RE-336

EVALUATION OF THE BANK'S GLOBAL MULTISECTOR CREDIT OPERATIONS - 1990 TO 2005

Office of Evaluation and Oversight (OVE)

Inter-American Development Bank
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ACRONYMS

ABS:	Asset Backed Securities
ASQ:	Creditworthiness of Private Sector Companies (Asset Quality)
B2P:	Publicly Owned Second-Tier Bank
BDB:	Bahamas Development Bank
BICE:	Banco de Inversión y Comercio Exterior - Argentina
BIS:	Bank for International Settlements
BMI:	Banco Multisectorial de Inversiones
BNDES:	Banco Nacional de Desenvolvimento Econômico e Social - Brazil
CAP:	Increased and Sustained Availability of Funding for Commercial Credit (Capital)
CFN:	Corporación Financiera Nacional - Ecuador
CGP:	Credit Guarantee Programs
COFIDE:	Corporación Financiera de Desarrollo S.A. - Peru
CORFO:	Corporación de Fomento de la Producción - Chile
ECLAC:	Economic Commission for Latin America and the Caribbean (CEPAL in Spanish)
EMBI:	JP Morgan's Emerging Market Bond Index
FDI:	Foreign Direct Investment
FELABAN:	Latin American Federation of Banks
FI:	Financial Intermediary
FNI:	Financiera Nicaraguense de Inversiones
FOGAPE:	Fondo de Garantía Para Pequeños Empresarios
G-7:	Group of Seven; the group of seven industrially advanced nations
GDP:	Gross Domestic Product
GMC:	Global Multisector Credit Operations
IDB:	Inter-American Development Bank
IIC:	Inter-American Investment Corporation
IIC-FIL:	Financial Intermediary Lines of the Inter-American Investment Corporation
IMF:	International Monetary Fund
INT:	Effectiveness of the Financial Intermediation Sector (Intermediation)
LAC:	Latin American and the Caribbean Region

MBS:	Mortgage Backed Securities
MIF:	Multilateral Investment Fund
MLT:	Medium and Long Term
NAFIBO:	Nacional Financiera Boliviana
NAFIN:	Nacional Financiera S.A. - México
OVE:	Office of Evaluation and Oversight, Inter-American Development Bank
PBL:	Policy Based Loan
PCR:	Project Completion Report
PD:	Project Document
PPMR:	Project Performance and Monitoring Report
PRI:	Private Sector Department
PSC:	Private Sector Company
ROA:	Return on Assets
ROE:	Return on Equity
SELIC:	Central Bank Overnight Lending Rate (Sistema Especial de Liquidação e Custodia) - Brazil
SME:	Small and Medium Enterprise
SPVs:	Special Purpose Vehicles (for the purposes of this report, mostly in the form of Financial Trusts)
TC:	Technical Cooperation
TJLP:	Long Term Interest Rate (Taxa de Juros de Longo Prazo) - Brazil
WB:	World Bank (International Bank for Reconstruction and Development)

INTRODUCTION

The Bank's Operations Manual[1] defines Global Multisector Credit Operations (GMCs) as "loans with sovereign guarantees granted to intermediary financial institutions or similar agencies in the borrowing countries to enable them to on-lend to sub-borrowers for the financing of multisector projects." The absence of long term funding is a market failure, addressed primarily through comprehensive market reforms. GMCs were important accompanying elements of the reforms, fostering orderly transitions after significant redefinitions of the role of government in the financial markets.

Between 1990 and 2005, the Bank approved 27 GMCs in 13 countries for a total of $7.6 billion.[2] GMCs represented a significant share of total Bank's lending activity – averaging 7% of the Bank's lending during the period and peaking as high as 15% during critical years such as 1998-1999. GMC operations have facilitated more than 100,000 loans to private sector companies via more than 350 commercial banks and other specialized financial institutions, thus having a direct interaction with LAC's real economy.

Although technically public sector loans, GMCs also single-handedly accounted for 48% of all Bank funds aimed at private sector beneficiaries – *de facto* making GMCs the Bank's top "private sector tool". In addition, GMCs became one of the cornerstones of the Bank's support for financial sector reform, accounting for 39% of total Bank lending in the financial sector.

This evaluation is based on a detailed analysis of the GMCs approved between 1990 and 2005. About two-thirds of the GMCs – representing 82% of the approved GMC funding – were reviewed in-depth and involved fieldwork in the respective countries. The remaining GMCs were desk-reviewed via Project Reports, Portfolio Performance Monitoring Reports, Credit Regulations, Project Completion Reports, and any other available document, e.g. *ad hoc* consultant studies.

OVE complemented the evaluation with surveys and interviews providing both Bank staff and clients with an opportunity to participate. As a result, 65% of the Bank's Multisector and Financial Specialists ended up contributing constructive and candid input, which is reflected in the evaluation. Similarly, 90% of the executing agencies in our client countries provided their views on past GMCs and shared insights on their future needs.

This report is divided into five chapters. Chapter I describes the context of the evaluation by profiling GMCs in terms of their objectives, resource allocation and execution performance. Chapter II reports on the current status of GMC's developmental objectives. Chapter III assesses the results and additionality of the Bank. Chapter IV discusses any changes affecting the validity of the assumptions underlying the GMCs. Finally, Chapter V summarizes the main conclusions and recommendations of the evaluation.

[1] Policy OP-306 – "Forms of Bank Financing and Assistance for the Mobilization of Financial Resources."
[2] In addition, the Bank also approved $947 million for regional programs that followed a similar operational mechanism. This evaluation assesses results at a country level and thus only considers country-specific GMCs.

I. CONTEXT OF THE EVALUATION

A. The Profile of GMC Operations

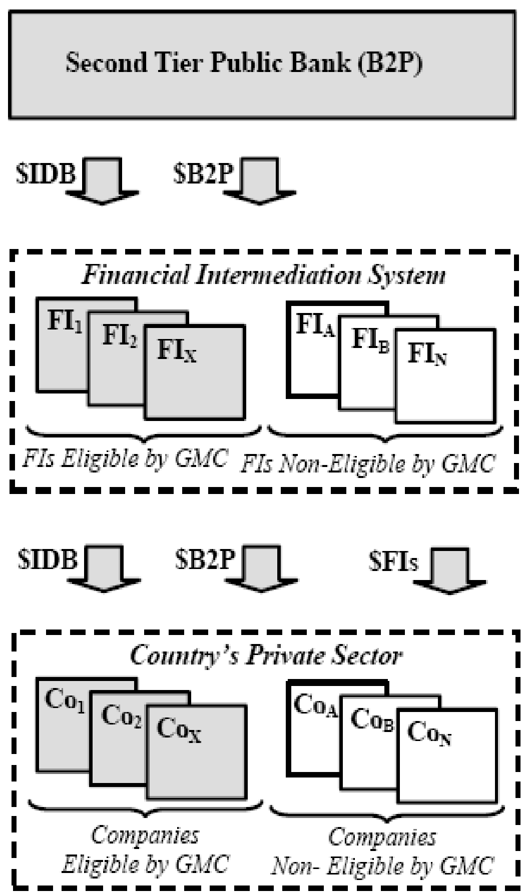
1.1 **As State intervention gave way to free-market reforms in the early 1990s, the Bank accompanied the process by transforming its traditional Industrial Loans[3] into a more market-driven product denominated GMC**. Since 1961, the Bank had used Industrial Loans to promote specific sectors – usually associated with import substitution. Like Industrial Loans, GMCs were to be executed by public development banks, but only if they agreed to complement the private sector and become second-tier banks (B2Ps), working via first-tier financial intermediaries (FIs) under strict market-driven conditions. GMCs removed the ability to select final beneficiaries from B2Ps; delegated all credit allocation decisions to FIs, and opened financing on an equal basis to all economic sectors.

1.2 **With a fairly standardized design, the customization of each GMC revolved almost exclusively around two technical issues: *pricing* and *allocation of resources* to FIs.** The interest rates charged by B2Ps to FIs were to meet the Bank's Sub-Loan Interest Rate Policy[4] by being positive in real terms. It was also expected, but not required, that pricing would be at parity with the opportunity cost of alternative funds mobilized domestically.[5] GMCs also set detailed credit regulations regarding eligible FIs. Most GMCs targeted regulated banking institutions, but about 25% of the GMCs also allowed non-banking FIs (e.g., leasing companies). A few GMCs introduced diversification criteria, by either limiting the maximum amount of Bank resources that could be granted to each FI – 35% of the GMCs, or by setting a minimum number of participating FIs – 12% of GMCs. By contrast, the eligibility of sub-borrowers was left entirely to the FIs, as long as they met minimum requirements – legal formalization and compliance with environmental, tax and labor regulations. Likewise, sub-borrower developmental impact criteria – such as export or employment generation potential – were never introduced as formal GMC requirements.

[3] An evaluation of Industrial Loans conducted in 1992 recommended: (i) strengthening the institutional capacity of State-Owned Development Banks; (ii) stressing compliance with the Bank's interest rate policy and credit regulations; and (iii) preventing arrears by monitoring portfolio quality.
[4] OP-709 "Sub-loan Interest Rates", December 1994.
[5] In practice, the real interest rate was also influenced by the currency denomination of the resources, but, with few exceptions, the Bank left this aspect to the B2Ps' discretion. As a result, over 50% of FIs and 80% of sub-borrowers received funds in the local currency at interest rates potentially mismatched from those corresponding to the Bank-provided dollar-denominated resources.

Figure 1.1: GMC Participants, Financial Flows, and Design Elements

GMC Participants & Financial Flows



GMC Design Elements

- **Creation / Strengthening of B2P:** New systems and organization, e.g., credit risk management systems
- **New Product Development:** Only in a few GMCs, e.g., liquidity insurance for FIs provided by the B2P

- **Cost of Funds:** Positive real rates - preferably also comparable to cost of alternative sources
- **Currency:** Usually US$ (with exceptions)
- **Allocation:** Usually 1st come - 1st served, but some GMCs experimented with auction mechanisms

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- **FI Eligibility:** case-by-case for each GMC, as per Credit Regulations
- **FI Risk:** First ad-hoc, later as per rating agencies
- **Type of FI:** Initially banks, but later included specialized financial companies (e.g., leasing)
- **FI Ownership:** mostly private FIs

- **Cost of Funds:** defined by FIs (market based)
- **Currency:** usually US$ (with exceptions)
- **Allocation:** no sectorial allocation, nor any kind of quotas whatsoever
- **Constraints:** Few, except minimum sub-loan term

- **Cos. Eligibility:** Determined solely by the FIs
- **Cos. Strengthening:** in very few cases, GMC sought to improve ability of Cos. to prepare "bankable" projects (e.g., Technical Coop.)
- **Cos. Compliance:** Emphasis on environmental, tax and labor law compliance

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B. GMC's Developmental Objectives

1.3 **GMCs set out to achieve numerous developmental objectives.** OVE compiled a list of all of the developmental outcomes and outputs claimed in GMC's Project Documents (PD), Project Performance Monitoring Reports (PPMR), and/or Project Completion Reports (PCR). Objectives were later classified by type and frequency in order to create a pro forma logical framework synthesizing all GMCs being evaluated[6]. The rest of the evaluation is structured around a discussion of the GMC objectives, their progress to date and the additionality of the Bank.

[6] Over time, GMCs placed less emphasis on B2P institutional development and SME technical advisory activities, focusing instead on credit flow. For example the objective of "Improving technical, financial and economical feasibility of private sector projects" is mentioned by 30% of GMCs approved between 1990-1994, but none of the GMCs approved between 2000-2005.

Table 1.1: Proforma Logical Framework - GMCs from 1990 to 2005 - Objectives and Frequency

<table>
<tr><th colspan="4">GMC GOAL</th></tr>
<tr><td colspan="4">Increase economic growth, employment and exports via greater utilization of credit by private sector companies.</td></tr>
<tr><th colspan="4">GMC PURPOSE</th></tr>
<tr><td colspan="4">Promote sound, efficient and dynamic market-based mechanisms for delivering credit to private sector companies</td></tr>
<tr><th colspan="2">GMC OUTCOMES</th><th colspan="2">GMC OUTPUTS</th></tr>
<tr><td rowspan="3">Increased and Sustained Availability of Funding for Commercial Credit</td><td rowspan="3">100%</td><td>Extend and/or diversify funding sources for Financial Intermediaries (FIs)</td><td>100%</td></tr>
<tr><td>Create and/or strengthen Second-Tier Banks (B2Ps)</td><td>46%</td></tr>
<tr><td>Strengthen capital markets and mobilize domestic savings</td><td>25%</td></tr>
<tr><td rowspan="3">Improved Effectiveness of Financial Intermediation Sector</td><td rowspan="3">79%</td><td>Rationalize public sector's role in financial intermediation</td><td>42%</td></tr>
<tr><td>Promote strengthening and efficiency of Fis</td><td>42%</td></tr>
<tr><td>Eliminate structural barriers hindering access to credit and develop new financing services</td><td>63%</td></tr>
<tr><td rowspan="3">Improved Creditworthiness of Private Sector Companies</td><td rowspan="3">38%</td><td>Improve compliance with environmental, tax and labor regulations</td><td>25%</td></tr>
<tr><td>Improve technical, financial and economical feasibility of private sector projects</td><td>21%</td></tr>
<tr><td>Enhance financing potential of SMEs and companies in underserved sectors & geographies</td><td>17%</td></tr>
</table>

C. GMCs in the Bank's Portfolio

1.4 **GMCs have played a dual role – in the *private* sector, as well as in the *financial* sector.** About 99.5% of GMC resources[7] flowed to private sector companies. In fact, GMCs single-handedly accounted for 48% of all Bank funds aimed at private sector beneficiaries – making GMCs the Bank's largest "private sector tool". In addition, GMCs became one of the cornerstones of the Bank's support of financial sector reform, which accounted for 39% of total Bank lending in the financial sector, by promoting financial deepening.

1.5 **GMCs have all the makings of private sector tools, but had so far operated in isolation from the Bank's other private sector windows.** OVE conducted prior evaluations on all private sector windows of the Bank group: the Private Sector Department (PRI), the Inter-American Investment Corporation (IIC) and the Multilateral Investment Fund (MIF).[8] As a result, OVE formulated recommendations for all private sector windows, which included: (i) sharing market diagnostics, (ii) fostering greater internal coordination and (iii) redesigning private sector products to make them competitive.[9] However, GMCs have so far been executed in isolation from the Bank's other private sector windows, e.g., not sharing information on common FI and PSC clients, or not systematically cooperating on issues of common interest regarding programming, product development and evaluation.

[7] Only about 0.5% of GMC funding was allocated to support the strengthening of publicly owned B2Ps and FIs.
[8] RE-303; IIC/RE-6; GN-78
[9] See table in Annex I: RE-287 – Synthesis of OVE Evaluations of Bank Action for Private Sector Development.

1.6 **By contrast, the Bank emphasized the financial sector role of GMCs, but even for this role it provided little policy guidance for their design and execution**. Almost half of all GMCs that were planned ended up being cancelled. Between 1990 and 2005, 43 GMC operations were programmed in 21 countries, but only 24 (56%) were actually disbursed. Most cancellations occurred in countries where financial sector reforms were less intensive[10]. By contrast, there is no evidence that private sector financing needs had played any role in the decision to grant or deny GMCs to a particular country. Only in 1994 did the Bank set some minimum policy restrictions affecting GMCs,[11] but without getting into the finer details about the GMC's design, performance or optimization.

Figure 1.2: GMC Programming, # of Operations

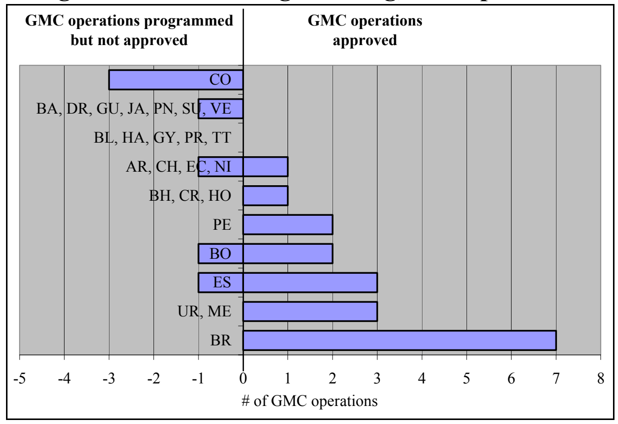


Table 1.2: GMC Programming, # of Operations

# of Projects	**90-94**	**95-99**	**00-05**
Programmed	**16**	**17**	**10**
Originally Approved	*12 (75%)*	*8 (47%)*	*7 (70%)*
Currently Approved	*10 (63%)*	*8 (47%)*	*6 (60%)*

D. Execution of GMCs

1.7 **GMCs became one of the fastest-disbursing types of investment lending at the Bank, growing in importance within the Bank's portfolio.** On average, GMCs took 15 months to approve, 11 months to start disbursements and were completed 9 months later than their originally planned disbursement period of 34 months. This compares favorably with all other investment lending at the Bank, which on average took 18 months to approve, 15 months to start disbursements and were completed 21 months past their planned disbursement. "Follow-up GMCs" in the same countries were even more efficient, taking only 12 months from Profile 1 to Approval – the fastest time for any investment loan at the Bank – and were completed only 6 months later than their planned disbursement period.

1.8 **However, GMC disbursements have been very uneven, due mainly to delays in adjusting the price of GMC funds.** GMCs disbursements were in line with expectations in about a fifth of the time. By contrast, GMCs exceeded

[10] The average financial reform index for countries with GMCs is 0.81, while those that did not receive a GMC have a reform index of 0.48. Financial reform indices were calculated using the table "Summary of Financial and Capital Market Reforms in LAC" found in the IDB Economic and Social Indicators Yearbook, 1997. The average for countries with no GMCs excludes Colombia and Trinidad & Tobago, which have high reform indices above 0.8. In addition, Policy Based Loans (PBLs) supporting financial sector reform were sometimes approved in connection with GMCs.

[11] In particular, "OP-309 Global Loans to Intermediary Financial Institutions, Contributions by Sub-borrowers, Dec. 1994" sets minimum co-financing levels for FIs and sub-borrowers and "OP-709 Sub-Loan Interest Rates, Dec. 1994" establishing that funds could not be intermediated at negative real rates, and in the ideal situation should at least reflect the opportunity cost of capital.

expectations in another fifth of the time. The rest of the time disbursements fell short of expectations (See Table 1.3). B2Ps report that the delays in adjusting the pricing of GMC funding versus competitive sources were key to determine the disbursement speed. GMC pricing is adjusted periodically – usually on the basis of a formula. In addition, GMC funding carried information requirements, procurement restrictions and environmental compliance that have also increased the perceived cost, according to FIs.[12]

Box 1.1. Expected versus Actual Disbursements in Peru

Peru's first GMC program was disbursed almost entirely during the first two years of operation. The second program disbursed 53% of the funds in the first year and a half of operation, but later slowed down. The slowdown has been explained by three factors: **First**, the Bank decided to establish a yearly quota for disbursements and, once the quota was filled, the facility closed. This generated uncertainty and discomfort in the FIs who had given assurances to clients that they would be receiving the funds. **Second**, domestic recession, bank failures and political uncertainty slowed down the demand for credit. As the economy recovered in subsequent years, the financial system was awash with liquidity and the program's facility became one of many competing alternatives. Some banks preferred using their own funds, while others found lower-cost alternatives. **Third,** FIs argue that the B2P was often too slow to adapt to changes in market conditions. As spreads declined, it took time for the B2P to react. Until the pricing of GMC resources was adjusted downwards, demand was low or non-existent.

Table 1.3: % Difference Between Actual and Expected GMC Disbursement by Year

GMC	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
AR (1)				-60%	-100%	-100%	-96%	-100%							
BH (1)						-70%	-100%	-100%	-91%	-85%	-100%				
BO (2)		85%	8%	-43%	-10%	-37%	-51%	-10%	-52%	-92%	0%				
BR (7)	-60%	38%	-10%	-53%	-39%	0%	297%	20%	10%	-12%	51%	43%	196%	100%	10%
CH (1)									34%	10%	-99%	-74%	-88%	-100%	
EC (1)			-60%	-37%	-43%	-42%	-9%	-59%	0%						
ES (2)		-7%	-54%	0%	-46%	-38%	0%								
ME (3)			21%	44%	95%	-86%	-78%	-79%	-63%	-21%	-73%	-56%	0%	0%	
NI (1)														-23%	48%
PE (2)					58%	-52%	-30%	0%	-1%	-39%	-91%	-76%	-75%	0%	0%
UR (3)				-20%	-87%	-1%	-23%	0%				50%	-84%	-88%	-92%

Key: *10% or more below planned disbursements* *10% or more above planned disbursements*

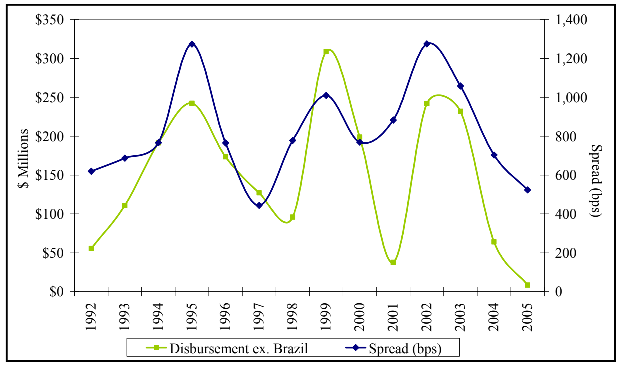
1.9 **This slowdown allowed the GMCs to behave counter-cyclically, providing some liquidity at times of stress.** Excluding Brazil,[13] the GMCs had disbursement peaks in 1995, 1999 and 2002 – roughly coinciding with all major regional crises. The correlation of GMC disbursements excluding Brazil and the JP Morgan Emerging Market Bond Index spread (EMBI) for LAC is 0.7, showing that the higher the risk perception, the higher the GMC disbursements, and vice versa.

[12] FIs estimate "the hassle cost is worth about 50 basis points." In other words, a firm would not borrow from the GMC facility unless the cost was 0.5% lower than any competing alternative.

[13] Brazil is a special case because Banco Nacional de Desenvolvimento Economico e Social (BNDES) has taken the Bank's GMCs as a continuous source of funds – building expectations of continuity. Through BNDES, Brazil had a sequence of six GMCs, including a CCLIP approved in 2004 for US$3.000 millions with a term of 9 years and its first associated GMC for US$1.000 million. One of the positive factors of having this sequence of operations is that FIs are aware of the BNDES/GMC lines and behave as if they were "permanent" credit lines. Including Brazil in the group does not change the cyclical nature of the activity; it only adds a smaller disbursement peak in 1997.

1.10 **But information on the prices themselves is incomplete, and potentially in conflict with the intent of the Bank's interest rate policy.** Data for interest rates charged by B2Ps to FIs is available for only half of the countries with GMCs.[14] In the countries were there is data, compliance with the minimum requirement of the Bank's interest rate policy mandating positive interest rates occurs almost every year – with exceptions due to unforeseen changes in inflation. However, the additional policy goal of also pricing GMC resources at market rates – to minimize potential subsidies – was not consistently followed or monitored.[15] Bank staff reported in a survey conducted by OVE that "the Bank has tried and failed to develop more definitive, market-oriented policies on wholesale and retail interest rates for global credit operations…[but] it is difficult to generalize, given the vast differences among countries."

Figure 1.3: GMC Disbursements vs. EMBI Spread



Box. 1.2: The Case of Brazil - Pricing Issues

On the hand, GMC funds are intermediated between BNDES and the FIs with spreads ranging from 1% to 3% over the Taxa de Juros de Longo Prazo (TJLP) – a reference rate regulated by the National Monetary Council.[16] On the other hand, the market cost of funds is better referenced to the Sistema Especial de Liquidação e Custodia (SELIC) – the Central Bank's overnight rate. Even after adding BNDES' spread, the cost of GMC funds to the FIs is much lower than the cost of funding in the marketplace. The difference between the market cost of funds, as very conservatively measured by the short-term rate SELIC, and **the rate charged by the BNDES has averaged a 35% discount in comparison with the SELIC**, making the program very attractive.

In turn, the spread charged by the FIs to the borrowers is very modest – 3 to 5% – compared to the cost of funds in Brazil and to the spread normally charged in the banking system. FIs explain this as a result of competition. FIs report that this credit line is **a sort of "loss leader" needed to secure customer loyalty**. Its availability may be conditional on the client using other bank services. In addition, the fact that the variance on the spreads is not very high is consistent with a competitive situation. This view is also reinforced by the fact that some of the heaviest users of the GMC credit line were FIs linked to automobile manufacturers, who arguably price financing very competitively to promote sales.

It also appears that **the number of clients to which FIs are willing to lend long-term is limited, despite the low cost of the resources** – the cost to the final borrower is usually below the SELIC, the overnight rate charged to banks. This is also consistent with the fact that, according to the BNDES' statistics, many FIs significantly underutilize the credit line that is available to them.

[14] The data for this comparison have been compiled from PCRs, PPMRs and from information supplied directly by the B2P to OVE. The data are compared with the publicly available information on inflation, deposit and lending rates in each country. In some cases, to make rates comparable, OVE had to convert floating to fixed rates based on prevailing swap rates.

[15] Chile, Nicaragua, Peru and Uruguay priced resources above cost of funding, while Brazil utilized a "below-market" interest rate. El Salvador alternated between both. Countries with no reported information are: Argentina, Bahamas, Bolivia, Ecuador and Mexico.

[16] The TJLP is made up of two components: (i) an inflation target, calculated, on a pro-rata basis, for the twelve months following publication date, based on the annual targets set by the National Monetary Council (CMN); (ii) a risk premium, which incorporates a real international interest rate and a country-risk element over the medium to long term.

E. Monitoring and Evaluation

1.11 **The evaluability of GMCs is low due to a general lack of indicators, baselines and progress information.** Only 39% of the outcomes and outputs pursued by GMCs had any indicator. Similarly, only 30% had a baseline and only 23% any measurable target. Only 48% of the original indicators were tracked during execution.[17] In addition, most GMCs were modified during execution potentially altering the nature of the intervention[18]. For example, GMC Credit Regulations were customarily modified with the sole approval of the Country Offices. There is no centralized record of the modifications or of the reasons behind them. In summary, GMC's reporting on results is very weak, thus much of the information in the following sections had to be reconstructed by OVE from external sources.

[17] Excludes GMC disbursement, which was tracked in every GMC loan as part of the Bank's administrative requirements.

[18] Modifications after approval affect not only GMCs, but are also pervasive at the Bank. Their effects in potentially eroding requirements imposed by the Board of Directors at time of loan approval are unknown.

II. EVOLUTION OF THE DEVELOPMENTAL OBJECTIVES PURSUED BY THE GMCs

2.1 **GMCs sought to spur economic growth by increasing the utilization of commercial credit.** With that goal, the GMCs set out to promote sound credit markets by: (i) increasing and sustaining the availability of funding for long-term commercial credit, (ii) improving the effectiveness of financial intermediation, and (iii) improving the creditworthiness of private sector companies. [19]

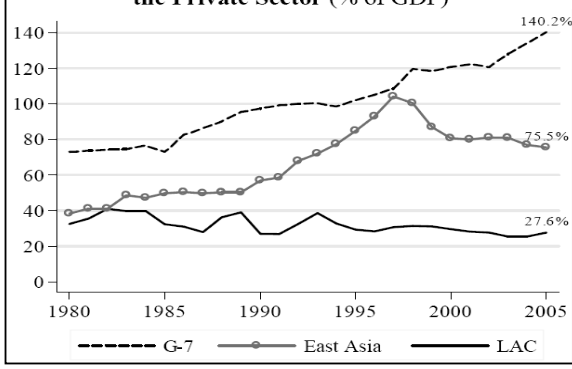
A. Credit and Economic Growth 1990-2005[20]

2.2 **The 1980s were marked by interventionism and periodic financial crises.** Average per-capita GDP shrank by 0.6% per year[21] and inflation was rampant. As the Region entered the 1990s, LAC suffered widespread financial repression and periodic financial crises:[22] Publicly owned financial institutions distorted the allocation of credit; interest rates were controlled and often negative in real terms; most central banks lacked autonomy; capital markets lacked depth and transparency; foreign exchange was administratively controlled and regulation and supervision were weak.

2.3 **The 1990's brought comprehensive free-market reforms.** Common features of the reform were:[23] deregulation of interest rates; downscaling of direct lending programs; elimination of foreign borrowing restrictions; privatization of State owned banks; transformation of development banks; and a general overhaul of the prudential regulation. The focus shifted from direct intervention to the creation of proper institutions.

2.4 **As a result, macroeconomic volatility has fallen drastically across LAC.** Inflation peaked at 900% in 1993, to rapidly decrease to single digits for the rest of the evaluation period. GDP volatility has consistently fallen and is now 25%[24] less than in 1990. Similarly, the standard deviation of private sector credit decreased from 16.8% to 6.1%.

Figure 2.1: Domestic Credit to the Private Sector (% of GDP)



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[19] This section limits itself to a factual reporting of developmental results, postponing for the next chapter any discussion on the potential additionality of the Bank in bringing them about.

[20] Some of the data series in this Section run only until 2004, due to unavailability of more recent information.

[21] Arminio Fraga, "Latin America since the 1990s: Rising from the Sickbed?," *Journal of Economic Perspectives* 18, no. 2 (Spring 2004): 89.

[22] Inter-American Development Bank, "IPES 2005: Unlocking Credit - The Quest for Deep and Stable Bank Lending", October 2004, p. 142.

[23] Augusto de la Torre, Juan Carlos Gozzi, Sergio L. Schmukler. *Innovative Experiences in Access to Finance: Market Friendly Roles for the Visible Hand* World Bank 2006.

[24] An average of the entire LAC Region, instead of the selected countries, shows volatility decreasing almost 40%.

2.5 **However, economic growth and credit penetration have not kept pace with other developing regions.** LAC ranks along Sub-Saharan Africa as one of the slowest growing developing regions in the world. Domestic credit to the private sector has stagnated compared with annual growths of 2.68% in the G-7 economies and 1.16% in East Asia.[25]

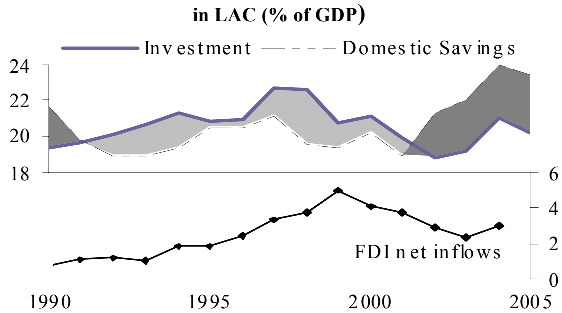
Box 2.1: The Correlation Between Economic Growth and Financial Development

It has been traditional to observe that more developed countries also have more developed financial sectors. More recently, there is increasing evidence of causality between financial development and economic growth[26]. For example, LAC countries with higher credit to GDP ratios in the 1980s show higher GDP growth rates in the following decade. In fact, a 20% higher credit penetration in the 1980's corresponded, on average, to a 1% increase in per capita GDP growth between 1990-2005.

B. Increased and Sustained Availability of Funding for Commercial Credit

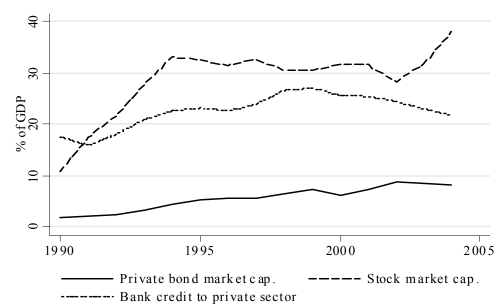
2.6 **For most of the 1990s, domestic savings were unable to support any significant growth in private sector investment.** Gross domestic savings as a percent of GDP were lower during the 1990s – namely 20% of GDP versus 23% in the 1980s. Until then, FDI fueled the growth in capital formation. The situation was reversed in 2001, with domestic savings growing and investments remaining stable.

Figure 2.2: Investment, Domestic Savings and FDI Net Inflows in LAC (% of GDP)



Source: World Development Indicators database, accessed

Figure 2.3: Bank Credit, Equity and Private Bond Markets
(% of GDP, Mean of Selected Countries)



Source: Financial Structure Dataset, Beck & Al-Hussainy (2006)
Countries included: Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.

2.7 **Traditional banking intermediation has steadily lost ground as a source of funds for the private sector**. While private assets of the financial sector increased from 30% to 68% of GDP, the share of bank credit to the private sector decreased from 68% in 1990 to 40% in 2005. Equity markets in LAC have more than tripled since the early 1990s, but they are still small, illiquid, and

[25] Individual countries show large variation. While credit in Chile grew from 47% to 63% of GDP, credit in Venezuela declined from 26% to 13% of GDP. Adolfo Barajas and Roberto Steiner, "Credit Stagnation in Latin America," IMF Working Paper No. 02/53 2002, http://www.imf.org/External/Pubs/FT/staffp/2001/00-00/pdf/abrs.pdf

[26] The literature on the finance-growth nexus is vast. A comprehensive review is found in Levine (2005) - Finance and Growth: Theory and Evidence, in P. Aghion and S. Durlauf (eds.), Handbook of Economic Growth, Elsevier: Amsterdam.

concentrated in a small number of issuers[27]. The private bond market grew fivefold from 1990 to 2004.[28] Public sector debt accounts for three-fourths of the bond market[29].

2.8 **Institutional investors started experiencing growth.** From 1990 to 2005, ten LAC countries introduced private pensions. The combined pension assets reached 15% of GDP in 2005. However, most pension funds have a high proportion of governmental debt – representing an average of 53% of pension assets. On a smaller scale, holdings of insurance companies grew from 1.4 to 1.9 % of GDP during the same period. Finally, financial trusts, both privately and publicly traded, more than doubled in the last five years, from less than 2% of GDP in 2000 to more than 5% in 2005.

2.9 **A number of financial innovations have also complemented the traditional sources of funding.** The most notable innovations are related to microcredit, mortgages and credit guarantees. For example, in Bolivia, micro-credit by specialized institutions increased six-fold between 1995 and 2004. B2Ps have also introduced some new products geared toward SMEs, such as credit guarantee programs (CGP), participation in investment funds and factoring of SME receivables.

C. Improved Effectiveness of the Financial Intermediation Sector

2.10 **Financial reforms liberalized most financial markets in LAC.** LAC countries strengthened the regulatory and supervisory frameworks, modernized banking and securities laws, and applied risk-based oversight and supervision. Yet, using the Basel Core Principles as a benchmark, bank supervisory frameworks in LAC still lag behind other developing regions.[30] The reforms also reduced Public Sector participation in direct lending.[31] The reduction in direct lending by the public sector generates the need for alternative sources of funds and provides the rationale for GMCs to support the transition.

2.11 **And now most LAC banks are sounder and more profitable.** Capital adequacy, provisioning, profitability and liquidity indicators have improved. Only Argentina shows returns on equity below 5%, and generally banks have increased capital in relation to assets. On average, LAC banks are also more liquid and more efficient.

[27] Information about equity financing, e.g., secondary offerings, IPOs, and convertible bonds, was not available, so market capitalization was used as a proxy of capital market growth.
[28] This is the unweighted average for Argentina, Brazil, Chile, Mexico and Peru. A weighted average shows an increase from 0.8% of GDP to 8% of GDP.
[29] Portfolio reallocation in favor of investments in public debt is related to the financial crisis of the late 90s. After the crisis, remaining banks and institutional investors found themselves liquid but unwilling to lend, while governments increased their financing needs. The combination of those elements increased the sovereign risk exposure of LAC's banks and institutional investors.
[30] Inter-American Development Bank, "IPES 2005: Unlocking Credit - The Quest for Deep and Stable Bank Lending", October 2004, p. 89.
[31] Ibid, p. 151.

Table 2.1: Indicators of Soundness, Liquidity and Efficiency

Country	*"Soundness"* ROE (Net Income / Equity)			*"Soundness"* Equity / Total Assets			*"Liquidity"* Net Loans / Total Deposits			*"Efficiency"* Op Expense / Net Int. Income + Non-Int. Income		
Year	1995	2000	2005	1995	2000	2005	1995	2000	2005	1995	2000	2005
Argentina	n.a.	0%	1%	n.a.	10%	13%	n.a.	80%	55%	n.a.	69%	71%
Bahamas	24%	28%	6%	9%	12%	17%	106%	111%	114%	41%	56%	46%
Bolivia	10%	-9%	6%	7%	10%	11%	114%	103%	83%	80%	67%	82%
Brazil	-2%	4%	12%	7%	8%	9%	76%	78%	68%	102%	93%	74%
Chile	13%	13%	18%	7%	8%	7%	121%	111%	115%	49%	30%	12%
Ecuador	n.a.	-5%	13%	n.a.	39%	13%	n.a.	78%	71%	n.a.	61%	78%
El Salvador	20%	3%	10%	8%	9%	11%	86%	82%	100%	56%	63%	50%
Mexico	n.a.	-1%	5%	n.a.	9%	11%	n.a.	119%	94%	n.a.	87%	65%
Peru	16%	5%	20%	10%	10%	10%	84%	85%	77%	73%	75%	59%
Uruguay	n.a.	3%	9%	n.a.	11%	8%	n.a.	n.a.	n.a.	n.a.	89%	88%

Source: Banking Superintendencies in each country.

2.12 **Despite the reforms, LAC financial systems remain highly concentrated.** High concentration has persisted, with the three largest banks in each country holding about two-thirds of total bank assets.[32] In most countries, concentration has increased from 1995 to 2002.[33] In addition, the share of assets held by foreign banks increased from 13% to 45% between 1994 and 1999.[34] Large international financial groups, providing a variety of financial services, dominate many LAC markets.[35] Empirical studies are inconclusive regarding the net effect of these factors on credit access and competition.

2.13 **And structural barriers still beset the different credit markets.** Structural barriers are less important for credit markets where the local credit infrastructure can be bypassed, e.g., large corporate lending where information is abundant and jurisdiction is a matter of choice, or consumer lending where scoring methods can lower the costs of screening and monitoring. Conversely, structural barriers are more important in SME credit markets where the use of the local credit infrastructure is intensive. In these markets, informational costs are high, scoring methods are less applicable, and contract enforcement must take into account the local judiciary or local property registries. Information gathering is now more accessible thanks to credit bureaus and public registries in many LAC countries, in fact, more than 60% of the existing public registries were created after 1990.[36]

2.14 **B2Ps confirmed similar barriers in a survey conducted by OVE.** B2P officials deemed an insufficiency of collateral, lack of long-term funding, high transaction costs, rates insufficient to compensate risks and unreliable information on firms as key obstacles to medium and long-term credit. Other important barriers included

[32] Idem.
[33] Inter-American Development Bank, op. cit., p. 136.
[34] Maria Soledad Martinez Peria, Ashoka Mody. *"How Foreign Participation and Market Concentration Impact Bank Spreads: Evidence from Latin America,"* Journal of Money, Credit and Banking Volume 36 Number 3 (2004). Page 512.
[35] Inter-American Development Bank, op. cit., p. 129.
[36] Idem.

the high mortality of firms, judicial insecurity, informality and the low quality of projects.

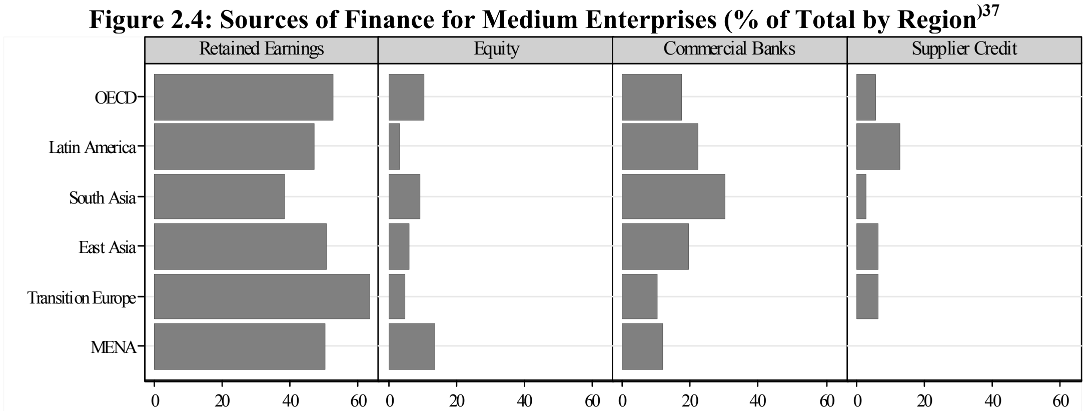
Table 2.2: Perceived Barriers to Growth of Medium and Long Term Credit

Barriers to Medium and Long Term Credit	Not Important	Medium Importance	Important
Insufficiency of Collateral	0	0	100
Lack of Long-Term Funding	0	10	90
High Transaction Costs	0	11	89
Rates Insufficient to Compensate Risk	0	16	84
Unreliable Information on Firms	10	10	80
Volatility of Demand	0	20	80
High Mortality of Firms	0	22	77
Judicial Insecurity	10	15	75
Informality of private sector companies	0	33	67
Low Quality of Projects	0	40	60
Excess Demand from Less-Risky Clients and Products	11	78	11

Source: B2P survey conducted by OVE

2.15 **Finally, alternative sources, such as supplier credit, are more than twice as large as other sources of finance for SMEs in LAC when compared to any other region.** The relative importance of supplier credit in LAC points to the importance of alternative institutional arrangements that bypass the formal credit infrastructure. The continuous roll-over of formal short term lending is another mechanism to overcome informational barriers, heterogeneity, scale, and regulatory requirements in SME lending. Banks are reluctant to provide long term funding – 75% of banks active in SME financing focus on short term working capital loans only. In fact, 80% of banks will not lend to SMEs on terms over five years, even if provided with collateral, adequate financial information, and a positive credit history. Another common mechanism to overcome structural and regulatory barriers is to apply consumer credit tools to SMEs.

Figure 2.4: Sources of Finance for Medium Enterprises (% of Total by Region)[37]



D. Improved Creditworthiness of Private Sector Companies

2.16 **Information of LAC's private firms is generally insufficient to assess their creditworthiness.** Although a more stable macroeconomic environment must have had a positive impact on the feasibility of private sector projects, micro-level

[37] Source: The World Business Environment Survey (WBES) 2000, The World Bank Group.

information is often limited[38] and in some cases outdated[39]. Information on the economic feasibility of firms and on the financial inputs utilized for production is scarce.

2.17 **The only area where there have been noticeable improvements since 1990 is in the labor and tax compliance of firms.** Labor market reforms implemented at the beginning of the 1990s increased labor mobility[40]. An expected consequence of the reforms was a decrease in informality[41]. However, informality has decreased only slightly – self-employment remained around 28% of total employment. LAC also underwent significant tax reforms – increased role of value-added taxes, reduction of tariffs, and a general simplification of the tax system[42]. As a consequence, the tax base has increased, as reflected in total taxes collected by Central Governments – from 10% in 1990 to 13.3% in 1999.

[38] Pablo Angelelli, Rebecca Moudry and Juan José Llisterri, "Institutional Capacities for Small Business Policy Development in Latin America and the Caribbean," Inter-American Development Bank, Sustainable Development Department, Technical Papers Series, Dec. 2006, http://www.iadb.org/IDBDocs.cfm?docnum=876121, page 10

[39] Firm-level statistics rely mainly on outdated industrial surveys: Peru (1993), Argentina (1993), and Brazil (1994). See the SME Observatory, http://www3.iadb.org/sds/mic/publication/gen_159_3861_e.htm

[40] Inter-American Development Bank, "IPES 2004: Good Jobs Wanted: Labor Markets in Latin America", October 2003: 140.

[41] Loayza and Rigolini, "Informality Trends and Cycles", World Bank Policy Research Working Paper 4078, December 2006: 2.

[42] Vito Tanzi, "Taxation in Latin America in the Last Decade" (2000), accessed from http://siepr.stanford.edu/conferences/FFReform_LA/Tanzi_Taxation_in_LAC.pdf : 38.

III. Additionality of the Bank's GMCs

3.1 **This section assesses the additionality of the Bank towards the achievement of the outcomes and outputs pursued by the GMCs.** Whereas the prior section reported the factual results, independently of the Bank's contribution, this section assesses the Bank's contribution towards achieving these results. Like previous sections, the discussion is organized around the GMC pro forma logical framework (Table 1.1).

A. Increased and Sustained Availability of Funding for Commercial Credit

1. Extend and/or diversify funding sources for Financial Intermediaries (FIs)

3.2 **GMC funding helped mobilize an approximately equal amount of additional resources from local counterparts**. The average GMC committed $135 million and disbursed $95 million to 12 FIs. In addition, an average $100 million was disbursed by local counterparts.[43] However, given that there were no targets in terms of mobilization, it is not possible to conclude whether this level of financial additionality is above or below expectations. Altogether, each GMC provided an average of $48,000 of Bank funding to an average of 2,000 private sector companies per operation.[44]

3.3 **GMC's small size makes any macro-level effect on credit availability unlikely.** On average, GMC disbursements were 3.65% of the *change in credit to the private sector* or 0.72% of *gross fixed capital formation*. By contrast, GMCs were significant during crisis periods when other sources dried up. B2Ps also report that their financing portfolio returned to pre-GMC levels after the operations finished. Finally, the information on long-term credit by country is still incomplete – despite having been a key GMC objective since 1990.

Table 3.1: Relative Size of GMC Programs

Annual GMC Disbursements as % of:	Change in Domestic Credit to the Private Sector		Gross Fixed Capital Formation		Changes in LT Credit	
	Average	Maximum	Average	Maximum	Average	Maximum
Bahamas	0.40%	0.82%	..	..	..	
Mexico	0.60%	2.59%	0.08%	0.08%	..	..
Brazil	1.11%	4.33%	0.26%	0.86%	..	..
Chile	2.37%	6.14%	0.19%	0.52%	0.8%	5.5%
Ecuador	3.08%	9.15%	0.39%	0.78%	..	..
Bolivia	3.94%	12.29%	1.29%	4.01%	2.3%	8.3%
El Salvador	5.04%	14.64%	1.76%	2.53%	..	..
Peru	6.34%	23.43%	0.26%	0.61%	6.9%	19.8%
Uruguay	9.99%	58.00%	1.57%	7.45%	..	..
Average	***3.65%***	***14.60%***	***0.72%***	***2.10%***	***3.33%***	***11.21%***

Sources: Program Reports, World Bank Statistics, Country Statistics and OVE estimates.

[43] This result is based on reports of 19 completed operations.
[44] The averages were estimated excluding the largest GMC operations in Brazil and Mexico.

2. Create and strengthen Second-Tier Banks (B2Ps)

3.4 **Small B2P institutional strengthening components were included in 38% of the GMCs.**[45] Except for a few operations where the B2P strengthening component didn't materialize as expected;[46] most operations completed their stated outputs. In two cases – Bolivia and El Salvador – operations had specific components to help create a new B2P. In general, the Bank does not report any information on B2P strengthening. B2Ps themselves report that fulfilling the requirements to run GMC programs has permanently improved the institutions.[47] Indeed, 70% of B2Ps state that the mechanisms introduced to select FIs are still being used to on-lend other funds.

3.5 **B2Ps now have access to other financing options, not available in 1990.** About a quarter of B2Ps now access funding at better terms from other multilateral and bilateral international organizations.[48] About one third of B2Ps now have access to commercial bank lines and about a quarter of B2Ps now have direct access to debt markets. Finally, about 20% of B2Ps now have regular access to government transfers or can draw from accumulated earnings that were not available at the time of the GMC.

3.6 **Despite some setbacks since 1997, B2Ps financial performance has generally improved.** B2P assets have grown steadily until 1997. Average ROA reached 2.4% and average ROE 7.5%. Similarly, operating expenses decreased to 8.7% and interest income over earning assets increased to 3.1%. Starting in 1997, many B2Ps re-emphasized direct actions towards SMEs – SMEs and micro-enterprises now account for 32% of the average B2P portfolio. At the same time, B2P financials gradually started to deteriorate.

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[45] Or other institutions through which GMC funds were channeled, such as the Central Banks in Bolivia, El Salvador, and Uruguay.

[46] In one case, the operation was partially cancelled (ME0126), while in another, funds were re-directed to other uses (BO0034). In addition, two operations that included institutional strengthening components were cancelled without disbursements - ES0130 and HO0034.

[47] For example, in the case of El Salvador the second GMC operation was entrusted to the newly created Banco Multilateral de Inversiones (BMI), which later incorporated most of the program's operational requirements and methodologies to its lending procedures.

[48] B2Ps' dependence on multilateral sources of funding varies by country. On the one hand, in countries such as Mexico, Peru, Chile, Bolivia, and Nicaragua, B2Ps' dependence on multilateral sources is significant. Liabilities with multilateral sources as a percentage of total liabilities have consistently averaged 40% in NAFIN and COFIDE, and 55% for CORFO, NAFIBO, and FNI. On the other hand, in countries such as Brazil and El Salvador, liabilities with multilaterals are less than 10% of total liabilities.

Table 3.2: Financial performance of B2Ps in the region

Country	B2P	ROA		ROE		Operating Expenses / Income		Overdue Loans / Gross Loans		Interest Income / Earning Assets	
		1997	2004	1997	2004	1997	2004	1997	2004	1997	2004
Argentina	BICE	2.6%	3.7%	4.4%	4.9%	11.9%	20.8%	..	..	4.8%	4.1%
Bahamas	BDB	..	..	..	..	..	..	..	..	..	..
Bolivia	NAFIBO	3.8%	1.0%	5.0%	6.7%	21.9% *	6.9%	0.0%	0.0%	7.2%	2.2%
Brazil	BNDES	1.5%	0.8%	8.7%	8.7%	3.5%	2.2%	..	6.4%	3.2%	2.3%
Chile	CORFO	-1.3%	1.3%	-1.9%	1.3%	3.4%	..	..	..	-0.2%	1.5%
Ecuador	CFN	5.5%	2.7%	25.6% *	5.1%	5.3%	10.8%	1.4%	37.5% *	4.1%	0.0%
El Salvador	BMI	0.9%	0.6%	3.6%	1.9%	4.6%	10.5%	1.5%	..	2.2%	1.0%
Mexico	NAFIN	0.1%	0.1%	4.0%	3.2%	4.7%	8.3%	1.6%	0.1%	0.6%	0.3%
Nicaragua	FNI	7.3%	4.6%	13.9%	6.6%	11.6%	17.9%	..	0.0%	4.1%	4.9%
Peru	COFIDE	1.1%	0.2%	5.0%	0.6%	13.8%	16.4%	1.0%	3.9%	2.2%	1.6%
Average*		***2.39%***	***1.67%***	***5.34%***	***4.33%***	***7.35%***	***11.73%***	***1.10%***	***2.08%***	***3.13%***	***1.99%***

Sources: ALIDE and own elaboration from B2Ps financial statements. Outliers (*) were excluded from averages.

3. Strengthen capital markets and mobilize domestic savings

3.7 **About 20% of GMCs sought the development of capital markets, but their goals lacked specificity regarding the connection with credit markets.** The development of capital markets appeared as a stated objective in 6 GMCs, yet only 3 had specific components. There was scant detail as to how this objective would be achieved. There was also scant detail as to how the development of capital markets is connected to the development of secondary markets and other means to access funding for commercial credit[49]. Only one operation (BH0015) disbursed this component as expected;[50] while the other two (ME0126 & UR0021) cancelled the component.[51]

B. Improved Effectiveness of the Financial Intermediation Sector

1. Rationalize public sector's role in financial intermediation

3.8 **Some early GMCs accompanied policy reforms that aimed at rationalizing the public sector's role in financial intermediation.** While 80% of GMCs in the period 1990 to 1994 mentioned the rationalization of the public sector's role in financial intermediation as an objective, only 17% of the GMCs approved between 2000 and 2005 had a similar objective. Overall, 42% of GMCs

[49] The PCR of one program reports that some FIs entered the mortgage market and others issued medium and long-term bonds.

[50] In the case of Bahamas (BH 0015), the venture capital firm feasibility study actually recommended against the creation of a venture capital firm, so in the only case where the component disbursed, there was no capital market follow-up.

[51] Finally, although unrelated to GMCs, some B2Ps have accessed capital market funding: in Mexico, NAFINSA issued bonds representing 5.3% of total liabilities (2005); in Brazil, BNDES has funded 8% (2004) of liabilities through bonds; and in Peru, COFIDE's outstanding bonds represent 9.4% of liabilities. COFIDE was the first agent to issue ten-year bonds in local currency in the domestic market. In this particular case, bonds reached 17% of total liabilities in 2001. The reduction in activity is due more to lack of opportunities to invest resources than lack of market interest for their obligations.

mentioned this objective, but only 0.1% of GMC funds approved since 1990 were allocated to related activities.[52]

2. Promote strengthening and efficiency of FIs

3.9 **Technical assistance to promote strengthening and efficiency of FIs was mentioned by 25% of GMCs, but rarely pursued.** Although ten operations included this objective, only five had a specific component to improve FIs' efficiency and capacity for risk analysis (ME0126, UR0021, EC0089, NI0167 and ES0130). Implementation was difficult: in two of them (ME0126 and UR0021) the resources were redirected to the credit component and another operation was cancelled (ES0130).

3.10 **Indirectly, GMCs also attempted to promote system-wide efficiencies via restrictive FI selection mechanisms – however, participant FIs turned out to be virtually indistinguishable from their respective system averages**. GMC eligibility requirements for FIs were supposed to weed out weak institutions that dragged down the financial system's averages. At the time of selection, participating FIs did tend to be more profitable - ROE of 17.8% vs. ROE of 14.0% in their overall financial systems – and with slightly better quality portfolios – overdue loans of 4.3% versus 4.6% of the system. However, after the GMC, participating FIs return to the average of their respective financial systems in terms of profitability, loan quality, capitalization and liquidity.[53]

Table 3.3: Difference Between Participating FIs and Their Respective Market Averages

	ROA	ROE	Overdue Loans / Gross Loans	Equity/ Assets	Net Interest Margin	Liquid Assets / Cust & ST Funding
1 year before GMC	*0.21*	*3.80*	*–0.24*	*–1.93*	*–1.71*	*–2.19*
During GMC	*0.41*	*2.97*	*0.33*	*–1.56*	*–0.22*	*–5.42*
1 year after GMC	*0.35*	*3.41*	*–3.68*	*–2.74*	*0.42*	*–6.73*
Last available	*–0.49*	*0.31*	*1.20*	*–4.48*	*–0.55*	*–4.58*

Source: OVE's elaboration based on data from Bankscope

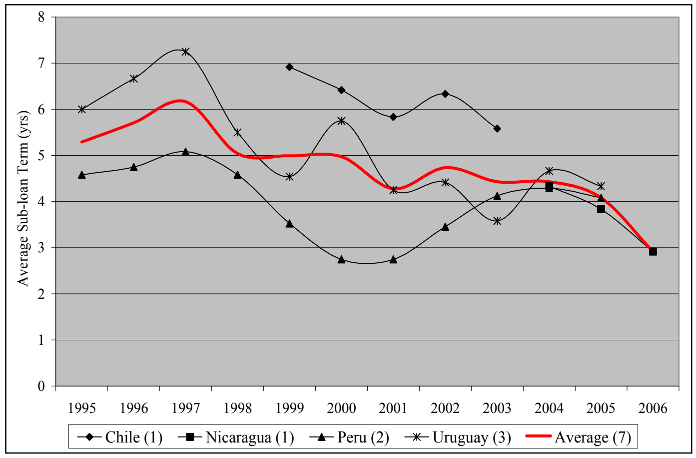
3. Eliminate structural barriers hindering access to credit and develop new financing instruments

[52] Some GMC programs included components to help restructure B2P and FI portfolios. For example, one of the programs in Bolivia (BO0034) included financing for FONDESIF, a public institution created to strengthen problematic FIs. Four FIs were able to restructure their liquidity, portfolio quality, and solvency, by obtaining credits in the amount of $44 million: $22.6 million in subordinated debt and $21.4 million in structural liquidity credits (Banco Nacional de Bolivia, Banco Unión, Banco Mercantil and Banco de La Paz).

[53] The comparison is based on a sample of 74 participating Commercial Banks in the following countries: Argentina (5), Bolivia (12), Chile (11), Ecuador (10), Nicaragua (5), Peru (13), El Salvador (6), and Uruguay (12).

3.11 **Although there is little information regarding the evolution of credit terms, available evidence suggests that structural barriers still preclude the lengthening of credit terms**. The terms of sub-loans financed via GMCs have actually shortened over time instead of lengthening as expected. GMCs[54] with available information report a decrease in average terms of sub-loans: from 5 years in 1995 to 2.5 years in 2005.

Figure 3.1: Average Term of Sub-loans (in years)



3.12 **Occasionally, GMCs introduced new instruments[55] able to address structural barriers.** For example, a GMC (UR0021) introduced a platform to support leasing operations and compensatory lines of credit to cover FI's term imbalances. Another GMC (BR0277) included a Guarantee Fund to partially cover credit risks using program funds. In addition, a few GMCs included feasibility studies for new instruments, but there is no evidence that they have led to specific actions. The future importance of new instruments is clear: 67% of the B2Ps asked the Bank to offer comprehensive GMCs – which also include technical assistance and risk capital, whereas 56% suggest that the Bank offer more innovative instruments.

3.13 **But the innovations were opportunistic, rather than based on a systematic diagnostic of the barriers.** Experts report that most structural barriers to credit manifest themselves at the FI's operational level, e.g., securing of collateral or credit screening costs. However, GMCs do not report FI operational issues, e.g. whether transaction costs with SMEs have diminished; whether terms, rates and products offered to SMEs have been modified; or whether SME oriented processes and systems have been implemented by FIs.

C. Improved Creditworthiness of Private Sector Companies

1. Improve compliance with environmental, tax and labor regulations

3.14 **GMC required compliance with environmental, tax and labor regulations, but the Bank lacked an independent verification system.** All GMCs imposed environmental, labor and tax compliance requirements. Compliance was verified via self-reported information provided by FIs and B2Ps, without any evidence of systematic, independent verification. However, FIs and B2Ps report that the fact

[54] In 71% of the GMCs, no reported information exists on the terms of the sub-loans.

[55] Some innovative B2Ps have themselves introduced new wholesale programs similar to GMCs. For example, "BNDES Automatico" facilitates disbursement by simplifying information requirements for loan applications and relying on ex-post reviews. It also simplifies the use of funds by creating a register of program-approved vendors and goods.

that GMC raised these issues has raised awareness and induced participants to modify some behaviors.[56]

2. Improve technical, financial and economical feasibility of private firms

3.15 **GMCs do not systematically track key developmental results at the firm level.** According to PCRs, at least 100,000 firms received sub-loans from GMCs, yet there is no information on their developmental performance, e.g., employment, exports. GMCs do not systematically collect developmental impact information at the firm level. A couple of isolated studies in Brazil indicate positive effects on employment and revenues, but the methodologies utilized are problematic.[57]

3.16 **But recognizing the importance of work at the firm level, two GMCs attempted to create business development centers – achieving, however, inconclusive results**. The first GMC program in Mexico (ME0152) partially financed the creation of 19 NAFIN Centers. However, in 1995 NAFIN decided to discontinue the centers, in part because of the ongoing financial crisis. In the case of Peru (PE0191), the PPMRs and the PCR provided little information on the evolution of COFIDE Centers introduced by the loan.

3. Enhance the financing potential of SMEs and other underserved sectors

3.17 **Over time GMCs have increasingly designated lending for SMEs, but this was not accompanied by effective diagnostics on the barriers to credit for SMEs**. About 90% of the GMC's funds approved between 2000 and 2005 were designated in project documents for SME financing. However, there is no evidence that such designation of funding had been based on any prior diagnostic of SME financing needs by economic sector and region.

[56] The PCR of a GMC in Bolivia (BO0034) states … "in regards to the financing of environmental impact studies, the achievement was that until that time FIs have not been prioritizing and financing those types of studies."

[57] There are some methodological and selection bias problems because these are not impact studies with a control group to measure real impact.

IV. GMC Assumptions and Implications for Future Operations

A. Scope of the Section

4.1 **GMCs possess some very positive characteristics.** The merits of GMCs as operations that mobilize funding to the real sector, while containing fiscal costs for the borrowing countries, are undeniable. The leveraging of additional private sector funding – so far roughly on a one to one ratio – is also a merit of GMCs; and so is the system to have private sector FIs make and bear the risk of credit granting decisions. Finally, the efficiency of the wholesale lending system set up by GMCs is remarkable, despite the additional costs imposed by the compliance with the Bank's administrative requirements.

4.2 **However, GMCs have been designed under a set of assumptions that may no longer hold true, as expressed by some Bank Staff.** In a survey conducted by OVE, some Bank Staff pointed out that traditional GMCs responded to a need for liquidity has now been largely solved in many countries. Some Staff observed that GMCs may need to become more flexible by partly subsidizing the cost of funds and striving to minimize the ensuing economic distortions. There is also concern about the difficulty of measuring the impact and additionality of GMCs, particularly since the unconfirmed suspicion is that many FIs utilize Bank resources to roll over existing credits, rather than expanding it to new customers. Finally, all these concerns have been amplified by the lack of a monitoring and evaluation framework that can provide factual support to the discussions.

4.3 **This section discusses GMC's underlying assumptions and highlights potential inconsistencies so management can further analyze them in the context of each country**. This section discusses the assumptions that underlie the GMC model. *The focus is not on whether the assumptions were true at the time the GMCs were approved and executed, but instead on their future validity.* Finally, because assumptions are potentially country-specific, conclusions cannot be generalized and will have to be tested by the Bank in each country.

Table 4.1: Implied Assumptions of the Current GMC Intervention Model[58]

Increased Availability of Funding for Commercial Credit
1. Do current market conditions still allow for a multi-tier supply *of long-term funding*?
2. Is GMC *funding large enough* to play an effective countercyclical role?
3. Is *capital market development* essential to the GMC intervention model?
Increased Effectiveness of the Financial Intermediation
1. Are *regulated banking intermediaries* the main channel for commercial credit?
2. Do FIs actively *compete* to expand commercial credit?
Improved Creditworthiness of Private Sector Companies
1. Is access to credit an *incentive for private sector formalization*?
2. Is there a *problem of access for long-term commercial credit?* If so, is it due to an *insufficient supply of long-term funding?*

[58] OVE's elaboration based on interviews and surveys to Sector Specialists, Project Documents, CRG Minutes and Bank Strategies.

B. Increased and Sustained Availability of Funding for Commercial Credit

1. Do current market conditions still allow for a multi-tier supply of long term funding?

4.4 **It is unclear whether long term commercial credit is still constrained by the unavailability of funding or whether B2P's cost advantages still hold.**[59] The Multi-tier business strategy is based on the ability of B2Ps to efficiently act as wholesalers. This strategy is therefore based on the spread between sovereign risk and local commercial bank risk. This spread is currently at historical lows for most LAC economies reflecting their current better access to alternative sources of funding. International banks have an important presence in the Region now. LAC governments, banks and corporations have registered greater activity in the international capital markets. LAC governments have substantially replaced external debt with internal debt and have also increased their international reserves to unprecedented levels. Local pension and mutual funds have grown exponentially since 1990 and, moreover, B2Ps also enjoy greater access to funding: 90% of B2Ps surveyed are in a position to issue debt and 78% have access to commercial bank lines. Thus, fairly successful financial sector reforms and the overall macro conditions of LAC economies have made the multi-tier model less effective in the last years.

4.5 **And in fact, it is also unclear whether GMC funding actually increased commercial lending, or merely displaced existing funding**. With the current reporting mechanisms of the Bank, it is not possible to ascertain whether GMCs funded new long-term commercial loans. Because the Bank did not collect baseline information on overall portfolios of the FIs and B2Ps, there is no way to track the expansion of lending.[60]

2. Is GMC funding large enough to play an effective countercyclical role?

4.6 **A significant reduction in the volatility of long term funding for commercial credit requires a critical mass.** Some Bank Specialists report that GMCs had a target of maintaining a constant supply of long term funding of at least 10% of a country's Gross Capital Formation, but this was never the official policy of the Bank, nor was the target even remotely reached. GMCs were actually much smaller. The absence of long term funding as a market failure was to be addressed primarily through comprehensive market reforms. GMCs were designed as accompanying elements of the financial sector reforms and the GMC's main role was the fostering of an orderly market adjustment over an undefined transitional period. In fact, some Bank Staff pointed out in the survey conducted by OVE that in the future "GMCs may have to become [contingent] credit lines so countries

[59] Capital is by nature a scarce resource and thus a constraint. The issue is whether the constraint is "binding" or whether other constraints are the ones imposing the bottlenecks to economic development. See "Growth Diagnostics", March 2005, Ricardo Hausmann, Dani Rodrik, Andrés Velasco. http://ksghome.harvard.edu/~drodrik/barcelonafinalmarch2005.pdf

[60] The Bank's charter requires that investment lending be applied to new investment - defined as investment to be done in the future or done a maximum of 12 months earlier – however that information was self-reported to the Bank by companies, FIs and B2Ps, and was incomplete in the sense that it didn't report overall portfolios of the FIs.

can [readily] use them at the right time in their economic cycle. [Likewise] paperwork and information requirements should be greatly simplified and adapted to the capabilities of the executing institutions. [Similarly] the instruments should be more flexible to allow for the funding of different financial products more akin to the needs of the clients."

3. Is capital market development essential to the GMC model?[61]

4.7 **The main elements of GMC´s design –allocation criteria, pricing and distribution channels– were closely related to the need to mobilize resources during the transition years.** In most cases, the transition implied a significant redefinition of the role of the government in the financial markets. Financial innovation issues such as market-making and standard-setting were not considered a priority at that juncture. Capital markets can play a central role in the development of credit. But, under the GMC model, B2Ps were limited to operating a rediscounting facility, while refraining from any direct market intervention. GMCs did not focus on the potential role of B2Ps in the standardization of structured financial products.[62] In developed markets, non-banking, specialized financial intermediaries whose funding comes from capital markets now dominate credit segments such as mortgages or leasing. In fact, these financial intermediaries use capital markets to finance themselves and to resell their lending portfolios and free up capital for new loans.

C. Improved Effectiveness of the Financial Intermediation Sector

1. Are regulated banks the main channel for commercial credit?

4.8 **In some developed markets, banks are no longer the main originators of credit.** During the last decades, specialized financial providers,[63] as well as specialized legal structures, often called Special Purpose Vehicles (SPVs), have been important complements for banks. For example, financial trusts or micro-credit financial institutions have grown exponentially in many LAC countries, particularly at times of crises when banking credit contracted.[64] GMCs have not used SPVs to expand credit, with the notable exception of a GMC modified after approval.[65]

[61] In fact, the only connection with capital markets that was mentioned by a few early GMCs related to the potential direct access of firms to the capital markets. Although possible, the evidence shows that such access is restricted to the few LAC firms with sufficient scale to bear the associated costs, thus it is not a meaningful linkage for the vast majority of firms.

[62] For example in the United States, State sponsored entities such as Fannie Mae play "standard setting" and "secondary market making" roles that have been essential to the development of the underlying mortgage credit market.

[63] The world's largest leasing provider is not a bank, but a diversified financial company. Similarly, many of the largest US mortgage originators are no longer banks.

[64] A recent paper predicts this countercyclical behavior and shows that the increasing depth of the mortgage secondary market has reduced the impact of local funding shocks on credit supply. Source: "Securitization and the Declining Impact of Bank Finance on Loan Supply: Evidence from Mortgage Acceptance Rates" Elena Loutskina, Philip E. Strahan, http://www.nber.org/papers/w11983.pdf

[65] The latest GMC in Uruguay was modified to facilitate its disbursement after the 2001/2002 financial crisis.

2. Do FIs actively compete to expand commercial credit?

4.9 **Competition is different for different credit markets and reflects the interaction between the institutional matrix, the loan technologies, and the strategies of credit suppliers.** The relevant elements of the institutional matrix[66] affect the nature of competition differently in the different credit markets. The easier the avoidance of the local credit infrastructure, the higher the competition in the respective credit market. Thus, competition in the large corporate segment of commercial lending and in the credit card markets is higher than competition in mortgages or car loans, which in turn is higher than competition in SME lending.

4.10 **The credit infrastructure and corporate governance is still relatively weak in most LAC countries, potentially impairing competition.** The strength of creditor rights, the strength of investor protection and enforcing contracts indexes are well below average when compared with OECD countries[67]. GMCs were designed at a time at which the entrance of foreign players and the drive to privatize or professionalize State-owned FIs was expected to generate a competitive financial sector. However, most LAC markets now have a concentrated financial sector with 3 or 4 dominant players that compete mostly for large corporate and consumer credit clients, but leave other segments underserved.

D. Improved Creditworthiness of Private Sector Companies

1. Is access to credit an incentive for private sector formalization?

4.11 **There is no clear evidence that access to credit has effectively acted as an incentive for formalization.** LAC companies still face strong incentives to remain informal. GMCs emphasized financial products – e.g., long-term investment credit – requiring extensive firm analysis and full formalization. By contrast, products that rely on less involved analyses of firms – e.g., asset-based or score-based financing – would have been more suitable to less formalized economic sectors.

2. Is there a problem of access for long-term commercial credit? If so, is it due to an insufficient supply of long-term funding?

4.12 A problem of access to long-term commercial credit occurs when a project that would be internally financed –if funds were available– is not bankable. A problem of access thus reflects a "*wedge between the expected internal rate of return and the rate of return that external investors require to finance it*"[68]. Typically, principal-agent problems and transaction costs are at the origin of this wedge and may reflect either supply or demand factors. GMCs addressed some of the supply

[66] The institutional matrix is given by the formal and informal rules governing credit markets. It refers to the infrastructure for writing and enforcing credit contracts and includes credit bureaus, property registries, the judiciary, the financial safety net, the framework for bank supervision and regulation and the accounting standards.
[67] Doing Business 2006. The World Bank.
[68] Augusto de la Torre et al. (2006) Op cit, p7.

factors of this problem of access, namely, opening a channel for the Bank's long-term funds to the private sector and the overhaul of the operational capabilities of B2Ps. Demand factors were addressed by other components of the financial sector reform. As mentioned before, it is not clear whether the lack of long term funding is still a major constraint. Demand factors and the quality of the credit infrastructure seemed to better explain the problem of access under the current, post-reform, market conditions.

V. CONCLUSIONS

5.1 **Although GMCs directed more funding to the private sector than all the other private sector windows of the Bank combined, they had not been evaluated until now**. While the Private Sector Department, Inter-American Investment Corporation and MIF have been subjected to increased scrutiny regarding their developmental impact and the Bank's additionality, GMCs have remained almost unchanged since they started over 15 years ago. This evaluation fills that analytical gap by systematically reviewing all GMCs, assessing developmental progress and offering recommendations for future operations.

A. The Effectiveness of the GMC Design

5.2 **GMC's successfully replaced the Bank's traditional industrial loans that chronically burdened public development banks with non-performing loans**. The GMCs succeeded in addressing the public bank sustainability concerns that were raised in 1990 by turning them into second-tier entities (B2Ps) and delegating credit decisions to private first-tier institutions (FIs). Multi-tier lending contained fiscal costs efficiently.

5.3 **GMCs focused most efforts and 99% of funding on selecting sound FIs and ensuring that funding would be priced at market rates.** The evaluation found that: (i) the GMC-selected FIs fare no better than the average FI in their markets, and (ii) the GMCs disbursed in a "stop-and-go" pattern, compatible with the intermittent presence of implied subsidies. Thus, the focus of most Bank efforts – rates and FI selection – did not produce the expected results, while burdening executing agencies and clients.

5.4 **Only about 1% of GMC resources were dedicated to technical assistance for B2Ps, FIs and firms – an area where needs continue to be acute**. Early GMCs had components to create and strengthen the B2Ps. Most of the projects were successful in streamlining B2Ps and transferring know-how that is still used by more than 70% of the B2Ps. B2Ps assets, profitability and asset quality improved steadily until 1997, when they started to impair. Around the same time, most B2Ps regained their interest in directly reaching SMEs and micro-enterprises and started exploring ways to return to the first tier. Thus, market conditions forced major revisions of B2P's strategies.

5.5 **A negligible amount of resources was dedicated to evaluating the developmental impact of GMCs – which is still unknown despite representing about 7% of the Bank's total lending**. GMCs suffered from a severe lack of evaluability: only about a third of their objectives had indicators, baselines and targets. Furthermore, the conceptual design of GMCs focused mostly on credit risk management by making FIs responsible for credit allocation. However, as a collateral effect, the Bank withdrew from collecting reliable information on the beneficiaries' developmental impact, e.g. on jobs and exports. Thus, severe gaps in the information available from the GMCs and country sources prevented ascertaining key aspects of the GMCs' developmental impact.

B. GMC Results

5.6 **GMCs' pursued higher economic growth via greater utilization of credit – however, LAC's growth has been disappointing and relatively insensitive to credit**. At 3% per year, LAC's average GDP growth was the lowest of all developing regions and credit to the private sector has barely kept pace with it. Furthermore, because LAC's long-term growth is relatively insensitive to greater credit penetration, credit alone is insufficient to support it. OVE estimates that a 1% increase in long-term growth of GDP per capita would require 20% of additional penetration of credit versus GDP, which is equivalent to an increase of $300 billion in the stock of private sector credit. For comparison purposes, GMCs contributed only about 2% of that amount over the last 15 years.

5.7 **GMCs behaved counter-cyclically – disbursing at times of financial distress – but were too small to promote self-sustaining long-term credit markets**. GMC's were relatively small – less than 1% of gross capital formation or less than 4% of that year's increase in credit to the private sector. The rate-fixing mechanism adopted by GMCs has failed to reflect market conditions in real time. Thus allowing Bank funds to be transferred at lower than market rates. Disbursement peaks exceeded 200% of planned disbursement rates when the Bank's funds were under-priced vis-à-vis the market and, conversely, GMCs have gone undisbursed for years at times of high market liquidity.

5.8 **The requirements for the formation of credit markets – funding, intermediation and ability of private companies to absorb the funding – were only partially met**. Although funding and intermediation improved, a long-term commercial credit market failed to materialize fully because of the presence of structural barriers that could not be removed by financial market players alone.

5.9 **The availability of funding for long term credit increased, buoyed by greater macroeconomic stability, domestic savings and foreign direct investment**. LAC's long-term volatility is now 25% lower than in 1990. Domestic savings – which had decreased to about 20% of GDP for most of the 1990s – have now recovered and surpassed the 1980 levels. FDI has regained an upward trend – reaching 3% of GDP. Thus, LAC domestic savings now exceed private investment by approximately 3% of GDP. Institutional investors, such as pension funds, accumulated holdings equivalent to 15% of LAC's GDP. B2Ps – which were successfully created or streamlined during the period – now have assets exceeding 1% of regional GDP. B2Ps financing options have also greatly improved relative to those prevalent in 1990, reducing the appeal of the Bank's GMCs.

5.10 **LAC banking intermediation is also much sounder than in 1990.** Public ownership of financial intermediaries decreased to about one third of LAC banking assets, while foreign participation in bank ownership increased to 45%. There was also significant progress towards the implementation of prudential regulations. FI's return on equity averaged 10% during the decade, while capitalization increased to 10% of assets and operating expenses decreased to 63% of net income.

C. Challenges for the Future

5.11 **Although GMC assumptions were adequate at their time, significant financial market changes require that they be revisited for future operations**. GMC assumptions could have been justified at a time when the idea of free financial markets needed to be reintroduced in many LAC countries. However, because most countries have made great strides in the formal aspects of financial liberalization, the GMCs need to be reviewed. OVE found that it is critical to identify the loci of the developmental bottlenecks and adapt the type of interventions accordingly – e.g., moving from being a provider of funding to a developer of financial infrastructure and from institutional arrangements to financial innovation.

5.12 **Key pieces of financial infrastructure that are required to incorporate underserved segments into credit markets remain undeveloped.** Financial sector consolidation accelerated and, on average, the top 3 players in each market now account for two-thirds of banking assets. Product development and innovation were intense, but focused mostly on the lower and higher ends of consumer and corporate credit markets. By contrast, middle market companies have remained underserved because the financial infrastructure required to incorporate them could not be developed by market forces alone and requires a deliberate coordination between the private and public sectors. As a consequence, a high proportion of middle market companies confront a problem of access to long-term credit.

5.13 **However, LAC markets already show signs of resolving these issues via alternative means.** About 75% of LAC commercial banks with an active SME policy lend only short-term – shunning the long-term credit promoted by GMCs. In fact, traditional commercial banks are no longer the main conduit for credit to mid-size LAC companies being responsible for only 20% of their credit needs. Specialized financial providers,[69] as well as specialized legal structures have grown exponentially in many LAC countries. So far, financial trusts operate under specific legislation, but lack specialized supervision – falling marginally under both banking and capital market regulators.

5.14 **Capital markets could play a central role in the development of credit.** GMCs assumed a subsidiary role for capital markets and left undefined their connection to the development of commercial credit markets.[70] The role of B2Ps in the standardization of structured financial products was not incorporated into GMCs. Evidence indicates that the lack of unified standards stood on the way of developing a critical mass of credit assets that could be reliably transacted in secondary markets.

[69] The world's largest leasing provider is not a bank but a diversified financial company. Similarly, many of the largest US mortgage originators are no longer banks.

[70] In fact, the only connection with capital markets, which was mentioned by a few early GMCs, related to the potential direct access of firms to the capital markets. Although possible, the evidence shows that such access is restricted to the few firms with sufficient scale to bear the associated costs. Thus it has no meaning for the vast majority of LAC firms.

VI. RECOMMENDATIONS

6.1 **As a result of this review OVE formulates two types of recommendations: (i) recommendations regarding the existing GMC instrument, and (ii) recommendations regarding a new generation of GMC instruments focused on business development and market deepening.** Existing GMCs could continue in a simplified form with the help of enhanced technical cooperation activities (Recommendations 1 and 2). In parallel, the Bank should gradually introduce a new generation of GMCs – also executed by B2Ps or similar State-sponsored development agencies, but geared towards innovation in financial infrastructure and services. These new business development operations will seek to jointly engage the public and private sectors to solve specific, well identified market failures, through selective, time-bound micro interventions. (Recommendations 3 and 4).

6.2 **Recommendation 1: Simplify existing GMCs by reducing administrative requirements and utilizing B2P's internal risk management systems.** Simplify and standardize GMC's administrative requirements, rely on the B2P's own risk management systems – e.g., allocation criteria, pricing and distribution channels – and monitor progress at a portfolio/system level instead of only tracking Bank-provided funds.

6.3 **Recommendation 2: Significantly reinforce technical assistance activities to B2Ps in the areas of risk management, financial innovation and development evaluation.** To utilize the B2Ps own internal systems and to cope with the severe lack of evaluability of GMCs, technical assistance activities should be substantially increased and reinforced. Among other activities, develop and implement a pro-forma framework for monitoring and evaluation in order to set minimum standards. Similarly, cooperate with B2Ps to develop best practice standards for risk management and product innovation.

6.4 **Recommendation 3: Closely connect the new GMC Business Development operations with all the other activities of the Bank's Group targeted to foster private financial intermediation and to solve problems of access to financial services.** Ensure that the new GMCs are well grounded on private sector needs, by leveraging the work and capabilities of the Bank's group, all its private sector windows and its private sector strategic partners, in order to tackle all elements of financial access. Ensure that those market development interventions are sequenced and sustained over a predefined time horizon.

6.5 **Recommendation 4: Utilize the new GMC Business Development operations to transform the B2Ps into stewards of financial product innovation.** Engage the public sector – possibly via the B2Ps – in the on-going selection of technical proposals for new financial products submitted by private FIs. Consider creating transparent bidding mechanisms to allocate innovation funds, so that FIs can compete for funding to defray part of the development costs of new standardized products in each market. Focus on improving the creditworthiness of productive enterprises and on the quality of the credit infrastructure. Priority should be given to public-private business development ventures and the regional dissemination of best practices.