## BASIC INFORMATION

### A. Basic Project Data

<table>
<thead>
<tr>
<th>Country</th>
<th>Project ID</th>
<th>Project Name</th>
<th>Parent Project ID (if any)</th>
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<tbody>
<tr>
<td>Ecuador</td>
<td>P172899</td>
<td>Promoting Access to Finance for Productive Purposes for MSMEs</td>
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<th>Estimated Board Date</th>
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<tr>
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<td>23-Jun-2020</td>
<td>Finance, Competitiveness and Innovation</td>
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### Financing Instrument
- Investment Project Financing

<table>
<thead>
<tr>
<th>Borrower(s)</th>
<th>Implementing Agency</th>
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<tr>
<td>Corporación Financiera Nacional</td>
<td>Corporación Financiera Nacional</td>
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### 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

- Strengthening the Institutional Capacity of CFN
- Development and Improvement of Financial Products to Promote Access to Finance for MSMEs
- Credit Line Intermediated by CFN to PFIs for On-Lending to MSMEs
- Project Management

## PROJECT FINANCING DATA (US$, Millions)

### SUMMARY

<table>
<thead>
<tr>
<th>Total Project Cost</th>
<th>260.00</th>
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<tbody>
<tr>
<td>Total Financing</td>
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</tbody>
</table>

| of which IBRD/IDA | 260.00 |

| Financing Gap     | 0.00   |

### DETAILS

**World Bank Group Financing**

<table>
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</table>
Environmental and Social Risk Classification

Moderate

Decision

The review did authorize the team to appraise and negotiate

Other Decision (as needed)

B. Introduction and Context

Country Context

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 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, 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 April 15, 2020, 7,858 cases – including 388 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.

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.

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 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.

Sectoral and Institutional Context

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, 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.1 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.

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 supervisory

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1 Public banks include: Corporation Financiera Nacional (CFN), Banco de Desarrollo, BanEcuador and CONAFIPS. Banco Pacifico, 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.
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.

**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. 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)\(^2\) 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.

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**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
- Capital ratios are above the regulatory minimum
- NPLs appear low and adequately provisioned
- Lending rates have begun to rise as a result of higher cost of funding

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\(^2\) Second Inclusive and Sustainable Growth (P171190)
Businesses, particularly micro, small, and medium enterprises (MSMEs), struggle to grow and create adequate and stable employment.³ 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.⁴ 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.⁵ 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.⁶ 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

³ MSMEs are defined according to domestic regulation.
⁴ Ho et al. (2019), Productivity and Reallocation: Evidence from Ecuadorian Firm-Level Data, mimeo.
⁵ World Bank (2019), Country Private Sector Diagnostic.
⁶ 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.
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.

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.

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 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.

Access to credit seems to be more limited for businesses headed by women and by indigenous peoples and nationalities, afro-Ecuadorians and Montubians (IPAM). 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. 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

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7 IFC, MSME Finance Gap Database.
8 World Bank, 2018, Gender Gaps in Ecuador: An Overview, Washington DC.
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.

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:

(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.

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.

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 December 2018, CFN held liabilities of US$ 1.1 billion with the central bank, US$ 434 million with commercial banks (mandatory allocations), and US$ 290 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.

**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 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.

**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.

**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 it 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.

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.

The Corporación Financiera Nacional (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 (CBE) is CFN’s sole shareholder following a debt-for-equity swap deal between the Ministry of Economy and Finance (MEF) and CBE, 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 finding 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.

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 LAC region, 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 $ 26 million and outstanding guarantees of $ 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

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9 Banco del Pacífico will not be included as PFI for this Project.
2015. 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. Proposed Development Objective(s)

Development Objective(s) (From PAD)

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.

Key Results

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 guarantee provided to MSMEs with Project funds; and (iii) Share of second-tier financing of CFN.

D. Project Description

The proposed Project is a US$ 260 million IBRD Financial Intermediary Financing that will be executed in five years with the objective of promoting access to finance for productive purposes for micro, small, and medium enterprises (MSMEs) in the context of COVID-19 crisis. The proposed Project would support the borrower and implementing agency, CFN, to: (i) strengthen the institutional capacity of CFN, (ii) develop and/or improve financial products to promote access to finance; and, (iii) create and expand second-tier lending operations for MSMEs.

The proposed Project consists of four main components:

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 true extent of the quality of its assets and clean up its balance sheet. 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 a new 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 the second-tier credit line, including the strengthening of their environmental and social management systems.

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 (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 (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.

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.

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
(g) Project’s financial audits.

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<th>Legal Operational Policies</th>
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<td>Projects in Disputed Areas OP 7.60</td>
<td>No</td>
</tr>
</tbody>
</table>

Summary of Assessment of Environmental and Social Risks and Impacts

E. Implementation

Institutional and Implementation Arrangements

**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.

**The IBRD will enter into a Loan Agreement with CFN.** The Republic of Ecuador, represented by MEF, will guarantee the obligation of the Borrower in respect to the Loan Agreement. 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, CFN, through NGF, will enter into a Partial Guarantee Agreement with eligible PFIs, which would lend to eligible MSMEs through Subloan Agreements.

**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.

**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, (iii) financial management and disbursement officer, and (iv) E&S specialist.

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APPROVAL

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