.9
Finance						
Percent of firms with a checking or savings account	96.7	97.8	93.1	99.8	91.5	89.6
Percent of firms with a bank loan/line of credit	59.6	54.1	61.9	87.4	47.3	40.2
Proportion of investment financed internally (%)	54.7	60.3	52.9	41.8	62.7	68.3
Proportion of investment financed by banks (%)	18.2	13.5	23.1	22.7	21.8	18.2
Proportion of investment financed by supplier credit (%)	13.5	13.7	7.9	23.8	6.8	5.4
Proportion of investment financed by equity or stock sales (%)	8.5	6.7	12.2	6.8	4.4	4.8

Source: Enterprise Survey 2017