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STAFF APPRAISAL REPORT

COLOMBIA

FIFTH SMALL AND MEDIUM SCALE ENTERPRISE PROJECT

FEBRUARY 9, 1989

Trade, Finance and Industry Division
Department III, Latin America and the Caribbean Region

CURRENCY EQUIVALENTS

(as of July 1, 1988)

Currency Unit	=	Colombian Peso (Col$)
US$ 1	=	Col$ 300.0
Col$ 1	=	US$ 0.0033

FISCAL YEAR OF THE GOVERNMENT OF COLOMBIA

January 1 - December 31

GLOSSARY OF ABBREVIATIONS

ACOPI	SME Producers' Association
BR	Central Bank of Colombia
CDT	Term deposit certificate
CF	Private development bank
CFP	Public SME Development Bank
DANE	National Agency for Statistics
DNP	National Planning Department
DTF	Average 90-day rate for term deposit certificates issued by development and commercial banks.
FFI	Industrial Finance Fund
FNGI	National Deposit Insurance Fund
GDP	Gross domestic product
ICOR	Incremental capital-output ratio
IDF	Industrial Development and Finance Division of the World Bank
INCOMEX	National Institute of External Commerce
IDB	Inter-American Development Bank
LIBOR	London Inter-Bank Offering Rate
MED	Ministry of Economic Development
NGO	Non-governmental organization
PFI	Participating financial intermediary
PROEXPO	Export Promotion Agency
SME	Small and medium scale enterprise
SME 4	Fourth Small and Medium Scale Enterprise Project
SME 5	Fifth Small and Medium Scale Enterprise Project
SOE	Statement of expenditures
WWB	Women's World Banking

STAFF APPRAISAL REPORT

COLOMBIA

FIFTH SMALL AND MEDIUM SCALE ENTERPRISE PROJECT

TABLE OF CONTENTS

This report is based on the findings of an appraisal mission which visited Colombia in July 1988. The mission comprised Messrs./Mmes. J. Hanna (Senior Financial Analyst and Mission Leader), K. Hallberg (Economist), and H. Jackelen (Consultant).

SUPPORTING GRAPHS IN THE TEXT

SUPPORTING TABLES

ANNEXES

STAFF APPRAISAL REPORT

COLOMBIA

FIFTH SMALL AND MEDIUM SCALE ENTERPRISE PROJECT

Loan and Project Summary

Borrower:	Banco de la Republica (BR)
Guarantor:	Republic of Colombia
Beneficiaries:	Small and medium scale enterprises (SMEs) in manufacturing, mining and related service industries with total assets of less than US$1.0 million equivalent.
Loan Amount:	US$80 million equivalent, to be repaid in 17 years, including 5 years of grace, at the standard variable interest rate.
Relending Terms:	BR would relend the proceeds of the loan to participating financial intermediaries (PFIs), pegged to the fully variable average deposit rate of the Colombian banking system (DTF). BR would relend in local currency and would bear the foreign exchange risk since the free market DTF rate has reflected over the long run expectations of currency adjustment and thus contains an implicit foreign exchange risk premium. Relending rates to SMEs by PFIs would be determined by the PFI according to the maturity, credit risk, operational cost and competition for each SME loan. Guidelines would establish an allowable maximum of DTF+4 percentage points in 1989 and DTF+5 percentage points in 1990 for SME loans carrying the minimum 4 year maturity. Maximum interest rates to SMEs and the margins of PFIs would be progressively increased for loans with longer maturities, up to an additional one percentage point for maturities up to 10 years.
Project Description:	The proposed Project is intended to accelerate the growth rates of value added and employment creation of SMEs, mainly by: (a) making modest changes in public policy and institutional mechanisms influencing SME access to longer-term credit; (b) engaging Colombia's commercial and development banks as SME loan intermediaries and the resources of these entities for this purpose; (c) simplifying Bank loan processing and increasing technical cooperation to SMEs; and (d) preparing studies and recommendations during project implementation on policies influencing capital intensity, business establishment and operations, to help promote a neutral policy environment for SME development. Project resources would be committed over about a two-year period during CY1989-91.

Project Risks: The central project implementation risk lies in the ability of commercial banks to adapt their appraisal and supervision work to SME lending. To mitigate this risk, PFIs would make clear organizational, staff and financial resource commitments to the Project with the support of staff training prior to Project start-up.

Estimated Costs:

	Local	Foreign	Total
	-------US$ millions--------		
Credit program	154.9	80.0	234.9
Technical cooperation	0.2		0.2
Total	**155.1**	**80.0**	**235.1**

Financing Plan:

				%Total
Enterprises	54.1		54.1	23
Financial intermediaries	43.7		43.7	18
Industrial Finance Fund	44.1		44.1	19
Other Domestic Sources	13.2		13.2	6
World Bank		80.0	80.0	34
Total	**155.1**	**80.0**	**235.1**	**100**

Estimated Disbursements: Based on average profile for SME Bank loans in Colombia

	US$ millions					
FY	89	90	91	92	93	94
Annual	0.3	9.7	20.7	27.7	15.8	5.8
Cumulative	0.3	10.0	30.7	58.4	74.2	80.0

Rate of Return: SME loan approvals would require at least an 11 percent financial rate of return

COLOMBIA

FIFTH SMALL AND MEDIUM SCALE ENTERPRISE PROJECT

1. The Industrial and Financial Sectors

Recent Industrial Sector Performance

1.01 The 1967-74 period witnessed strong growth and diversification of industrial production in Colombia, both as a result of import substitution and export market penetration. The industrial sector showed its highest growth since World War II, with manufacturing value added increasing at 8.6% per year in real terms, forming an increasing share of GDP (see Tables 1.1 and 1.2). In addition, industry's contribution to employment creation was high, labor productivity exceeded the increase in real wages, and capital-output ratios fell markedly.

1.02 An overvalued foreign exchange rate and other macroeconomic management problems associated with a boom in world coffee prices were substantially responsible for a fall over the 1974-80 period in the average annual value added growth rate to 4.8%. Overtaken by growth in the service sector, the share of manufacturing value added in GDP began a steady decline that was to continue through the early 1980s. With the end of the coffee boom in the early 1980s and other external shocks, combined with domestic structural problems and a macroeconomic policy framework which was generally unfavorable to industrial development, manufacturing value added declined by an average of -0.1% per year during the 1980-83. This period was characterized by stagnant domestic and foreign investment, low rates of employment creation, low factor productivity and a serious deterioration in the financial condition of enterprises.

1.03 A period of macroeconomic adjustment beginning in 1984 saw both GDP and industrial output recovering more quickly in Colombia than in the rest of Latin America, propelled by substantial real devaluation in 1985, the coffee boom of 1986, and Colombia's relatively sound macroeconomic management. During 1984-86, manufacturing value added rose by 4.9% annually, compared to 3.0% in the rest of Latin America. Industrial value added continued to grow in 1987 at 5.9%, with industrial exports (excluding nickel) increasing by 35% in U.S. dollar terms.

1.04 A sense of confidence generated by the recent impressive macroeconomic performance and industrial growth is tempered by several factors. First, the level of industrialization in Colombia, as measured by the share of manufacturing value added in GDP, is at 21.6%, still below its 1974 peak of 23.5%. In addition, the importance of the industrial sector in Colombia has been and continues to be less than in other Latin American countries. Second, much of the recent growth in manufactured exports may be attributed to real exchange rate devaluation rather than to structural change and improved efficiency in the industrial and financial sectors. The authorities feel that, as the demand effects of the coffee boom fade,

the industrial sector must increase its international competitiveness if growth is to be sustained. The Administration has consequently focused heavily on increasing industrial efficiency as a central theme in its 1987-90 National Plan. Finally, recent industrial growth has been achieved at considerable resource cost, reflected in increasing ICORs. Future rates of growth in industrial output and exports are likely to be lower than in recent years unless policy reforms address the lack of competitive pressure, both domestic and international, and barriers to real and financial resource mobility. Alternatively, attempts to maintain industrial growth rates at recent levels under the existing policy framework would require increasingly high resource costs which would make future adjustment more difficult.

SME Structure and Growth

1.05 In 1985, small and medium scale enterprises (SMEs)[1] accounted for 93% of the 6406 formal sector firms with more than 10 employees in Colombia. While SMEs produced about one-third of total industrial output (13% by small scale enterprises, 25% medium scale) and value added (11% small scale, 23% medium scale), they accounted for over half of industrial employment (small scale enterprises accounted for 22% and medium-scale enterprises another 30%). The importance of SMEs has remained fairly constant during the past ten years in relation to some 450 large scale Colombian industrial enterprises, following the heavy industrial import substitution phase of the 1950s and 1960s in which large firms increased their share of industrial activity.[2]

1.06 Small scale enterprises were particularly hard hit during the recession of the early 1980s, possibly as a consequence of a relatively stronger impact of the restrictive import regime of the period, lower access to working capital to support operations during poor sales performance, and more fragile marketing systems. Manufacturing value added of small scale enterprises fell -40.4% and -17.5% in 1980 and 1981, compared to -9.6% and -0.4% for the industrial sector as a whole. Medium scale enterprises were able to maintain more stable value added growth rates during the 1980-83 period. During the recovery phase initiated in 1984, however, small scale enterprises showed more dynamism than either medium scale or large enterprises, with value added growing at an annual average of 22.3% during 1984-85, compared to 4.6% for medium scale firms and 7.4% for large enterprises.

1/ In this section, firm size is defined according to number of employees: microenterprises (fewer than 10 employees); small scale enterprises (10 to 49 employees); medium scale enterprises (50 to 199 employees); and large enterprises (200 or more employees). For purposes of the project, however, "small and medium scale enterprises" are defined as enterprises with total assets less than US$1.0 million equivalent.

2/ Pinto, Juan S, and Arango, Juan F. La Pequeña y Mediana Industria en Colombia. Situación y Perspectivas. Universidad Externado de Colombia, Bogotá, 1968. Also, additional DANE date for 1984-85 provided by ACOPI.

1.07 In 1985, SMEs generated more than half the total value added in 27 of the 94 four-digit industrial subsectors (see Table 1.3). These include apparel, shoes, leather products, wood products and furniture, metal products and machinery. SMEs are also prominent in food, printing, rubber and plastic products. The participation of SMEs is notably lower in such concentrated industries as textiles (dominated by a few large firms but under increasing competition by medium scale firms employing modern technology), beverages and tobacco, clay and cement, glass products, basic metals, and petroleum refining. About 69% of SMEs are located in Colombia's four principal cities (Bogota 33%, Medellin 17%, Cali 12%, and Barranquilla 7%) and the remainder mainly in smaller cities.

SME Exports

1.08 Industrial exports, responding to a favorable real exchange rate, grew from US$624 million in 1984 to US$875 million in 1986, though still falling short of the 1980 level of US$949 million (Table 1.4). Recent data show continued strong growth: during the first four months of 1988, registrations of industrial exports were 21% higher in dollar terms than during the same period a year earlier. Growth in exports of ferronickel (114%) was an important factor in this expansion; non-nickel industrial exports were 14% over their 1987 values.

1.09 The export orientation of small scale enterprises is generally low, due primarily to lack of knowledge of external markets and export procedures, other fixed costs involved in exporting, more restricted access to credit to handle export risks, and inability to satisfy the quantity and quality requirements of external markets. In all but five 4-digit industries (in food products and leather goods), small firms export less than 10% of their production.

1.10 Medium scale enterprises have a stronger external orientation than do small firms, exporting more than 10% of their production in 14 of 94 4-digit industries. Large firms export more than 10% of production in about the same number of industries, though the particular industries differ. In many subsectors -- e.g., milling, cotton weaving, leather goods, plastics, non-electric machinery -- medium scale enterprises export a larger share of their production than do large firms. Mainly as a result of exports by medium scale firms, direct exports by SMEs as a group contributed fully 43% of total industrial exports in 1986 (Table 1.4). SME exports in 1985 accounted for more than 50 percent of exports in four branches -- food processing, furniture, paper products and non-ferrous basic metals. In four others, SME exports constituted between 40-50 percent of total exports---other wood products, plastics, metal products (excluding machinery and equipment) and "other" industries.

1.11 As in the case of production and value added, SME exports have been more variable during the 1980s than exports from larger enterprises. During 1981-84, SME exports declined more rapidly than those of larger firms (-16.2% for SMEs versus -4.2% for large enterprises), while their recovery rate was more rapid than that of large firms (29.3% for SMEs

versus 12.0% for large enterprises). Preliminary data indicate that subsectors in which SMEs are concentrated have been the most responsive segment of industry in Colombia's recent industrial export expansion. However, by 1986 SMEs had not yet regained the share of total exports they accounted for in 1980.

SMEs and Protection

1.12 The Colombian industrial sector is characterized by distortions in product markets and factor markets, which are created or reinforced by economic policies. The most significant policy-determined distortions stem from the trade regime, financial policies (dealt with in the proposed Project) and, to a lesser degree, from labor market regulations (paras. 1.23-1.24). Factor markets providing labor and capital inputs to SMEs are substantially free of distortions, particularly relative to larger enterprises. This is corroborated by evidence from Colombia as well as other countries which suggests that differences in efficiency across industrial firms are often correlated with firm size, as small and (particularly) medium-scale enterprises frequently outpace larger enterprises in various measures of efficiency.

1.13 The trade policy reforms made since 1984 and supported by two World Bank loans (the Trade Policy and Export Diversification Loan of 1985 and the Trade and Agricultural Policy Loan of 1986) reduced the average level and the dispersion of tariff rates, but did not significantly change the protection granted to domestic production by quantitative restrictions. Average tariff rates were reduced by 31 percentage points and their standard deviation was halved between 1984 and 1988. Currently the unweighted average tariff rate is 27.4% for raw materials and intermediate goods, 22.9% for capital goods, and 42.9% for consumer goods. In addition, a surcharge of 18% of the c.i.f. value applies to all imports, and some imports are also subject to a sales tax. Tariff receipts are substantially reduced by an extensive system of exemptions for both the public and private sectors. A recent proposal for tariff reform would reduce the number of rates to five and would reduce the dispersion of rates, but would still leave a wide variation in the levels of effective protection and would afford the greatest protection to those industries with low domestic content.

1.14 Colombia's system of import licenses remains more important than tariffs in determining the structure of protection, particularly during periods of foreign exchange scarcity. Where INCOMEX believes there is domestic production of sufficient quantity and quality, import licenses are not granted. While the number of tariff positions subject to prior licenses or prohibitions fell during the recent reform period, the reduction did not completely reverse the import protection measures introduced in the early 1980s. Currently, about three fifths of tariff positions are restricted by licensing requirements, compared to less than a third in 1980. In 1987, the foreign exchange budget available for prior licenses was only about 54% of the value of applications for these licenses.

1.15 According to preliminary results of Bank sector work, coverage of domestic manufacturing by licenses or prohibitions fell from 99.7% in 1984 to 82.1% in 1988, which remains high by international standards. For example, in Venezuela, the coverage of domestic manufacturing by quantitative import restrictions is 49%; in México, the production coverage by quantitative restructions fell from 100% to 20% during the first three years of the reform program; Chile and Bolivia have no system of quantitative restrictions on imports.

1.16 With respect to output markets, the available evidence suggests that industries (at the four-digit classification level) in which SMEs are important receive about the same protection as industries in which larger firms dominate. For example, there is no significant correlation between output coverage by import restrictions, and either average firm size or the output contribution of SMEs. Similarly, four-digit industry estimates of nominal protection calculated using tariffs do not appear to be related to average firm size in the industry.

1.17 On the input side, however, the distortionary effects of the import regime are significantly lower for SMEs than for larger enterprises. SMEs use fewer directly imported inputs than do large enterprises. In part, this is due to the administration of the licencing regime. During times of greater foreign exchange scarcity (or anticipated future scarcity), the priorities assigned by INCOMEX to prior license applications sometimes favor large firms. In addition, INCOMEX will consider the employment impact of denying import licenses, which also tends to favor large firms employing more workers. More importantly, SMEs use fewer directly imported inputs because of their lack of information about external markets and the fixed costs of direct importing, of which bureaucratic obstacles are a major component. These costs involved in direct importing cause SMEs to substitute locally produced inputs or "indirect imports" bought off-the-shelf from direct importers.

1.18 Prices of indirect imports of raw materials, intermediates and capital goods are often significantly higher than those of direct imports. During times of foreign exchange scarcity, the premium paid for indirect imports is of course even higher. In these times, INCOMEX also frequently favors applications for direct imports by manufacturing enterprises over those by commercial distributors, in effect severely restricting the supply of indirect imports for SMEs. The oligopolistic structure of markets for indirect imports may also be an important factor determining their high prices, and this concentration of sellers is encouraged by the INCOMEX practice of approving prior licenses based on historical import records of the applicant.

1.19 Prices of alternatives, domestically produced inputs (when reasonable substitutes are available), also exceed the prices of directly imported products. There are a number of examples of final goods produced by SMEs in which the domestic markets for intermediate inputs are highly concentrated (and substantially protected by the trade regime)-- e.g., garments (with concentration in textiles), plastics (with concentration in

petrochemicals), furniture (with concentration in certain wood products), and metal products (with concentration in basic metals). It should also be noted that SMEs often pay higher prices for the same domestically produced input than do large enterprises, simply because the scale of production of the latter allows greater access to quantity discounts.

1.20 In sum, due to economies of scale associated with direct importing and the administration of the import licensing system, SMEs use a greater proportion of indirect imports or locally produced goods, usually purchased at higher cost, than do larger firms. As a result, effective protection of SMEs is often lower than for large enterprises. With respect to exports, similar conclusions apply: though the administration of incentives does not appear to discriminate against SMEs, their use of them is less profitable at lower scales of production. In addition, with respect to PROEXPO credit, collateral and counter-guarantee requirements of the National Guarantee Fund impede SME access to this export incentive.

SME Employment and Wages

1.21 Open unemployment in Colombia has been and continues to be high. The unemployment rate reached 14-15% in the mid-1980s, fell to nearly 10% toward the end of 1987, and subsequently climbed to 11.9% in June 1988. The growth rate of labor supply is likely to remain high into the 1990s, particularly in urban areas, in view of high birth rates prior to the 1960s and the more recent increase in women working in the formal marketplace. These factors, combined with persistent socio-political unrest, have led the Government to assign a particularly high priority to employment creation and socio-economic development among lower income segments of Colombian society.

1.22 The creation of new SME firms accounted for about half of all industrial employment growth during 1953-78. Such firms had rates of employment creation (15% per year) which substantially exceeded the average for all SMEs (about 5%).[3] During the recessionary period of the early 1980s, SMEs were relatively more stable employers than were large firms, as they adjusted to declining output by lowering wages rather than the number of workers. Full-time employment in the industrial sector fell by about 70,000 jobs (13.5% of the industrial labor force) in the early 1980s; of this reduction, 83% was accounted for by large firms.

1.23 Remuneration per employee in SMEs averages only 40% of the that paid to employees of large firms, though in a few four-digit subsectors, e.g., some clothing, non-electrical machinery, and petroleum and coal derivatives industries, labor in medium scale firms are paid more than large firms. In most industries, both wages/salaries and non-wage benefits are highest in large firms, followed by medium scale and small scale enterprises. The higher labor remuneration in large firms is apparent for skilled and unskilled worker categories. This is partly due to the fact that workers and managers in SMEs are less specialized than their large-enterprise counterparts.

3/ Cortes, Berry, and Ishaq. Success in Small and Medium Scale Enterprises: The Evidence from Colombia. The World Bank, 1987.

1.24 SMEs tend to be less subject to distortions created by labor market policies. Current labor legislation makes no distinction according to size of firm regarding non-wage benefit requirements. However, large enterprises tend to pay higher "extra-legal" benefits as a result of agreements negotiated with unions, which are predominant in large firms, and because of lower turnover rates in large firms. SMEs also tend to use a greater proportion of workers from the "informal" labor market, at lower labor costs and with greater flexibility in the allocation of workers to different tasks within individual firms. On balance, then, SMEs are less subject to distortions created by labor market policies.

SME Efficiency and Factor Intensity.

1.25 Capital-labor ratios in SMEs are lower than in larger enterprises: in the industrial sector overall, the value of fixed assets per employee in small scale enterprises is about one-third that of large firms, while it is about one-half in the case of medium scale enterprises. Within most three-digit subsectors, it is still the case that capital-labor ratios increase with firm size. During 1975-83, capital-labor ratios in medium scale firms increased relative to those in large firms, while the reverse was true in small enterprises. The lower capital intensity of SMEs is also reflected in lower levels of value added per employee, by about the same proportions, and in higher output/capital ratios.

1.26 The study by Cortes, Berry and Ishaq cited above suggests that technical efficiency, in addition to being associated with operating levels in relation to the optimum scale of production, is predominantly correlated with the personal characteristics of the entrepreneur (skills, education and previous job). Entrepreneurs whose skills are limited to production tend do to rather poorly because they find it hard to organize other aspects of the business. While nearly 90% of those surveyed go to fairs or read trade catalogs and magazines, technical improvements reflect mainly an entrepreneur's learning by doing in the firm, knowledge acquired in a previous job, and technical cooperation. Empirical evidence from the study shows that many SMEs have an impressive capacity for technical change, even without help from outside. It found that smaller firms are able to adapt technology according to the changes in its financial situations, market access and factor prices which they face and that technical change tends to be diffused from one firm to others with labor mobility and the movement of workers from the factory to their own enterprises.

Financial Sector Institutions and Performance

1.27 Credit in the Colombian financial system is dispensed by some 96 intermediaries, ranging from commercial banks to savings banks, development banks, savings and loan corporations and trade finance companies. The Central Bank, Banco de la Republica (BR), also plays a significant role in credit markets through its management of the directed credit system and external credit lines. Commercial banks are the central players in the financial system, accounting for more than one-third of the total outstanding credit, and have by far the largest branch network (over 1,800 offices) across the country.

1.28 The Colombian financial system has experienced substantial difficulties in the 1980s. Financial intermediaries encountered an increasing inability of a broad range of borrowers to repay as a result of sharp changes in relative prices over 1976-82, high real interest rates in combination with stagnation in aggregate demand, and relaxed credit standards applied to their affiliates in the real sector. As a consequence, net profit as a share of equity of the commercial banking system fell progressively over 1980-85 from 10.1% to negative levels while total arrears (under and over 1 year) as a share of equity rose from 7.0 to 20.4% and total assets in relation to equity increased from 10.1 to 39.6. The financial performance of private developments banks (CFs) was far less drastically affected overall, though reflected similar tendencies (Tables 1.5 and 1.6).

1.29 The Government has taken a number of steps to redress the financial sector's weak conditions and underlying problems. In 1982, it set restrictions on interlocking ownership of financial and industrial entities and on the portfolio concentration of financial institutions. Over 1983-85, it increased the yield on forced investments from 8 to 15% created a facility to help recapitalize the system by financing the purchase of equity and quasi-equity in financial and industrial enterprises at subsidized rates, created a Deposit Insurance Fund (FNGI), nationalized the banks in greatest trouble (CF Grancolombiana and Banco de Colombia) and used the FNGI to lead workout exercises and to provide financing to other banks.

1.30 More recently, Colombia has moved ahead under the reform of the Andean Pact Decision 24 to seek foreign investment in the financial sector in order to increase capitalization and efficiency of intermediaries. It has designed reforms in legislation for receivership ("concordato"), which currently favors debtor firms over creditors in the workout process. In addition, it has changed the interest rate structure for its industrial directed credit lines by converting them from fixed to fully variable rates. The average level of interest rates charged to enterprises was also raised to about 2 percentage points above the average 90-day rate for term deposit certificates (DTF). And at year-end 1987, the Government made adjustments to reduce the low yields and illiquidity of forced investments by reducing the share of institutions' assets subject to forced investment (from 16.5 to 15.5%), increasing their effective yield (from 15.2 to 17.4% though still remaining significantly below the 26% inflation rate), making forced investment paper negotiable and permitting about half of reserve requirements to be met by them.

1.31 The condition of the banking system, supported by strong aggregate demand growth and relatively sound macroeconomic management over 1986-87, has slowly improved since its 1985 lowpoint. After-tax profit reached 5.6% of equity, arrears fell as a share of equity to 14.4% and total assets in relation to equity dropped to 11.2, comparable to its 1980 level. Nevertheless, steady progress needs to continue in order to bolster the solvency, liquidity and efficiency of the system and to better support development of the real sector. In particular, the forced investment

system needs to be gradually phased out (see para. 2.10), incentives and mechanisms strengthened to restructure non-performing portfolios (para. 3.11c and Annex 7), fiscal disincentives to write off bad debts removed, and new financial instruments and services promoted, such as investment banking, venture capital and medium-term bond markets. These issues are currently under discussion with the Government in the context of Bank sector work and preparation of other projects.

2. Increasing the Development Contribution of SMEs

National Objectives and SME Policy Agenda

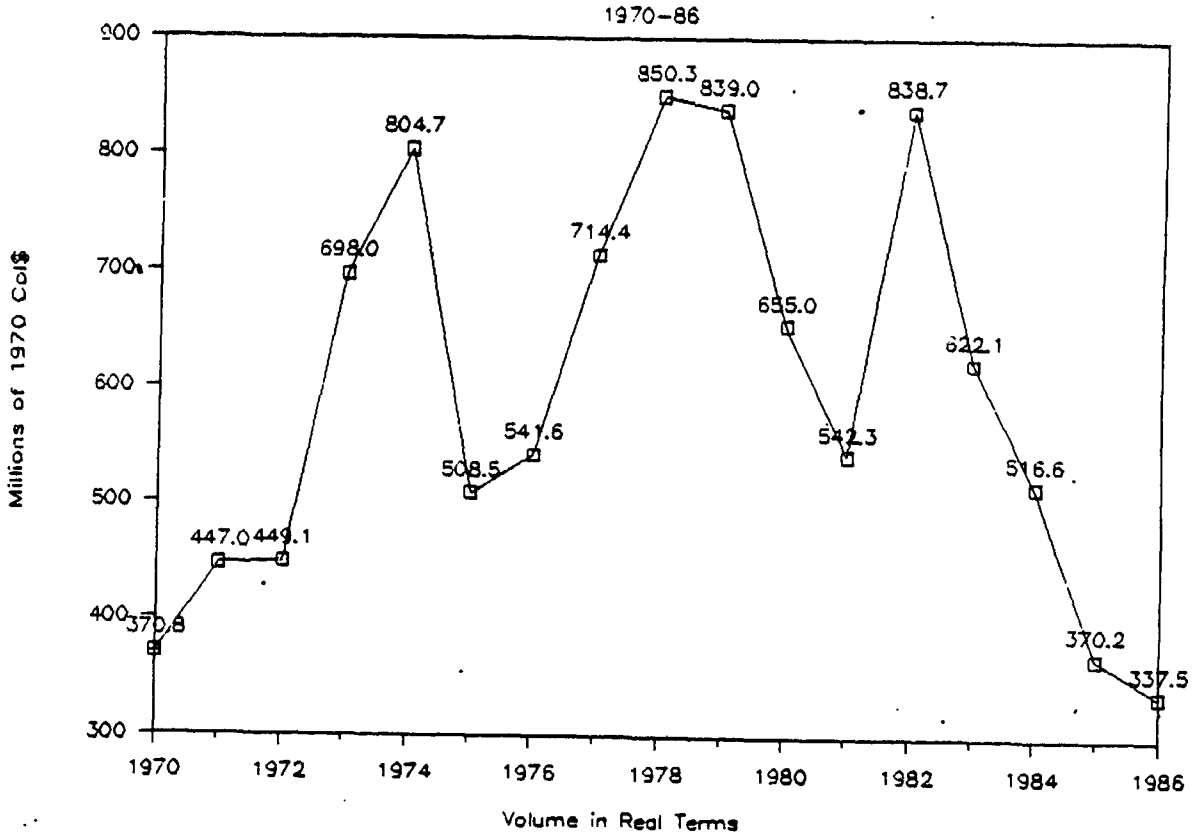
2.01 Colombia's current development strategy, the 1987-90 National Plan, views SMEs and microenterprises primarily as important instruments to increase productive employment, income and output -- especially among lower income groups. They have demonstrated their ability to provide employment creation in a capital efficient fashion, and a large share of the country's SME output---particularly in agroindustry, apparel, household goods, construction materials and metal mechanical products---is oriented toward low-income users' needs rather than large import-substitution industries, which tend to produce primarily for higher income groups.

2.02 The Cortes, Berry and Ishaq study referred to in the previous section suggests that larger firms among SMEs have higher average benefit-cost ratios, explained statistically by their access to finance, entrepeneurial skills, and type of technology rather than by size itself. These findings are reinforced by a recent survey on the determinants of investment by the private sector in Colombia, in which SMEs ranked the availability of funds as clearly the most important factor determining the investment decision. The public policy agenda, much of which is already identified in the National Plan, should thus concentrate on three main areas to accelerate SME development: (a) increased access to institutional credit facilities tailored to SME needs; (b) increased access to vocational training and technical cooperation, particularly that which supports resolution of enterprise-specific problems in production, management and marketing; and (c) a more neutral policy environment in order to expand the potential scope of benefits from SME development.

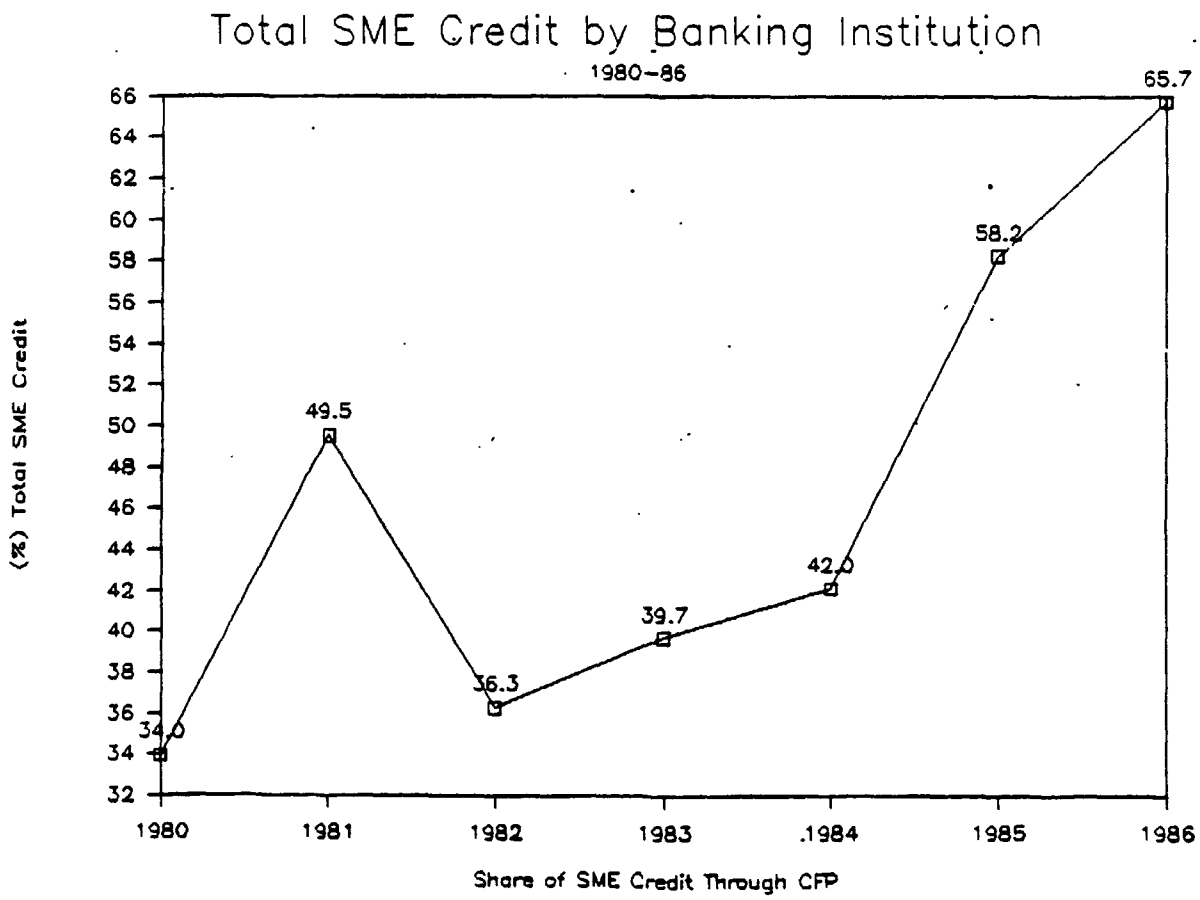
The SME Credit System

2.03 Colombia's credit markets are characterized by a strong dualism in which SMEs are served almost exclusively by the subsized directed credit system and the extra-banking market, while larger industry is associated with the commercial banking network. Available data on investment and credit flows to SMEs over 1980-85 suggests that formal banking institutions intermediating SME directed credit - the Corporación Financiera Popular (CFP, the specialized public SME lender), Caja Agraria, CFs and commercial banks - financed a steadily diminishing share of SME investment financing (Table 2.1). Bank credit fell from 33 to 21% of total investment as firms resorted increasingly to internal cash generation (52 to 59%) and suppliers' credits (10 to 15%); the extra-banking financial market accounted for a relatively stable 3-6% of the total.

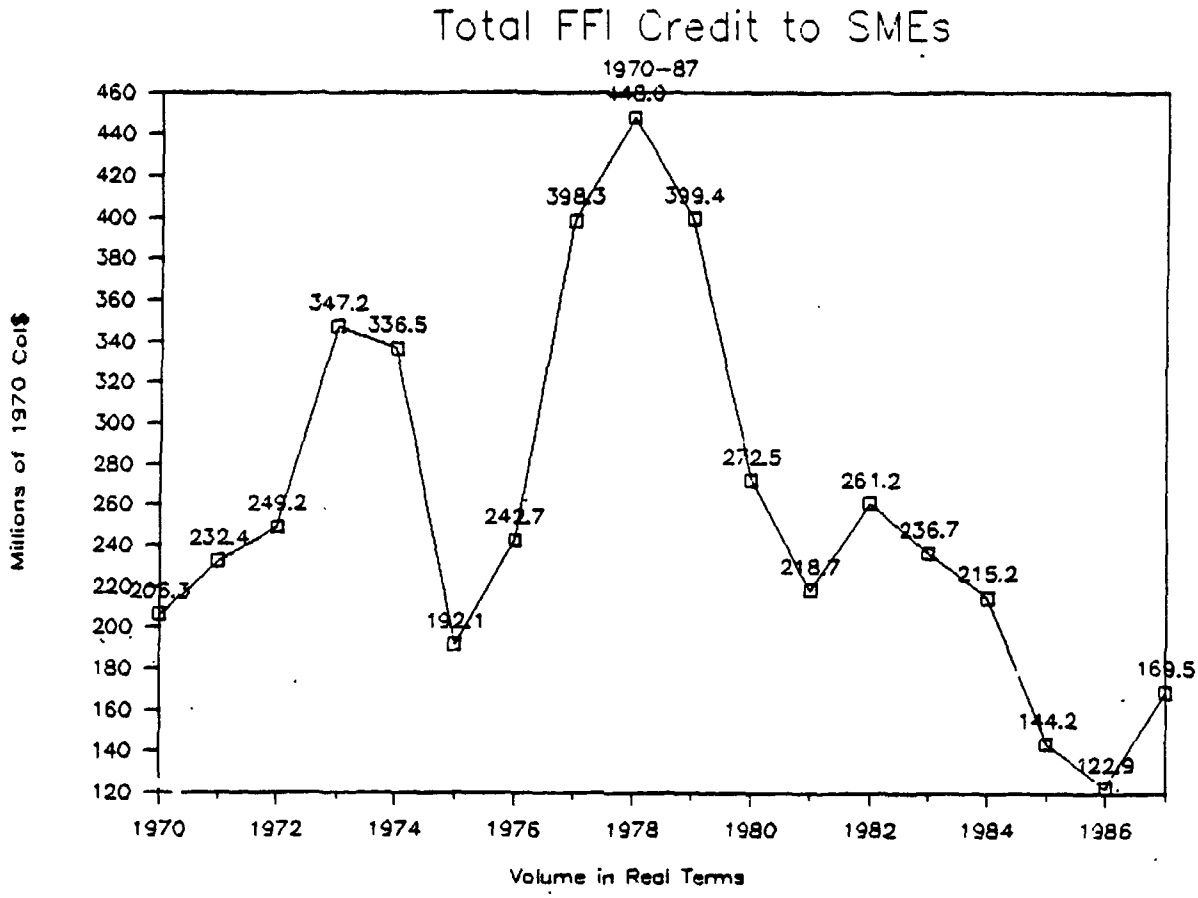
Graph 2.1



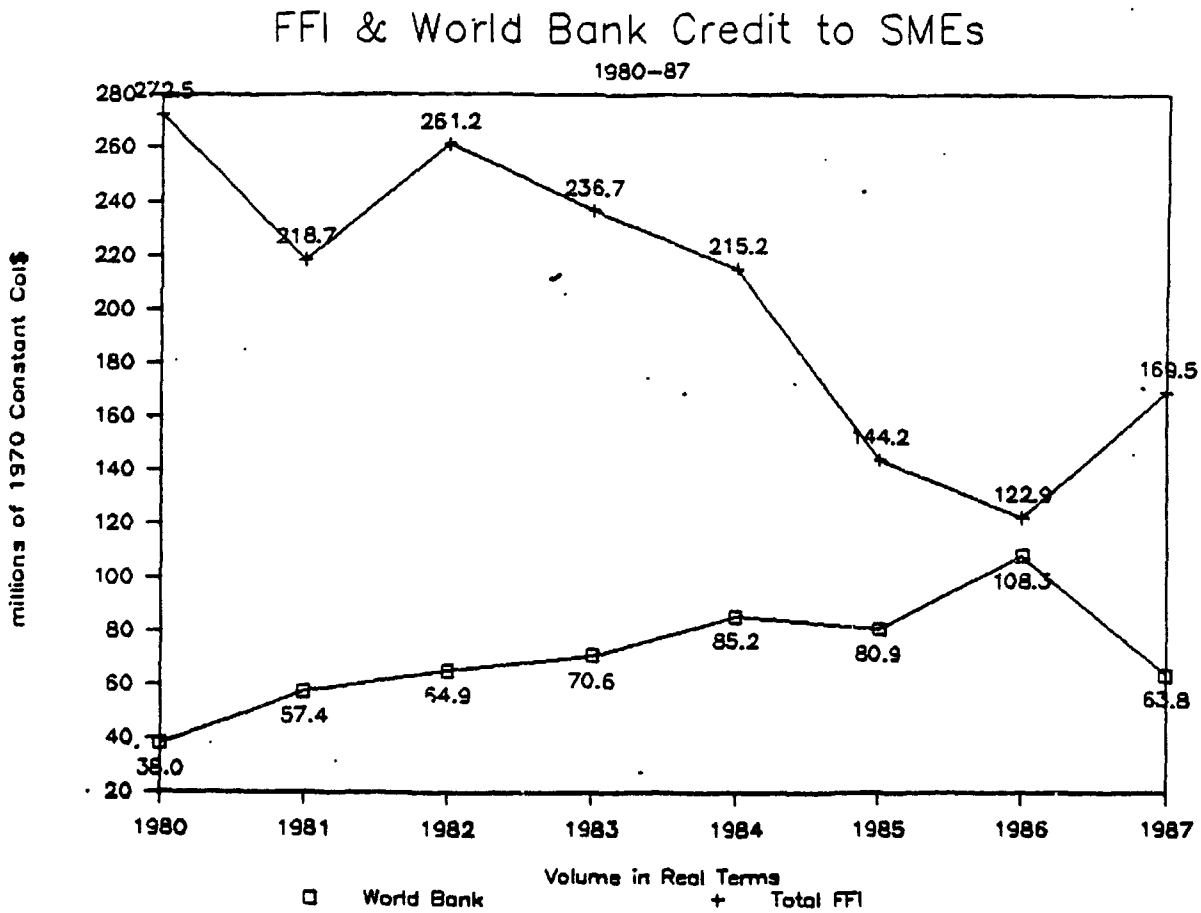
Graph 2.2



Graph 2.3



Graph 2.4



2.04 At the same time, the volume of SME credit provided by formal banking institutions has fallen in real terms almost steadily since 1979 from about Col$850 million annually to under Col$350 million in 1986 (in constant 1970 Col$) to a level lower than that in 1970 (Table 2.2 and Graph 2.1). This decline is likely to have been a consequence of falling SME investment levels during the early 1980s and a decline in their debt service capacity, as well as changes in the financial system---increasing real interest rates, decreasing use of directed credit by commercial banks and CFs, and shifts to larger enterprises which were perceived (in retrospect, probably incorrectly) to be better credit risks. Notwithstanding the overall real decline in SME formal credit, CFP increased the real value of its new lending over 1980-83 and maintained it in an irregular fashion over the course of the preceding Bank-financed project (SME 4, covering 1984-87). Consequently, CFP's lending as a share of total formal banking credit to the SME market nearly doubled over 1980-86 from 34 to 66% and probably continued to grow in 1987 (Graph 2.2).

2.05 Among banking institutions, sources of longer-term funds for SME lending have tended to emanate mainly from the Government's directed credit line, the Industrial Finance Fund (FFI) and the World Bank. The value of FFI resources utilized by these institutions has fallen substantially over 1978-87, to the extent that it was lower in 1987 in real terms than when the FFI was established in 1968 (Graph 2.3 and para. 2.10). Over a similar period, the volume of Bank funds become of comparable importance for SMEs (Graph 2.4). In fact, the maintenance in the real value of CFP's lending, the major user of both sources of funds, was made possible exclusively by the Bank's loan under SME 4. As a consequence, the Bank's share of total CFP outstanding borrowings increased from 41 to 64%.

2.06 Increasing SME Credit Volume and Access. Use of institutional credit from CFs and commercial banks by SMEs is very low, constituting about 0.2% of their total 1987 estimated commitments. It is funded almost entirely by the Government's FFI directed credit facility and is strongly positively correlated with enterprise size. Credit supply to SMEs by these institutions appears, according to interviews during project preparation, to have been constrained mainly by (a) the scarcity of resources in the system, (b) the absence of longer-term maturities of such resources, which are critical to SME lending, (c) the opportunity cost incurred by not lending to large, well-established clients, and (d) a general lack of an active marketing and promotion strategy by most of these institutions. As a consequence, SMEs frequently turn to the informal market or seek no credit at all.

2.07 Nevertheless, CFs and commercial banking intermediaries have the potential to offer the SME market wider access to credit, a broader range of banking services, more efficient intermediation and greater responsiveness to its changing needs. The Government's 1986 tax reform has effectively led financial institutions to seek new market segments and provide new services to sustain growth. By progressively reducing corporate tax rates from 40 to 30% through 1990, and eliminating double taxation on dividends and the deductability of the inflation portion of

interest costs, the reform provides incentives for traditional bank borrowers to reduce the share of indebtedness in their capital structure and increase internal cash generation for investment. Those institutions interviewed consider SMEs to be the next natural market into which to move and one in which enterprises are relatively creditworthy.

2.08 These institutions can help to promote the expansion of SME capacity as well as increases in efficiency of existing capacity. A significant number of SMEs require financial and physical restructuring efforts to enhance efficiency and loan repayment capacity. Specific restructuring exercises are needed to deal with an array of SME problems, ranging from high levels of customer receivables which have diminished working capital, to high debt service aris , partially from informal money market obligations and to more fundamental problems associated with inadequate prior investments and technological obselesence.

2.09 The proposed Project would represent a promotional and transitional step to stimulate increased SME credit volume and lending by private CFs and commercial banks. To this end, the project would offer the following incentives to such institutions: (a) a source of long-term funds approximating short-term deposit rates with no liquidity (short-term refunding) risk (para 3.18); (b) adequate profitability via flexibility in pricing new SME loans according to cost, risk and competition (para 3.19); (c) lower administrative cost via more streamlined administration in the use of domestic directed and Bank credit lines (para 3.11 b) and (d) flexibility in the definition of expenditures eligible to finance workouts of existing non-performing SME loans (para 3.11 c). The following paragraphs of this section discuss the institutional and policy aspects of these areas.

2.10 Directed Credit. The directed credit system in Colombia is funded primarily by forced investments of financial intermediaries, which represent about 15% of commercial banks' loan portfolios and carry substantially negative real interest rates despite the recent rate increases by the Government. Forced investments have been established by law to finance agricultural development, public debt and low-income housing, and by the Monetary Board to finance industrial activities, other housing and to recapitalize the financial sector.

2.11 The system not only promotes fragmentation of financial markets but increases spreads and raises market interest rates, creates barriers to the mobilization of financial resources and distorts factor markets. An analysis of marginal interest rates paid by the industrial sector in 1982 showed that rates exceeded 25% per year in real terms on 60% of its indebtedness while rates of -4 to 8% prevailed for the 23% of the debt originating from the Government's directed credit system. Interest rate differentials, while not as drastic today, persist with average effective commercial lending rates in June 1988 approximating 13% in real terms (43% nominal) alongside effective directed credit rates averaging about 7% (37% nominal).

2.12 Directed credit to SMEs is channelled primarily through the FFI, created in 1968, to rediscount loans made to industrial enterprises with total assets up to Col$140 million (US$467,000 equivalent) to cover fixed asset and incremental working capital needs. While all CFs and commercial banks are eligible intermediaries, in practice three public entities with a central mandate to support SMEs (CFP, Banco Popular and Caja Agraria) utilize the majority of the funds. The remaining FFI resources are utilized by commercial banks and CFs, which so fund nearly all their SME loans.

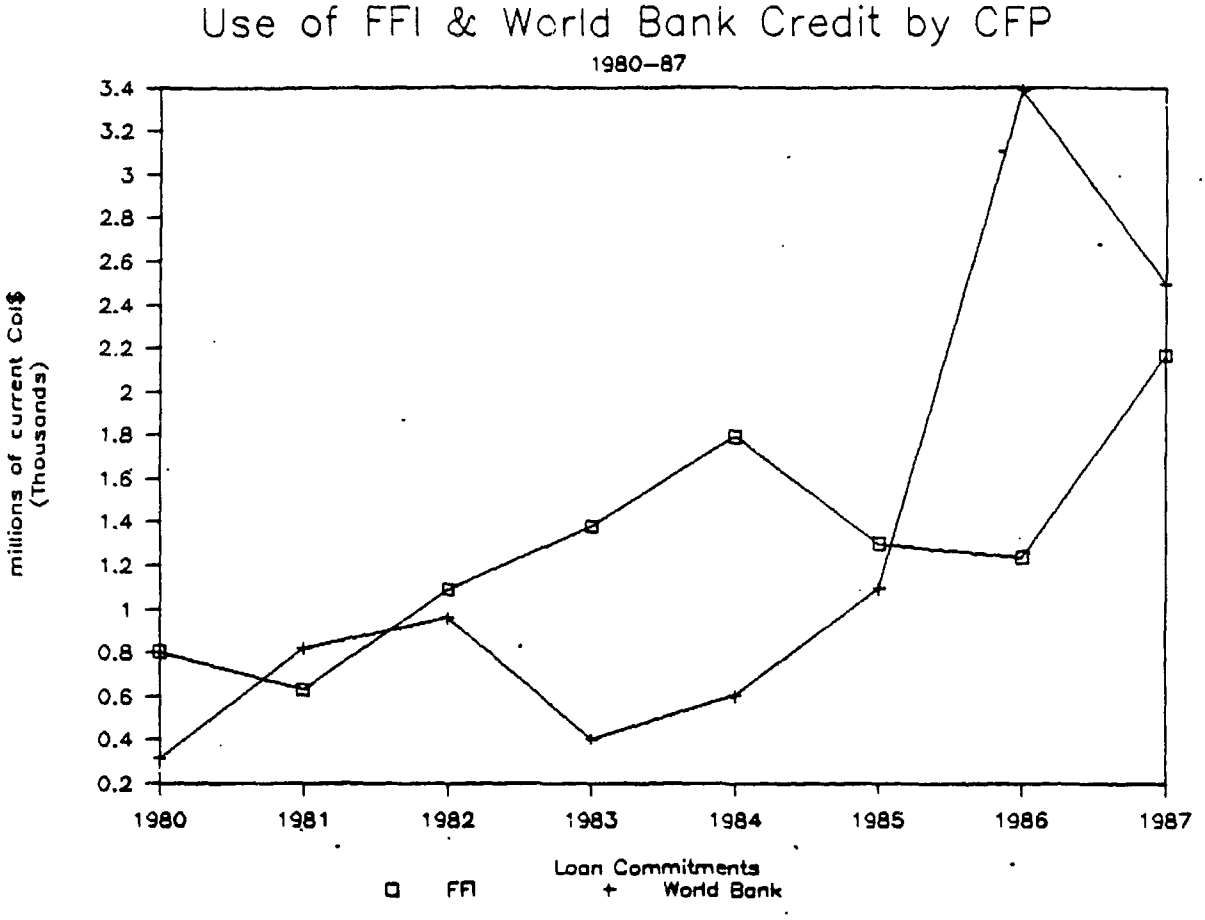
2.13 Commercial institutions have stated clearly that the FFI is not a commercially attractive proposition because of lengthy procedures, documentary requirements and rigid conditions for its use. These necessitate specialized staff, make its profitability marginal at best and thus lead CFs and banks to limit themselves to other markets. One main deterrent to the use of FFI under the present system is the establishment of obligatory enterprise production and other investment-related targets. FFI's focus on increasing output and immediate job creation largely excludes those enterprises which seek funds to reduce production costs and increase productivity without necessarily expanding employment in the short-term. Insofar as increased efficiency is likely to lead to increased product demand, enterprise expansion and employment creation, this narrow focus does not best serve the FFI's own objectives.

2.14 Other aspects of the present FFI system stifle its use: (a) long processing times for subloan applications, as FFI loans must be approved both by the intermediary and BR (CFP reports an average of 107.5 days from application to disbursement, of which 50 days for approval of BR); (b) high administrative costs associated with SME loan processing and supervision, especially for smaller loans; (c) high and costly rejection rates of SMEs' second loan requests under FFI (89% in CFP), due to their ineligibility if they have not met targets under a prior FFI loan; (d) inflexible loan conditions, with maturities of less than 5 years for fixed asset and construction financing, inadequate grace periods and the requirement that firms capitalize within the maturity period an amount equivalent to the loan; and (e) an inability to finance secondhand equipment already used in Colombia.[4] Some of these restrictions (particularly (d)) may place undue financial pressure on SME borrowers and be substantially responsible for the disproportionate share of non-performing assets associated with FFI lending. For CFP, FFI non-performing assets were 41.6% of all CFP non-performing assets, though the FFI portfolio represented only 21.0% of its total portfolio. The figures for Bank-financed loans were 2.2 and 46.2%, respectively.

4/ SMEs less than 5 years old were found, according to Cortes, Berry and Ishaq, to have nearly twice the share of used equipment as older ones. Its cost, possibly one-quarter to one-third that of new, can substantially influence capital requirements and the feasibility of market entry.

2.15 The stagnation in the use of FFI resources reflects widespread discontent by the banking system with these many conditions and administrative requirements. It has also resulted during SME 4 in Bank resources substituting for rather than complementing the use of domestic resources. Over 1984-86, FFI commitments fell on average 19.6% in real terms, commitments of Bank funds grew by 38.7% (the loan was fully committed by September 1987). This follows a pattern in which CFP's use of FFI has been inversely proportional to the availability of Bank funds (see below).

Graph 2.5



2.16 Some progress has recently been made toward reducing the rigidities of FFI. BR has adopted automatic rediscounting for FFI credits up to Col$2 million (about US$6,700), reducing the elapsed processing time for some credits. However, the need to increase substantially access to SME credit and to shift BR's role from ex ante project approval to ex post supervision of the institutional performance of financial intermediaries requires further change as outlined under the proposed Project (para. 3.11 b).

2.17 Administrative efficiency. The administration of SME lending by financial intermediaries and the Bank is also of concern given the already high operating costs of the banking system and the need for simplicity by

SMEs. A study was carried out in 1986 by the SME producers association, ACOPI, of about 150 SME users through CFP and commercial banks around the country.[5] It concluded that an average of 7.5 months was required between credit application and disbursement, undoubtedly influencing the ability of many SMEs to invest, promoting the use of extra-banking market credit and closing off access entirely to some SMEs.

2.18 From the SME perspective, institutional requirements for credit applications themselves represent a serious development obstacle. The study identified some 12 basic documents required for credit applications, which in addition to basic financial data included the tax returns and personal financial statements of principals, social security reports, registrations and certificates related to the Chamber of Commerce, real estate and equipment, banking and commercial references, property valuations, and property and personal life insurance. Collection and presentation of this information took on average about one-third of the elapsed time between loan application and disbursement. Once gathered, processing is frequently hampered by technical staff shortages, centralized decision-making and low priorities accorded (by private commercial intermediaries) to SMEs.

2.19 Some changes to reduce administrative time and expense are underway in these areas. The Superintendency of Notaries and Registration has begun to decentralize and computerize its operations. Requests for banking references have been reduced in favor of credit reference searches through the Bankers' Association, and efforts have begun between intermediaries and BR to seek more unified lending criteria. Further efforts are required, however, as proposed under the Project to streamline credit processing (see paras 3.21 and 3.25).

Technical Cooperation

2.20 More effective technical cooperation (TC) in support of SMEs is needed to help them to increase competitiveness and to reduce credit risk to lenders. The study by Cortes, Berry and Ishaq cited above suggests that entrepreneurs whose skills are limited to production tend do to rather poorly because they find it hard to organize other aspects of the business. Firms with less than 20 workers do participate in general administration and management training. It is freely available, mainly from CFP and the national vocational training service in Colombia, SENA. Larger SME firms, more frequently receive assistance on production issues from SENA, which has a staff of about 60 persons involved in this program nationwide. ACOPI, PROEXPO (the national export promotion agency), and several universities also provide such services. They together provided help, mainly in the form of courses and seminars, to some 2,300 SME participants in 1987.

2.21 Despite this help, however, surveys of SMEs reflect a strong interest in advisory services for individual enterprise problems, particularly in the areas of quality control, bulk purchasing of production

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5/ El Ejemplo Colombiano en la Agilización del Crédito de Fomento a la Pequeña y Mediana Industria. ACOPI 1988.

inputs and product marketing. Individual support is at a premium (only a total of 250 SME received such assistance in 1987), as priority is accorded by SENA and others to their group outreach programs. CFP, in collaboration with local SENA staff, helps to identify TC needs during appraisal and supervision of its SME loans. To help increase the provision of assistance in such areas, the proposed project would support through its financial intermediaries the promotion of expanded distribution services which provide bulk purchasing of production inputs and product marketing for SMEs. It would also finance the cost of private sector consulting services to expand TC for specific production, quality control, and other problems confronting SMEs (para 3.06).

Microenterprises

2.22 A great deal of interest and activity has been generated in Colombia by both public and private business sectors about those who are largely self-employed by forming small informal production units, or microenterprises (entities with fewer than 20 workers). Informal microenterprises probably directly employ about 450,000 people (1975), or as many as the formal industrial sector itself. It is estimated that over one-half are operated by women. Such operators tend to have very modest formal education and lack extensive marketing, business organization or financial management experience.

2.23 Colombia has become a laboratory for local initiatives in support of microenterprises. Non-governmental organizations (NGOs) endowed by the private sector provide a combination of credit, courses in business management and on-site counselling. Among foundations led by the Carvajal Group, training in business administration is a prerequisite for credit to such enterprises. They have been supported since 1980 by credit from the Inter-American Development Bank (IDB), which recently made a US$7 million loan available for this purpose. During 1987, over 1,800 businesses received loans averaging US$1,200 under this project. Results so far, in terms of repayment of loans accorded to graduates of the training program, have been very good.

2.24 The proposed project would seek to complement the IDB's support by orienting assistance through CFP and the Caja Social de Ahorros (CSA), a private bank experienced in lending to microenterprises, to (a) those who have already acquired adequate education and professional experience to establish an enterprise, and (b) those microenterprise groups supported by other NGOs in Colombia. In the former category fall those leaving manufacturing with experience to set up their own ventures and many with post-secondary school training (the largest single category of those currently unemployed in the country). In the latter category fall enterprises backed by organizations such as Solidarity Group, a set of eleven NGOs (including Women's World Banking in Colombia), which operate successful programs providing credit and technical cooperation to enterprises. The proposed program would offer credit on formal market terms to microenterprises benefitting from assistance of these NGOs and would also finance the expansion of the advisory services of such NGOs (see Annex 5).

Overall Policy Environment

2.25 Intervention to reduce capital market failure and to diffuse specialized knowledge in support of SMEs is more productive with a more neutral policy environment in which SMEs and large industries operate. More equal access to economic inputs and to development incentives is also likely to increase the labor-absorbing capacity and competitiveness of industry overall.

2.26 Under Colombia's import regime, difficulties in obtaining raw materials at reasonable prices and quality and in importing capital goods have been frequently mentioned by SMEs in surveys as primary constraints to operations. These increase uncertainty of supply and raise prices of capital goods, production inputs and spare parts for SMEs above those for larger firms (para. 1.17). Other drawbacks for SMEs are frequently found in investment incentives which favor large firms, burdensome registration, tax laws and other regulations which discourage setting up and legalizing SMEs, and large volumes of subsidized and venture capital for heavy industrial development. The proposed Project would support preparation of studies which would analyze the above-mentioned areas and make recommendations as warranted for changes in the policy and regulatory environment influencing the capital intensity of industry, business establishment and operations to help gain a more neutral business environment for SME development (para 3.15).

3. The Project

Relation to the Country Lending Strategy

3.01 The Government's key medium-term development objectives are to sustain economic growth at 4-4.5% per year while maintaining fiscal and monetary discipline; increase export diversification and maintain creditworthiness; and reduce poverty and unemployment. The Bank's country strategy calls for emphasis on project loans with selective support from policy-based operations to help achieve these aims. The Government's 1985-86 Reform Program, supported by two Bank trade-related loans, has led to a relatively satisfactory macroeconomic policy framework in which to pursue this strategy at the sector level. The proposed Project would be an instrument mainly to help reduce policy, institutional, and credit constraints associated with SME development (see Statement of Loans and Credits to Colombia in Annex 1).

Lessons from past Bank Assistance to Colombian SMEs

3.02 Four Bank loans totalling $92.5 million have been made to SMEs in Colombia over the past thirteen years. All have been intermediated by the public development bank established especially to support such enterprises, the Corporación Financiera Popular (CFP). The fourth loan was fully committed in September 1987 and 95% disbursed in October 1988. All of these operations have principally focused upon generating employment and

the development of CFP as a financial intermediary. These project have been successful in stimulating growth in employment and in increasing the quality of CFP's development banking services. They have made very little progress, however, toward reducing the administrative cost of CFP's operations and tackling policy issues influencing SME performance (ref. PPAR No. 2645 for Ln. 1071-CO of 1979; PCR of April 1983 for Ln. 1451-CO; PCR of April 1986 for Ln. 1834-CO, and Annex 2). The experience gained in these projects has inspired more attention under the proposed Project to changes in policy and institutional factors, which are equally important constraints to SME development as the lack of available credit. The Project also places increasing emphasis on raising efficiency and incomes of SMEs, which should also help generate increased employment over the medium-term. In addition, it would focus increasingly on the provision of technical advisory services to SMEs to resolve enterprise-specific production, management and product marketing problems.

3.03 The proposed Project also aims to reverse the trends of declining volume of institutional credit to SMEs and increasing concentration of flows through CFP by expanding the level of SME lending, relying more on private CFs and commercial banks, and introducing a specific component for microenterprises. Continued emphasis would be placed on increasing the capacity of CFP to efficiently intermediate SME credit by promoting a more competitive environment for SME lending. At the same time, to reduce the high share of Bank indebtedness in CFP's liability structure and to stimulate increased domestic market resource mobilization, the Project would provide for limitations on the share of CFP commitments financed by the Bank's loan.

Objectives, Strategy and Beneficiaries

3.04 The development objectives of the proposed Project would be to increase SME value added and employment creation. This would be done mainly by:

(a) making changes in public policies and institutional mechanisms influencing SME access to long-term credit;

(b) expanding the number of financial intermediaries making SME long-term loans and the volume of their own resources mobilized for this purpose;

(c) simplifying loan processing and increasing technical cooperation to SMEs; and

(d) preparing sector-wide industrial studies and recommendations during Project implementation on policies influencing capital intensity, business establishment and operations to help promote a neutral policy environment for SME development.

3.05 The project would be expected to support over its two year commitment period at least 2,500 existing and newly created SMEs and 2,000 microenterprises. Based upon past experience, direct job creation should exceed 14,000 positions, most likely to the direct benefit of the relatively young (about 77 percent of the unemployed in Colombia are 12-24 years of age). Productivity gains reflected in increased wage levels and other improvements in existing enterprises would complement employment creation, and be expected to help alleviate the poverty inherent in low incomes, long working hours and poor health and safety conditions.

Description

Credit Program (total cost, US$ 234.9 million)

3.06 The credit program would support SMEs and microenterprises in manufacturing and associated service sector businesses (e.g., repair shops and spare parts dealers) with total assets of less than US$1.0 million equivalent. The program would finance SME loans or equity investments for the purchase of machinery and equipment, spare parts, construction and/or purchase of industrial building facilities, and permanent working capital needed to increase SME productivity and expand production capacity. It would also finance technical cooperation to expand enterprise-specific support services for SMEs, responding to the expression of many SMEs for help in areas such as production, marketing techniques, organization and management. Such services would also include assistance to identify and adopt solutions to pollution and other environmental hazards being created by SMEs (Annex 3). Such financing would be made available in connection with a PFI's financing of pre-investment work, an SME investment, or in support of the investment itself.

3.07 Structure. All development and commercial banks legally constituted in Colombia would, in principle, be eligible as participating financial intermediaries (PFIs) of the proposed Project. Many are keenly interested in expanding their markets beyond their current exposure to a relatively small number of large clients, consumer finance and credit card operations (para 2.07). Interested intermediaries would be qualified as PFIs upon satisfactory review by BR and the Bank of the following eligibility criteria:

(a) certification by the Superintendency of Banks that the intermediary is in good standing with respect to overall operating policies and practices, financial condition and reporting requirements. The standards of the Superintendency are satisfactory to the Bank for the purposes of the proposed Project;

(b) for CFs, that it meets the operating and financial standards established by the CF Reform Act of 1987, which embrace virtually the same standards as set under past Bank DFC projects. It provides inter alia for a minimum share of long-term loans in a CF's portfolio (50%), a minimum level of capitalization (US$2.1-2.3 million), and a maximum debt/equity ratio (10:1) (Annex 4); and

(c) a satisfactory examination of its organization, staffing, loan appraisal and supervision procedures for SME lending under the Project.

3.08 Seven CFs and six commercial banks have expressed their desire to participate in the credit program, meet the eligibility criteria, and would constitute the initial PFIs: (CFs) Caldas, Del Norte, Nacional, Colombiana, Santander, Suramericana, and Valle; (commercial banks) de Bogota, Cafetero, de Colombia, Comercial Antioqueño, Popular, and Occidente. Their participation, with their 1,300 branch offices throughout Colombia (versus the 17 of CFP), would substantially increase the geographical and numerical coverage of the SME market. They are likely to focus on larger enterprises in the SME market, which tend to have stronger operating, management and marketing skills. CFP would continue to be a principal intermediary under the Project. It specializes in lending to SMEs with less than 20 employees, a market segment highly correlated with labor-intensive industrial subsectors, lower investment costs per job created and SMEs outside major urban areas (Annex 4).

3.09 Each PFI would conclude a Participation Agreement with BR, renewable annually, to protect the rights of the borrower and the Bank and to enable obligations to be carried out per the Loan Agreement. The Participation Agreement would specify inter alia indicative SME loan commitments under the Project, the need to maintain an adequate overall financial condition, employ an adequate number of staff capable of managing the portfolio of Project resources, and ensure proper control and provisions for SME arrears. As a condition of loan effectiveness, BR would conclude and duly execute Participation Agreements with at least three PFIs whose aggregate indicative commitments exceed 40% of the Bank's loan amount and one Managing Institution for the microenterprise program (see para. 3.10). A financial rate of return calculation, market evaluation, technical and management assessments would be prepared for SME loans in excess of $100,000. A cash flow analysis would be undertaken for loans below this threshold. SME loan approvals would require at least an 11 percent financial rate of return.

3.10 Lending to microenterprises under the credit program would be implemented by two Managing Institutions, CFP and the Caja Social de Ahorros (CSA). As second-tier banks, they would appraise the capacity of NGOs, and approve and supervise credit lines to these organizations (Annex 5).

3.11 <u>SME Financial Policies</u>. Under the proposed Project, changes in regulations and management of financial resources destined to support SME investments would be made in order to increase SME credit access and to encourage more diversified participation by CFs and commercial banks as PFIs. Simultaneously, this would support the on-going adjustment process in the financial sector by helping to reduce distortions in resource allocation, adjust the pricing of credit to reflect its cost and associated risk, and upgrade portfolio quality and profitability of those few financial intermediaries which are already significant SME lenders. Agreement was obtained during negotiations on the following policy changes:

(a) Definition of SMEs: increase the enterprise total asset ceiling which constitutes the definition of SMEs from the present US$467,000 (Col$140 million) to US$1.0 million (Col$300 million) and provide for annual corrections according to the full amount of inflation. This step, which became law in December 1988, would just recover the real value of the indicator at the outset of the SME 4 project (Col$100 million in 1984);

(b) Adjustments in FFI Credit Regulations: revise FFI regulations so as to (i) eliminate interest rate subsidies and expand financial margins to PFIs, (ii) extend maturities and grace periods, (iii) expand eligible expenditures to include imported used equipment, (iv) adopt substantially higher automatic rediscount ceilings and simplify documentation to reduce loan processing time and cost, (v) adopt repayment performance as the key ex post monitoring criterion, (vi) relax capitalization and production target requirements, and (vii) eliminate the discretionary bases for cancellation of already approved rediscounts (Annex 6). The implementation of these measures would be a condition of loan effectiveness; and

(c) Restructuring Program: make a provision for a broader definition of eligible expenditures under the credit program for enterprises preparing well-defined restructuring plans aimed to reduce output costs and increase productivity of existing assets of SMEs. Expenditures to be financed via SME loans or equity would include goods and services associated with such items as product research and development, marketing and distribution network development, labor relocation and retraining, and acquisitions where the utilization of capacity is substantially below subsector averages. The Bank's loan would provide a fresh injection of funds for such plans, generally in conjunction with rescheduling, quasi-equity, debt/equity conversions and/or write-offs of existing loans of PFIs (Annex 7).

3.12 Institutional Development. Like many commercial financial institutions, CFP's financial condition suffered considerably during the early years of SME 4 (1984-85) from rising non-performing assets, falling financial margins and high administrative costs. Despite improving performance over 1986-87, this cut into its capital base such that its 1987 debt/equity ratio was 16.7. With capital injections for 1988, it reached 7.5 by year-end. CFP's administrative cost as a share of average total assets for 1988, 6.9%, has not complied with the covenant under SME 4 of 6.0% (ref. Annex 2).

3.13 The proposed Project would establish a financial framework for CFP and the Government, defining the following targets which they would need to meet in order to maintain CFP's eligibility as a PFI: (a) attainment of the 6.0% administrative cost target in 1989 and 5.5% in 1990 under semi-annual monitoring arrangements, (b) attainment of a net after-tax profit/total average assets ratio of 1.0% in 1989 and 1.6% in 1990; and (c) a debt/equity ratio not to exceed 7.5:1 from 1989. BR's rediscounts for CFP using the Bank's loan, while having minimum access to US$25 million, would also be limited to 35% of CFPs total commitments over 1989-90 in order to reduce its high share of CFP's indebtedness (ref. Annex 4).

3.14 Most of the other core PFIs have a limited amount of SME lending experience. Although they generally do not presently maintain separate units within their organizations for such lending, a focal point exists for management of directed credit lines and represents a reasonable starting point upon which to build their Project participation. Each has agreed to designate a specific entity responsible for its SME lending program, allocate specific staff to it, and tailor its lending regulations and procedures as required. Most of the core PFIs, with the exception of Banco de Colombia, tend to rank above the banking system average with respect to overall return on equity, portfolio quality, net capital and institutional efficiency (ref. Annex 4). Given that lending of Project resources is not expected to exceed 1 % of total new loan commitments of these institutions over the commitment period, no explicit conditionality on institutional financial performance is warranted.

Technical Cooperation ($0.2 million)

3.15 Technical cooperation (TC) amounting to US$200,000 would be included in the Project, to be prepared and financed by BR, to assist in preparation of in-depth policy studies. These would be intended to improve the basis for a dialogue with the Government on steps which might be required to modify the regulations and policies influencing capital intensity, business establishment and operations so as to help establish a more neutral policy environment for SME development (Annex 8).

Cost and Financing

3.16 The Project's total cost is estimated at US$235.1 million. This takes into account projections of total SME credit demand for CY1989-91, commitments in principle by PFIs, which are significantly higher than SME 4 particularly in view of the Project's broader network of financial intermediation, the increased scope of enterprise eligibility, and simplification of FFI and other administrative procedures. Of the total cost, US$80 million or 34 % represents direct and indirect foreign exchange requirements. To finance the Project (Table 3.1), SMEs themselves would cover an average of 23 % (US$54.1 million) of total Project cost from internal sources. The proposed Bank loan of US$80.0 million equivalent would meet foreign exchange needs, while financial intermediaries would mobilize an estimated 18% (US$43.7 million), and FFI and other public domestic sources utilized by CFP (mainly PROEXPO) would cover the remaining 25 % (US$57.3 million).

Relending Terms and Conditions

3.17 The proposed Bank loan would be made to BR at the standard variable rate with the guarantee of the Republic of Colombia. BR would bear the explicit risks of interest rate and cross currency fluctuations and pay the standard Bank commitment fee of 3/4 of one % per annum. The loan would be repaid in equal principal installments over 17 years, including a five-year grace period. Any surplus of repayments from SME loans made by the Project's PFIs to BR over amounts due to the Bank by BR would be recycled to PFIs per the Project's legal agreements.

3.18 BR would relend the proceeds of the loan for the credit program. BR would rediscount 80 % of the total SME loan or equity investment amount and charge an interest rate in 1989 equivalent to DTF minus 1 percentage point to CFs and DTF for commercial banks; one percentage would be added to each rate in 1990 and these rates maintained thereafter. The difference between the rates to CFs and commercial banks reflects the lower average cost of funds of the latter, which have substantially greater access to demand and time deposits than CFs. As the DTF rate has over the long-term reflected international interest rates plus expectations of the local nominal devaluation rate, the interest rate risk would be implicitly borne by the PFI and passed on to SME beneficiaries. Maturities of funds relent to PFIs would match those set for SME clients.

3.19 The individual SME loan and cumulative financing limits for any one SME would be US$0.5 million. Maturities of between 4-10 years with 1-3 years of grace would be established for financing of fixed assets, restructuring plans and technical cooperation. Permanent working capital would carry maturities up to a maximum of five years including up to one year of grace. Flexible pricing by PFIs to client SMEs would be encouraged for the credit program by setting interest rates according to the maturity, credit risk, operational cost and competition for each SME loan. However, guidelines would establish an allowable maximum of DTF + 4 percentage points in 1989 and DTF + 5 percentage points from 1990 for SME loans carrying the minimum 4 year maturity. Maximum interest rates to SMEs and the margins of PFIs would be progressively increased for loans with longer maturities, up to an additional one percentage point for maturities of 10 years (Table 3.2). Such rate limits would recognize the probable oligopolistic tendencies in financial markets which drive up rates to beneficiaries. This structure would place the maximum project lending rate to SMEs above the "prime" rate (DTF + 3) to large-scale industrial enterprises, though slightly below average commercial lending rates, and 4-6 percentage points above the effective interest rates of the SME 4 Project. The long-term maturities of the Bank's loan would permit PFIs to compensate higher interest rates with longer maturities when necessary to meet cash flow requirements.

Project Implementation.

3.20 Administration and Oversight. The proposed Project would be administered by BR as the "second-tier" institution. To allow for maximum financial and administrative autonomy of PFIs, its role would be kept to a minimum consistent with accountability for the use of Bank funds. Specifically, it would (a) qualify and supervise compliance with eligibility criteria for PFIs, (b) review rediscount applications above the free limit for PFIs, (c) provide ex post monitoring of SME loan appraisal, supervision and portfolio quality, (d) disburse and account for Project resources, (e) aggregate and analyze Project implementation indicators, and (f) ensure compliance with the Project's Loan and PFI Participation Agreements. BR has an adequate organizational and staff capacity to carry out these responsibilities given in particular its experience in second-tier operations with Bank-financed DFC projects.

3.21 Several steps would be taken to reduce administrative requirements for the Bank's loan in order to reduce cost and elapsed time of SME loan processing for PFIs and to simplify the process for SMEs. The Bank's free limit for ex ante approvals by BR of SME loans would be set at US$400,000, covering an estimated 25 % of the Bank's loan amount. The ex ante free limit set by BR would vary according to the experience of the PFI. BR has established a limit of US$250,000 for CFP and most CFs, $120,000 for less experienced CFs, and US$80,000 for commercial banks. All SME loans and equity investments under the restructuring program would, however, require ex ante approval of BR and the Bank. To monitor portfolio quality, a provision would also be made for tracking by BR of SME loan repayment obligations and performance, and for the right of automatic suspension by BR of a PFI's access to the Project's rediscount facility if performance during a quarter, in terms of recovery of principal and interest due from SME loans, fell below 90 %. BR and Bank supervision of the Project would also make individual reviews of SME credits and the PFI's appraisal and supervision work. Data required by the Bank and BR for SME loans would be simplified to include only the essentials on an SME's financial performance and condition, the proposed investment and financing plan, and procurement of goods and services.

3.22 Procurement and Disbursement. BR would be responsible for ensuring the use of procedures under the Project for procurement of all goods and services aimed to obtain competitive quality and price. Given the relatively small average size of SME loans expected to be financed (about $57,000) and the limit of US$0.5 million in cumulative loans to any single SME, established commercial practices consistent with economy and efficiency would be the standard for this purpose. PFIs would maintain records enabling examination of the procurement procedures used, responses and price quotations received and criteria for selection of suppliers.

3.23 The final date for submission of SME loan proposals to the Bank would be June 30, 1991 and the closing date for loan disbursements would be December 31, 1993 (Annex 9). This takes into account the average disbursement profile for past SME loans to Colombia and the nearly two-year rather than three-year commitment period, which is considered appropriate given the expected increase in SME loan demand occasioned by the factors mentioned in para. 3.16. In view of the present shortage of financial resources, a provision has been made for retroactive financing of up to 10% of the proposed loan ($8.0 million) for SME loan and equity investments commitments incurred following completion of loan negotiations. The provision would be available only following certification by BR and the Bank that the PFI concerned has met the Project's eligibility criteria. Bank funds would be disbursed on up to (a) 80 % of expenditures under qualifying SME loans or investments of PFIs, and (b) 100% under the microenterprise program.

3.24 To facilitate rapid Project execution, a Special Account would be established in BR with an initial deposit of $7 million, representing on average about four months of disbursement requirements. BR would submit to the Bank a monthly statement of transactions of the Special Account.

Withdrawals from the loan account would be made on the basis of statements of expenditures (SOE), with detailed documentation for each SME loan and equity investment maintained by the PFI for review by the Bank upon request. As PFIs would be likely to experience a longer period between expenditures by SMEs and disbursement by PFIs than is normal for non-IDF projects, the Bank would disburse for expenditures incurred up to 180 days prior to the receipt by BR of a disbursement request.

3.25 Accounts, Auditing and Reporting. PFIs would maintain records adequate to reflect their operations and financial situation, in accordance with accounting principles consistently applied and in a form satisfactory to the Bank. They would maintain separate Project records, including for the Special Account, which would be audited annually by independent auditors acceptable to the Bank. Project audit reports, along with copies of financial statements and institutional audit information required by Colombia's Superintendency of Banks, would be submitted within six months after the end of the fiscal year of each PFI. They would include opinions inter alia as to the reliability of SOE to support claims for disbursement and to properly reflect the expenditures eligible for financing under the Loan Agreement. PFIs submitting requests for automatic rediscounting would submit to BR the SME loan agreement, repayment schedule and promissory note. For requests above their free limits, PFIs would submit a description of the SME and its financial performance, an appraisal of the SME investment, goods and services to be financed, the financing plan and terms and conditions of the loan. They would maintain for inspection during supervision work essential information on the SME's investment, financial performance, subloan and procurement characteristics. BR would obtain, aggregate and analyze information on progress of the Project's implementation (Annex 10).

Benefits and Risks

3.26 The proposed Project would help Colombia to realize its current development strategy by accelerating value added, employment creation and the supply of goods and services of SMEs. Previous Bank-financed projects have clearly demonstrated their ability to have a substantial impact in these areas. Under SME 3 (1834-CO), for example, an ex-post evaluation based on a survey 127 borrowers revealed average incremental growth in sales of 26.5% per year, in employment of 13.3% per year, and in labor productivity of 10.4% per year. The Project would also substantially expand access to scarce long-term investment resources to increase productivity, expand installed capacity, and help to revive existing non-performing loans in the banking system. It would make modest adjustments in financial policies influencing SMEs' credit access and help private development and commercial banks to expand their relationships with the SME market.

3.27 The main implementation risk associated with the Project lies in the ability of participating commercial banks to adapt their appraisal, supervision and administrative processes to the requirements of SMEs. To mitigate this risk, they, along with other PFIs, would make clear organizational, staff and financial resource commitments to the Project and participate in staff training courses under the aegis of Colombia's Bankers' Association in order to ensure that their systems are well prepared for SME lending.

4. Project Agreements

4.01 During negotiations, agreement was obtained on the following:

From BR

(a) Project objectives (para. 3.04) and the description of the credit program (paras. 3.06-3.10) and technical cooperation program (para. 3.15);

(b) SME financial policies (para. 3.11)

(c) Project costs, the loan amount and financing plan, and relending terms and conditions to financial intermediaries (paras 3.16-3.19);

(d) implementation arrangements for the Project's administration and oversight (paras 3.20-3.21); and

(e) procurement, disbursement, accounts, auditing and reporting arrangements (paras 3.22-3.25).

From PFIs

(a) CFP: (i) reach a target of 6.0 % of administrative cost as a share of average total assets in 1989 and 5.5 % in 1990, (ii) attain a target of 1.0% of net-after tax profits as a share of average total assets in 1989 and 1.6% in 1990; (iii) not exceed a debt/equity ratio of 7.5:1 from 1989; and (iv) limit BR rediscounts using the Bank's loan to 35% of total annual CFP commitments over 1989-90 (para 3.13); and

(b) All PFIs: a draft Participation Agreement between BR and PFIs which would specify inter alia relending terms from BR to PFIs and SMEs, appraisal guidelines, documentation requirements, minimum SME loan commitment volume, the need to maintain an adequate overall financial condition, employ an adequate number of staff capable of managing the portfolio of project resources, and ensure proper control over and provisions for SME arrears (para. 3.09).

From the Government

ensure that capital contributions to CFP are adequate to keep its debt/equity ratio within the 7.5 target from 1989 (para. 3.13).

4.02 As special conditions of loan effectiveness, (a) the Government would put into effect the financial policies and institutional changes outlined in para. 3.11, and (b) BR would conclude and duly execute Participation Agreements with at least three PFIs whose aggregate indicative commitments exceed at least 40% of the loan amount and with one Managing Institution for the microenterprise program (para 3.09).

4.03 The proposed Project constitutes a suitable basis for a Bank loan of $80 million equivalent on the terms and conditions set out in Chapters 1-3 of this Report.

Table 1.1

COLOMBIA
FIFTH SMALL AND MEDIUM SCALE ENTERPRISE PROJECT
INDUSTRIAL SECTOR GROWTH RATES, 1967-86

	1967-74	1975-79	1980-83	1984-86
Total (excluding processed coffee)	8.60	3.92	-0.13	4.87
Non-durable Consumer Goods	8.18	3.90	-0.34	3.68
Food	7.48	5.01	2.06	3.50
Processed coffee	2.35	13.14	-1.82	6.98
other food products	7.84	6.23	2.45	3.79
beverages	7.91	6.39	1.76	2.15
tobacco	5.90	-3.95	1.19	7.46
Textiles, clothing & leather	9.29	2.36	-5.02	4.19
Durable Consumer & Intermediate Goods	8.21	3.46	0.64	2.95
Wood industries & furniture	4.83	1.53	-0.89	4.91
Paper products & printing	13.70	6.20	0.81	5.88
Chemicals & rubber products	7.67	4.72	0.10	-2.79
Petroleum refining products	8.53	-2.14	5.92	9.74
Non-metal mineral products	6.20	5.43	1.51	5.33
Basic metals	7.74	2.58	-2.33	3.71
Capital Goods	17.10	6.67	-3.47	5.93
Machinery & equipment	11.84	7.16	-2.96	6.08
Transport equipment	27.46	6.14	-4.15	6.28
Other industries	5.46	3.36	3.99	6.72
Light Manufacturing 1/	8.47	4.04	-0.11	4.10
Heavy Manufacturing 2/	8.82	3.77	-0.15	2.64

1/ includes food, textiles, clothes, leather, wood & other
2/ includes paper, chemicals, non-metal minerals, basic metals & capital goods

Table 1.2

COLOMBIA
FIFTH SMALL AND MEDIUM SCALE ENTERPRISE PROJECT

INDUSTRIAL SECTOR SHARE OF GDP, 1967-87

	1967-74	1975-79	1981-83	1984-86
PRIMARY				
Agriculture, Fishing & Forestry	25.2	23.4	22.6	21.8
SECONDARY (INDUSTRY)	28.7	28.6	27.3	29.0
Mining	2.6	1.4	1.3	2.5
Manufacturing	21.7	23.0	21.3	21.3
coffee	3.4	2.8	2.9	3.0
other	18.4	20.1	18.4	18.3
Electricity, Gas & Water	0.8	0.9	1.0	1.0
Construction	3.6	3.3	3.6	4.2
TERTIARY (SERVICES)	43.3	45.5	46.6	46.2
Commerce	11.4	13.2	12.6	12.1
Transport, Storage & Communication	7.7	8.9	9.6	9.4
Financial Establishements	14.0	13.8	14.7	14.3
Communal Services, social & person	12.8	12.3	12.9	13.1
minus Imputed Bank Services	-2.6	-2.6	-3.2	-2.7
VALUE ADDED	97.2	97.5	96.5	97.1
indirect taxes	2.8	2.5	3.5	2.9
GROSS DOMESTIC PRODUCT, MP	100.0	100.0	100.0	100.0

SOURCE: DANE, Cuentas nacional

COLOMBIA

FIFTH SMALL AND MEDIUM SCALE ENTERPRISE PROJECT
SMEs BY 4-DIGIT SITC CLASSIFICATION 1/

SITC	Description	% total sub-sector output	% total SME output
SME Output Exceeding 50% of Total for Subsector			
3113	Canned Fruit & Vegtables	54.2	0.6
3132	Wine	89.8	0.5
Sub-total			1.1
3212	Made-up textile goods	57.0	0.3
3214	Carpets & rugs	52.5	0.4
3215	Cordage, rope & twine	93.9	0.2
3220	Apparel except shoes	86.3	9.1
3221	Apparel except shoes, other	82.4	0.6
3233	Leather products	100.0	0.9
3240	Footwear	59.3	2.2
Sub-total			13.7
3312	Wooden containers	100.0	0
3319	Wood products, n.e.c.	97.7	0.3
3320	Wooden furniture	75.6	1.4
Sub-total			1.7
3691	Structural clay products	59.1	1.1
3723	Precious metal refining	100.0	0.1
3812	Metallic furniture & fixtures	76.5	1.0
3814	Metallic plumbing & heating	60.3	0.4
3822	Agricultural machinery	100.0	0.4
3823	Metal & woodworking machinery	100.0	0.2
3824	Other specialty ind. machinery	100.0	0.6
3825	Office & computing machinery	100.0	0.2
3826	Other non-classified machinery	95.3	0.3
3829	Machinery, n.e.c.	52.4	0.7
3849	Transport materials, n.e.c.	57.9	0.1
3852	Photo & optical goods	76.6	0.1
Sub-total			4.0
3902	Musical instruments	100.0	0
3903	Sporting goods	100.0	0
3904	Miscellaneous ind. products	53.0	1.5
Sub-total			
% Total SME Output			23.2
Average SME Output in Industry		19.0	

SITC	Description	% total sub-sector output	% total SME output
SME Output Amounting to 20-49% of Total for Subsector			
3111	Slaughter & meat preparation	33.2	2.0
3112	Dairy products	33.5	4.3
3116	Grain milling products	35.0	13.0
3117	Bakery products	38.4	3.4
3121	Food products, n.e.c.	22.7	2.3
3122	Animal feeds	22.4	3.0
3134	Soft drinks	23.4	2.8
Sub-total			31.6
3211	Spun & woven textiles	27.3	2.6
3213	Knitting mills	40.0	2.8
3232	Skin dressing and dyeing	23.2	0.1
Sub-total			4.9
3311	Sawmills	42.0	1.1
3419	Paper products, n.e.c.	22.6	0.7
3420	Printing & publishing	28.9	3.5
Sub-total			4.2
3511	Fertilzers & pesticides	28.6	2.1
3528	Miscellaneous chemical products	46.1	0.3
3529	Chemical products, n.e.c.	49.4	1.4
3559	Rubber products, n.e.c.	34.0	0.8
3560	Plastic products, n.e.c.	34.3	5.3
Sub-total			9.9
3621	Other glass products	28.4	0.1
3699	Non-metallic mineral prod., n.e.c.	25.7	1.8
Sub-total			1.9
3722	Tin & nickel refining	32.8	0.1
3813	Structural metal products	29.5	1.2
3819	Fabricated metal products, n.e.c.	27.5	2.4
3827	Non-electrical mach & equip, n.e.c.	26.5	1.3
3831	Electrical industrial machinery	29.8	1.1
3842	Railway equipment	23.0	0.0
3844	Motorcycles & bicycles	33.2	0.4
3851	Prof & scientific equipment, n.e.c.	33.1	0.7
Sub-total			7.1
3909	Other miscellandeous ind. products	38.8	0.3
% Total SME Output			61.1

1/ Using 1985 DANE data and defining SMEs as those enterprises with total assets of less than Col$ 110 million, or an estimated Col$ 300 million in 1989.

Table 1.3

COLOMBIA

FIFTH SMALL AND MEDIUM SCALE ENTERPRISE PROJECT

SME EXPORTS, 1980-86

(millions of US$)

Table 1.4

	1980	1981	1982	1983	1984	1985	1986
Food Products	225.4	151.5	101.4	134.8	109.6	115.3	150.5
Clothing	113.8	114.0	130.7	59.2	39.3	49.5	77.0
Leather	23.5	28.6	32.3	25.1	22.5	38.7	51.9
Shoes	13.3	15.2	19.5	8.0	7.3	11.0	20.3
Wood Products	11.7	13.9	16.9	9.5	6.0	12.7	15.1
Furniture	3.2	4.5	3.9	1.6	1.7	3.8	7.9
Petroleum and Coal Derivatives	6.5	5.9	4.8	2.8	4.4	4.6	10.0
Plastic Products	11.2	11.7	9.2	12.6	11.3	10.3	11.2
Metal Products	46.1	52.7	56.2	28.5	22.1	22.8	26.6
Other	14.4	19.3	19.6	7.0	3.0	5.6	7.9
Total SME Exports	469.1	417.3	393.9	289.1	227.2	274.3	378.4
Large Scale Industrial Exports	479.4	485.5	424.2	367.0	396.5	427.7	496.5
Total Industrial Exports	948.5	902.8	818.1	656.1	623.7	702.0	874.9
Annual Growth Rates (%)							
Total SME Exports		-11.0	-5.6	-26.6	-21.4	20.7	38.0
Large Scale Industrial Exports		1.3	-12.6	-13.5	8.0	7.9	16.1
Total Industrial Exports		-4.8	-9.4	-19.8	-4.9	12.6	24.6
Share of Total Industrial Exports							
Total SME Exports	49.5	46.2	48.1	44.1	36.4	39.1	43.3
Large Scale Industrial Exports	50.5	53.8	51.9	55.9	63.6	60.9	56.7
Total Industrial Exports	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Banco de la Republica. Evolution Reciente de Las Exportaciones manufactureras, May 1987.

COLOMBIA
FIFTH SMALL AND MEDIUM SCALE ENTERPRISE PROJECT

FINANCIAL INDICATORS OF ALL COMMERCIAL BANKS, 1980-87

	1980	1981	1982	1983	1984	1985	1986	1987
1. SOLVENCY								
Total Assets / Equity	10.1	10.3	9.6	10.6	12.7	39.6	10.8	11.2
(Equity + NPA Provisions - NPA) / Equity	1.0	0.9	0.8	0.8	0.6	-0.9	1.3	0.8
2. PROFITABILITY								
Net Profit / Equity	10.1	14.1	5.9	5.7	4.6	-206.8	-3.5	5.6
Gross Financial Margin / Productive Assets	12.5	11.4	11.7	10.1	8.4	7.2	9.2	9.7
Net Financial Margin / Productive Assets	12.2	11.1	10.8	8.7	7.5	-0.3	8.3	8.6
3. RISK MANAGEMENT								
(Arrears + NPA) / Equity	7.0	7.6	11.4	12.4	19.4	20.4	18.2	14.4
(Arrears + NPA - NPA Provisions) / Equity	30.4	38.7	53.7	62.2	115.9	237.7	51.9	41.5
4. OPERATING EFFICIENCY								
Operational Expenditures / Total Assets	4.6	4.3	4.7	4.4	4.5	4.6	4.6	4.5
Operational Profit / Productive Assets	6.0	4.8	3.6	2.6	-0.2	-7.3	0.9	2.6

Source: Banco de la Republica

Table 1.5

COLOMBIA
FIFTH SMALL AND MEDIUM SCALE ENTERPRISE PROJECT

FINANCIAL INDICATORS OF PRIVATE DEVELOPMENT BANKS (CFs), 1980-87

Participants in Bank-financed DFC Projects (9) and Others (15)

	1980	1981	1982	1983	1984	1985	1986	1987
1. SOLVENCY								
Capital + Legal Reserves / Total Assets								
Bank-financed CFs	8.7	8.2	8.7	8.2	7.7	6.9	6.0	5.6
Other CFs	27.8	25.7	13.5	11.7	11.8	13.1	13.6	18.9
Total	11.2	11.0	9.8	9.1	8.7	8.1	7.5	7.7
2. PROFITABILITY								
Net Profit / Capital plus Reserves								
Bank-financed CFs	33.3		18.5	11.5	10.9	15.3	17.5	36.5
Other CFs	13.9		1.9	-0.4	-49.4	-31.8	-2.2	7.9
Total	29.9		13.3	7.8	-9.0	-0.4	10.5	27.0
3. RISK MANAGEMENT								
Non-performing Assets / Total Portfolio								
Bank-financed CFs	0.4	0.9	2.9	2.6	4.3	4.4	3.7	3.1
Other CFs	0.7	1.5	1.7	5.6	15.2	15.4	13.9	10.1
Total	0.5	1.0	2.6	3.1	6.2	6.3	5.3	4.5
4. OPERATING EFFICIENCY								
Operational Expenditures / Total Assets								
Bank-financed CFs	3.2		1.5	1.5	1.6	1.5	1.3	
Other CFs	3.9		1.8	1.9	2.1	1.7	1.8	
Total	3.5		1.6	1.6	1.7	1.5	1.4	

Source: Banco de la Republica

Table 1.6

Table 2.1

COLOMBIA
FIFTH SMALL AND MEDIUM SCALE ENTERPRISE (SMEs) PROJECT
COMPOSITION OF ALL CREDIT TO SMEs, 1980-85

	1980	1981	1982	1983	1984	1985
SOURCES OF FINANCING						
(Percent of Total)						
Internal Resources	51.9	49.7	50.9	52.9	61.0	58.9
Supplier's Credits	9.5	8.2	8.8	17.2	15.5	15.2
Banking Institutions	33.6	34.2	36.9	23.0	16.7	20.8
of which:						
Public Development Bank (CFP)	12.5	12.6	14.0	9.5	4.7	8.6
Private Development Banks (CFs)	4.9	3.8	2.3	1.9	1.5	2.0
Commercial Banks	15.6	17.8	14.6	11.6	10.5	10.2
Informal Money Market	5.0	3.1	6.0	4.4	4.3	3.1 1/
Other	0.6	.4.8	3.4	2.5	2.5	2.0 1/
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0

1/ Estimated

Table 2.2

COLOMBIA
FIFTH SMALL AND MEDIUM SCALE ENTERPRISE PROJECT
VOLUME AND COMPOSITION OF INSTITUTIONAL CREDIT TO SMEs, 1980-87

	1980	1981	1982	1983	1984	1985	1986	1987
BY SOURCE OF FUNDS								
(millions of 1978 Col$)								
Fondo Financiera Industrial (FFI)	272.5	218.7	261.2	236.7	215.2	144.2	122.9	169.5
The World Bank	38.0	57.4	64.9	70.6	85.2	80.9	108.3	63.8
Total	310.5	276.1	326.1	307.3	300.4	225.1	231.2	233.3
(% share of total)								
Fondo Financiera Industrial (FFI)	87.8	79.2	80.1	77.0	71.6	64.1	53.2	72.7
The World Bank	12.2	20.8	19.9	23.0	28.4	35.9	46.8	27.3
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
BY INSTITUTION								
(% share of total funds)								
Fondo Financiera Industrial (FFI)								
CFP	25.1	26.3	32.2	31.7	41.4	32.5	24.0	23.6
Caja Agraria	10.4	11.2	10.7	7.3	6.2	9.7	10.7	NA
Corporaciones Financieras (CFs	16.8	21.8	13.4	12.7	2.3	13.2	23.0	NA
Commercial Banks 1/	47.7	40.7	43.7	48.3	50.1	44.6	42.3	NA
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
The World Bank								
CFP	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Banco de la Republica and CFP
1/ Mainly Banco Popular and Banco de Colombia

COLOMBIA
FIFTH SMALL AND MEDIUM SCALE ENTERPRISE PROJECT

Table 3.1

DETAILED FINANCING PLAN

	1989	1990	Total 89-91	1989	1990	Total 89-90	% Total	% Total
	(in millions of Col$)			(in millions of US$)			SME Investment	Institutional Loans
I. Summary								
Total Financing	36326	54648	90974	107.2	128.0	235.1	100	
SME enterprises	8355	12569	20924	24.6	29.4	54.1	23	
Institutional credit	27971	42079	70050	82.5	98.5	181.1	77	100
of which:								
FFI	7300	9650	16950	21.5	22.6	44.1	19	24
World Bank	10980	20349	31329	32.4	47.7	80.0	34	45
Financial Intermediaries	7456	9260	16716	22.0	21.7	43.7	18	24
Other domestic sources via CFP	2235	2820	5055	6.6	6.6	13.2	6	7

	1989	1990	Total 89-90	1989	1990	Total 89-90	% Total
	(in millions of Col$)			(in millions of US$)			
II. Institutional Credit (A + B)	27971	42079	70050	82.5	98.5	181.1	
A. Corporacion Financiera Popular	13835	18320	32155	40.8	42.9	83.7	100.0
financed by:							
FFI	2300	3600	5900	6.8	8.4	15.2	18.3
World Bank - SME Component	3700	5900	9600	10.9	13.8	24.7	29.9
Capital and local CDT market	5100	5300	10400	15.0	12.4	27.5	32.3
PROEXPO credit via CFP	1785	2250	4035	5.3	5.3	10.5	12.5
Microenterprise Program - IDB	450	570	1020	1.3	1.3	2.7	3.2
Microenterprise Program - WB	500	700	1200	1.5	1.6	3.1	3.7
B. Other Intermediaries' Commitments	14136	23759	37895	41.7	55.6	97.3	100.0
financed by:							
FFI	5000	6050	11050	14.7	14.2	28.9	29.7
World Bank - SME Component	6780	13749	20529	20.0	32.2	52.2	53.6
Subtotal	11780	19799	31579	34.7	46.4	81.1	83.3
Intermediaries own resources	2356	3960	6316	6.9	9.3	16.2	16.7
Indicative Commitments by Intermediaries							
Total	11526	18788	30314	34.0	44.0	78.0	
of which:							
Banks							
Banco Cafetero	509	641	1149	1.5	1.5	3.0	
Banco Popular	848	1068	1915	2.5	2.5	5.0	
Banco de Colombia	848	1068	1915	2.5	2.5	5.0	
Banco de Occidente	848	1068	1915	2.5	2.5	5.0	
Banco Commercial Antioqueno (to confirm)	848	1068	1915	2.5	2.5	5.0	
Banco de Bogota (to confirm)	848	1068	1915	2.5	2.5	5.0	
Subtotal	4746	5978	10724	14.0	14.0	28.0	
Private Financial Corporations							
CF del Valle							
CF National							
CF Suramericana							
CF Colombiana							
CF del Norte							
CF Santander							
CF Caldea							
Subtotal	6780	12810	19590	20.0	30.0	50.0	

Table 3.2
Page 1 of 1

COLOMBIA
FIFTH SMALL AND MEDIUM SCALE ENTERPRISE PROJECT

INTEREST RATE STRUCTURE FOR SME 5

Credit Line:	World Bank				FFI (Directed Credit)			
Subloan Maturity	Min. 4 Years		Max. 10 Years		Min. 4 Years		Max. 10 Years	
Financial Intermediary	CB 1/	DB 2/	CB	DB	CB	DB	CB	DB
Intermediary Rate to SME								
1989	DTF+4	DTF+4	DTF+5	DTF+5	DTF+4	DTF+4	DTF+5	DTF+5
1990	DTF+5	DTF+5	DTF+6	DTF+6	DTF+4	DTF+4	DTF+5	DTF+5
Central Bank Rate to Intermediary								
1989	DTF	DTF-1	DTF	DTF-1	DTF	DTF-1	DTF	DTF-1
1990	DTF+1	DTF	DTF+1	DTF	DTF	DTF-1	DTF	DTF-1
Intermediary's Margin (Percentage Points)								
1989	4	5	5	6	4	5	5	6
1990	4	5	5	6	4	5	5	6

1/ Commercial Bank

2/ Development Bank

STATUS OF BANK OPERATIONS

A. STATEMENT OF BANK LOANS AND IDA CREDITS IN COLOMBIA (as of September 30, 1988)

Loan Number	Year	Borrower	Purpose	Amount Bank	(US$million) (less IDA	Cancellation) Undisbursed
89 fully disbursed loans and one IDA credit				2,536.1	23.5 1/	--
1593	1978	Zona Franca Industrial y Comercial de Cartagena	Industrial Export	14.7		0.1
1725	1979	Interconexion Electrica, S.A.	Power	72.0		2.1
1857	1980	Banco de la Republica	Industrial Cr.	142.0		3.3
1868	1980	Empresas Publicas de Medellin	Power	124.5		9.4
1953	1981	Empresas Publicas de Medellin	Power	85.0		41.8
1996	1981	Instituto Colombiano de Hidrologia	Irrigation	34.3		1.4
1999	1981	Corporacion Electrica de la Costa Atlantica	Power	34.2		6.3
2008	1981	Empresa de Energia Electrica de Bogota	Power	359.0		10.4
2090	1982	Ferrocarriles Nacionales de Colombia	Railways	30.0		0.4
2121	1982	Fondo Vial Nacional	Highways	149.6		6.9
2174	1982	Republic of Colombia	Rural Development	53.0		28.5

1/ Includes exchange adjustment of US$4.0 million.

A. STATEMENT OF BANK LOANS AND IDA CREDITS (as of September 30, 1988)

Number	Year	Borrower	Purpose	Bank	IDA	Undisbursed
2192	1982	Fondo del Ministerio de Educacion	Rural Education	14.0		2.5
2303	1983	Instituto Colombiano Agropecuario	Agricultural Research	63.4		24.0
2349	1983	Carbones de Colombia, S.A.	Coal Exploration	9.5		5.7
2379	1984	Republic of Colombia	Earthquake Reconstruction	40.0		1.3
2449	1984	Empresas Publicas de Medellin	Multipurpose power & water supply	164.5		125.6
2453	1984	Federacion Nacional de Cafeteros de Colombiano	Agricultural diversification	50.0		15.2
2464	1984	Banco de la Republica	Industrial Cr.	40.0		2.0
2470	1984	Empresas Municipales de Cucuta	Water Supply	18.5		11.4
2476	1984	Empresa Colombiana de Petrol	Petroleum	130.0		23.1
2477	1984	Banco de la Republica	Development Banking	90.0		33.2
2512	1985	Empresa Acueducto Alcantarillo de Bogota	Water Supply	129.0		101.0
2551	1985	Republic of Colombia	Trade Policy Export Diversification	300.0		0.5
2611	1985	Republic of Colombia	Health Services Integration	36.5		30.4
2634	1985	Empresas de Energia Electrica de Bogota	Power	171.0		163.0
2635	1985	Empresas Puertos de Colombia	Port Rehabilitation	42.8		29.9
2637	1985	Empresas Publicas Municipales	Water Supply	24.0		13.1
2667	1986	Instituto Colombiano de Hidrologia	Irrigation	114.0		101.0

A. STATEMENT OF BANK LOANS AND IDA CREDITS (as of September 30, 1988)

2668	1986	Fondo Nacional de Caminos Vecinales	Rural Transport	62.0		34.3
2677	1986	Republic of Colombia	Trade and Agriculture Policy	250.0		2.0
2829	1987	Fondo Vial Nacional	2nd Highway	180.3		168.9
2889	1988	Republic of Colombia	Power Sector	300.0		150.0
2909	1988	Caja de Credito Agrario	Caja Agraria	15.0		15.0
2961	1988	Water Supply & Sewerage	Water Supply	150.0		150.0
		TOTAL		6,028.7	23.5	
		Of which has been repaid		1,680.6	7.2	
		Amount sold	51.0	-		
		Of which has been repaid		51.0		
		Total now outstanding		4,297.1	16.3	
		(Exchange Adjustment B-Loans)		.4		
		Total now held by Bank and IDA		4,296.7	16.3	
		Total undisbursed				1,313.7

B. STATEMENT OF IFC INVESTMENTS (as of September 30, 1988)

Fiscal Year	Obligor	Type of Business	Amount in US$ Million Loan	Equity	Total
1959	Laminas del Caribe, S.A.	Fiber-board	.50		.50
1960-1965	Industrias Alimenticias Noel, S.A.	Food products	1.98	.08	2.06
1961	Envases Colombianos, S.A.	Metal cans	.70	-	.70
1961-1968	Morfeo-Productos para el Hogar, S.A.	Home furniture	.08	.09	.17
1961	Electromanufacturas, S.A.	Electrical equipment	.50	-	.50
1962-85	Corporacion Financiera Colombiana	Development financing	6.00	2.02	8.02
1962-1963-85	Corporacion Financiera Nacional	Development financing	6.00	2.04	8.04
1963-1967 1968-1969	Compania Colombiana de Tejidos, S.A.	Textiles	1.98	.15	2.13
1964-1970	Corporacion Financiera de Caldas	Development financing	-	.81	.81
1964-1968	Forjas de Colombia, S.A.	Steel forging	-	1.27	1.27
1966	Almacenes Generales de Deposito Santa Fe, S.A.	Warehousing	1.00	-	1.00
1966	Industria Ganadera Colombiana, S.A.	Livestock	1.00	.58	1.58
1967-70-74 85-86-87	ENKA de Colombia, S.A.	Textiles	18.31	2.61	20.92
1969	Compania de Desarrollo de Hoteles y Turismo, Ltda. (HOTURISMO)	Tourism	-	.01	.01
1969-1973	Corporacion Financiera del Norte	Development financing	-	.45	.45
1969-85	Corporacion Financiera del Valle	Development financing	6.00	.43	6. 43
1970	Promotora de Hoteles de Turismo Medellin, S.A.	Tourism	.23	.11	.34
1970-1977	Pro-Hoteles, S.A.	Tourism	.80	.24	1.04
1973-1975	Corporacion Colombiana de Ahorro y Vivienda	Housing	-	.46	.46
1974	Cementos Boyaca, S.A.	Cement	1.50	-	1.50
1974	Cementos del Caribe, S.A.	Cement	3.60	-	3.60
1976	Las Brisas	Mining	6.00	-	6.00
1977	Promotora de la Interconexion de los Gasoductos de la Costa Atlantica S.A.	Utilities	13.00	2.00	15.00
1977-80	Compania Colombiana de Clinker, S.A.	Cement and Construction Material	0.49	2.24	2.73

B. STATEMENT OF IFC INVESTMENTS (as of September 30, 1988)

Fiscal Year	Obligor	Type of Business	Amount in US$ Million Loan	Equity	Total
1981-85-87	Leasing Bolivar	Leasing	14.00	.20	14.20
1981-1982	Petroleos Colombianos LTd.	Chemicals and Petrochemicals	12.15	3.86	16.01
1983	Frigorificos Colombianos S.A.	Food Processing	1.0	0.54	1.54
1984	Cementos Rioclaro S.A.	Cement and Construction Material	22.47	5.00	27.47
1984-87	Carbones del Caribe S.A.	Mining	14.78	--	14.78
1986	SF/Chucuri	Chemicals and Petrochemicals	--	5.00	5.00
1987	Prodesal	Chemicals and Petrochemicals	6.00	1.18	7.18
1987	Promotora Gasoducto Centra	Chem & Petrochem		.04	.04
1988	Corp. Fin. del Valle S.A.	Dev. Finance	5.00	4.78	9.78
	Total Gross Commitments		145.08	36.19	181.27
	Less cancellations, terminations, repayments and sales		106.38	14.15	120.53
	Total commitments now held by IFC		38.70	22.04	60.74
	Total undisbursed (including participants)		14.10	7.23	21.33

Colombia

Fifth Small and Medium Scale Enterprise Project
Experience Under Past Bank Lending

Introduction

1. Four Bank loans totalling $92.5 million have been made to small and medium scale enterprises (SMEs) in Colombia over the past thirteen years. The first loan of US$5.5 million (1071-CO) was approved in 1975 and represented the Bank's first operation in Latin America for this purpose. Subsequent operations were approved for $15 million in 1977 (1451-CO), $32 million in 1980 (1834-CO) and $40 million in 1984 (2464-CO). The last was fully committed in September 1987 and 95 percent of its funds had been disbursed by September 1988. All of these operations have been principally focused upon generating employment, providing technical assistance to smaller enterprises and upon the institutional development of CFP.

2. All of the Bank's loans have been made to SMEs through the public development bank established especially to support such enterprises, the Corporacion Financiera Popular (CFP). CFP was founded in 1967 to contribute to SME development through the provision of financial and technical assistance. CFP is primarily publically capitalized, with only 2 percent held by the private sector, and its Board of Directors is chaired by the Minister of Economic Development. The organization currently has 376 staff members, of which some 162 are professionals who are well qualified to carry out the CFP's day-to-day operations. The following sections review who has benefitted from these loans and draw some conclusions about their institutional setting from experience with the CFP. Steps under SME 5 to increase the availability of credit and the efficiency in financial intermediation, particularly by CFP, are outlined in Annex 4.

Credit Program

3. CFP has developed a strong capacity to reach and support small-scale Colombian industrialists. The Bank's most recent loan of US$ 40 million under SME 4 was fully committed in September 1987, several months ahead of the December 31, 1987 Commitment Closing Date. This represented a real increase of financial support by CFP to the small business market of about 129 percent over the SME 3 project (1981-83 commitment period) and an expansion in the number of enterprises supported from 1,270 to 2,162.

4. All of the Bank's loans through CFP have tended to cover a similar segment of the SME market. Under SME 4, about 86 percent of the Bank's loan went to enterprises in the "small" category (under 50 employees); nearly two-thirds to enterprises with less than 20 employees and a remarkable 40 percent to enterprises with less than 10 employees. Over

half of loan commitments were to industrial subsectors with moderate to high average labor intensity - apparel, footwear and leather (14.2 percent); wood and furniture products (10.8 percent); metallic products (6.8 percent); food and beverages (20.7 percent). About 26 percent of the loan volume assisted new enterprises, nearly 98 percent produced for the domestic market and slightly more than half of the enterprises were located outside of Colombia's four principal industrial districts of Bogota, Antioquia, Valle and Atlantico. Survey data suggest that investments supported by the SME 4 loan generated about 6,500 new jobs directly at an average cost of some COL$1.3 million (US$ 6,500).

5. The median SME loan amount was about COL$ 6 million (US$ 30,000), with about 25 percent of the loan volume below loans of Col$ 2.5 million (US$ 12,500). Bank funds continued to be used primarily to finance the purchase of machinery and equipment (67 percent), some construction (15 percent) and working capital (18 percent). Subloan terms have effectively softened since SME 3 given a rise in inflation and an extension of average maturities. Real effective anticipated interest rates under SME 4 for fixed asset financing averaged 3.7-5.7 percent per annum (spread depends upon business location), a decline from 7.7 percent under SSI 3. Significant progress was made, however, toward the end of the project with the Government's 1987 reform of interest rates for directed credit. Project rates were pegged to the 90-day bank deposit rate (the DTF) and set at DTF + 1 percentage point, a rise of about 4 percentage points over the SME 3 rate. Meanwhile, maturities of subloans were extended, apparently in response to the effects on SMEs finances of the recessionary years and to the rising level of payment arrears. More than 90 percent of the subloan commitment volume under SME 4 provided repayment of 4 or more years (65 percent under SME 3), and about one-third exceeded 6 years (11 percent under SME 3).

6. These projects have had a measurable effect on the availability of credit for SMEs and on growth in value added, employment creation and the supply of goods and services derived from their investments. An ex-post evaluation of SME 3, based on a survey of 127 borrowers, revealed average incremental growth in sales of 26.5 percent p.a., in employment of 13.3 percent and in labor productivity of 10.4 percent. Less successful, however, has been the effort to develop an autonomous, financially self-sustaining institutional mechanism to serve SMEs.

Technical Cooperation

7. CFP has developed under previous Bank-financed projects a capacity to meet many basic technical cooperation requirements of SMEs. CFP's personnel support the preparation of financial feasibility studies and the provision of basic information for subloans approval. They also provide technical advisory services in different managerial and operating fields for small business. Under SME 4, such services were provided to nearly 1,600 firms and about 530 seminars have been organized by CFP in which some 6,300 industrialists participated.

8. At the same time, these programs have tended not to provide sufficient direct advisory services tailored to individual enterprises, particularly with respect to training in product planning and production techniques, quality control and marketing. Under the proposed Project, therefore, CFP would seek to develop information, mobilize and finance consulting services in such areas for SMEs to draw upon. CFP would also develop a modest feedback and evaluation system to try to better judge the utility and cost effectiveness of technical cooperation programs.

CFP's Operating Capacity

9. CFP has tried under Bank-financed project to improve the efficiency and quality of its operations. Under its 1984-87 Action Plan, for example, CFP revised its operating framework and stepped up staff training in an effort to decentralize its operations to CFP's regional offices. A progressive shift in staff away from headquarters has proceeded slowly, falling from 41 to 37 percent of total staff over the Plan period. There is evidence that subloan processing time over the past two years has been reduced by some 30-40 percent in most cases, and that appraisals and supervision activities have improved in quality as a result. A substantial increase in supervision visits by CFP has also taken place, growing from 1773 to 3056 per year over 1983-87. Information systems appear to have improved significantly with the installation of Bank financed computers and training. Six of 14 regional offices utilize this equipment both for administrative as well as project appraisal purposes. Information systems for accounting records, financial analysis, risk management and the socio-economic statistics generated by subprojects are sound, auditing procedures have been found satisfactory and audit reports have contained unqualified opinions.

10. However, the benefits of these steps have yet to be clearly realized in financial terms. Total CFP administrative costs in terms of average total assets were no lower in 1987 than comparable figures for 1983. Operating cost per project approved and per peso lent were also comparable. By year-end 1987, such costs remained at a high 7.0 percent of average total assets, in violation of the loan covenant under SME 4 requiring CFP to reach a 6.0 percent figure. Such costs are, in fact, in substantially the same range as those under previous projects. The proposed Project, while including further explicit measures to lower CFP administrative costs and increase profitability, thus places the emphasis on developing a more competitive environment in which CFP must operate as the main motivating force for increased efficiency.

CFP's Financial Performance

11. Although CFP's financial performance compares favorably with many Colombian financial institutions, it has been characterized over the long run by low profitability, periodic needs for the Government to replenish its capital base, and heavy reliance on forced investment and external credit lines. During SME 4, CFP's new loan commitments permitted it to maintain the real value of its loan portfolio, though the trend was uneven. It experienced a significant fall in the overall portfolio over 1984-85, at

an average rate of 6.6 percent per year, and a like rebound over 1986-87, both in step with macroeconomic trends. Over this period, CFP sustained net operating losses in each year excepting 1984, which averaged -3.3 percent of total assets. Three factors explain its faltering finances: (a) financial margins fell over the period from 7.4 to 5.4 percent of assets; (b) significant provisions for losses were made in 1986 to recognize the rising trend since 1982 in loan payment arrears; and (c) high administrative costs per peso lent.

12. Margins. The margins between CFP's interest income and its cost of funds has steadily narrowed from 50.3 percent of financial income in 1980 to 27.6 percent in 1987. It had dipped even further in 1986 (24.4 percent), but has rebounded with a fall in the proportion on non-performing assets and the implementation last year of fully variable interest rates to CFP's clients pegged to the DTF rate. The basic trend appears to reflect the rising share of non-performing assets in CFP's portfolio, and to a lesser extent the decline in spread on FFI and on the Bank's loan between SME 3 and SME 4 from 5.0 to 4.5 percent.

13. Arrears. After total arrears had risen steadily over 1980-84 from 8.4 to 16.8 percent of CFP's total portfolio, the proportion receded to 13.9 percent by the end of 1987. By comparison, this indicator for private development banks (CFs) participating in the DFC 9 project, which essentially serves large industrial enterprises, showed sharper improvement over June 1985-June 1987 from an average of 9.1 to 4.8 percent of total loan portfolio. CFP's non-performing assets (arrears over 360 days) fell noticeably over 1984-87 from 9.3 to 7.7 percent (from 4.6 to 2.1 for CFs).

14. As part of its risk management, CFP has implemented recommendations contained in a detailed evaluation by Peat Marwick in 1986 of the probable realizable value of its real property guarantees. It had by end-1987 made provisions to cover the likely shrinkage between their stated and market value amounting to about 41 percent of arrears exceeding one year. The uncovered share of such arrears represented about 75 percent of CFP's net worth at year-end 1987 and will amount to about 28 percent by year-end 1988 with the additional capital injection.

15. Capitalization. CFP's high administrative costs, narrowing financial margins and provisions for high levels of arrears have made deep cuts into CFP's net worth during SME 4. CFP embarked upon SME 4 underpinned by a debt/equity ratio of 4.6, well within the 6.0 target covenanted in the Bank's loan, but fell to 16.7 by year-end 1987. CFP's growth and the maintenance in the real value of its new loans since 1984 was financed almost exclusively by Bank funds, its indebtedness (through Banco de la Republica) jumped from 41.7 to 58.3 percent of its total indebtedness. Its mobilization of domestic term deposits (CDTs) during this period represented only a small fraction of total borrowings (4-5%).

16. The proposed Project would promote better financial performance by increasing financial margins on Project funds, introducing a restructuring program to deal more effectively with non-performing loans, and introducing new semi-annual performance indicators which would need to be met in order for CFP to maintain its access to Project funds (see Annex 4).

ANNEX 3

Colombia

Staff Appraisal Report

Fifth Small and Medium Scale Enterprise Project
SMEs and the Environment

1. Within the industrial sector, a significant segment of SMEs utilize materials which have the potential to pollute and otherwise create hazards for the environment. These are found, in particular, in the canned and preserved fruits and vegetables industry, leather tanning and finishing, and metal finishing where SME production constitutes the majority of value added within these subsectors. It is also relevant where SMEs produce a smaller share of subsector value added (about one-third of the total), in livestock feed, dairy and meat products, grain milling, textile products, fertilizers and plastics.

2. Legislation establishing environmental regulations for industry was first issued as Law 9a of 1979 the "Código Sanitario Nacional". This and later laws (particularly decree 1594 of 1984) regulate the use of water, waste discharges and atmospheric emissions; set standards for drinking water, occupational hazards and industrial safety, food quality control, and also sanitary standards for buildings. The main executing agencies for these laws are EMAR and the Ministry of Health, either directly or through its departmental secretariats and regional health units. However, some regional corporations have the authority to set water standards in their regions. The effectiveness of pollution regulations in Colombia seems to vary according to the type of pollution, the length of time of the legislation and the efficiency of the agency administering the regulations. However, even where enforcement is effective, the penalties for polluting can be well below the costs of installing pollution control equipment. Since the overall legislative and enforcement process does not provide sufficient environmental guidelines for SMEs in Colombia, provisions have been made under the Project for special assistance in enviromental matters to the SME borrowers.

3. Under the proposed Project, technical cooperation would be financed by the Bank's loan inter alia for the purposes of identifying and proposing solutions to environmental hazards created by SMEs. This would include examination of the production process with respect to (a) the storage, use and disposal of any toxic, explosive or reactive chemicals used as raw materials; (b) hazardous by-products and wastes generated; (c) monitoring arrangements for and compliance with environmental laws and occupational health and safety regulations. INDERENA, Colombia's agency which promotes environmental protection, would facilitate such assistance via the interpretation of the existing environmental legislation in Colombia and references to expertise to carry out these tasks.

Staff Appraisal Report

Colombia

Fifth Small and Medium Scale Enterprise Project
Participating Financial Intermediaries

Introduction

1. The public development bank for smaller-scale industrial sector lending in Colombia, the Corporacion Financiera Popular (CFP), has been the sole financial intermediary for the past four SME projects supported by the Bank. As one of the principal objectives of the proposed Project is to increase the access of SMEs to capital via the diversification of sources of credit, CFP is expected in the coming round to utilize about 45 percent of the Bank's loan, or about US$ 28 million equivalent. In contrast with the US$ 40 million Bank loan which CFP intermediated under SME 4, this will represent a substantial reduction in its reliance on external capital and a step increase in the mobilization of domestic capital to finance the growth in its portfolio.

2. At the same time, the number of participating financial intermediaries (PFIs) will be significantly expanded. Seven private sector development banks, or corporaciones financieras (CFs), are committed to join the project and are expected to intermediate about 40 percent (US$25 million) of the Bank's loan. They are qualified to do so and are well known to the Bank, having participated for many years in the Bank's DFC loans for large-scale industry in Colombia. In addition, six commercial banks have expressed their desire to enter the SME credit market as PFIs for the project and are prepared to commit at least the remaining US$ 10 million equivalent.

3. All PFIs are subject to the regulatory framework of the Superintendency of Banks in Colombia. The Superintendency is responsible inter alia for monitoring the procedures, practices, solvency and liquidity of all institutions in the financial system. It exercises this responsibility mainly via (a) its authority to approve the creation, restructuring and liquidation of such institutions, (b) setting regulations and technical norms to meet standards of operation and accountability, and (c) its authority to suspend operations of an institution found to be in violation of its statutes, financial or operational requirements. Facilities are available through the Central Bank to maintain liquidity requirements and, where an institution's financial and operating condition is endangered, the Superintendency has wide latitude to intervene to protect the interests of creditors and maintain its viability.

4. The Superintendency monitors in particular the following financial indicators: (a) reserve requirements, (b) debt/equity ceilings, (c) minimum net worth requirements (defined as at least 50 percent of paid-in capital), (d) delinquent payments (up to one year) and non-performing assets (over

one year), (e) provision requirements for non-performing assets (100 percent of the debt when backed by personal guarantees), (f) the distribution of profits (which require its prior authorization), and (g) the financial accounts reviewed by the fiscal examiners of each institution. It also places limitations on an institution's total loans outstanding, in particular of up to of 10 percent of paid-in capital and reserves in most cases for any single borrower. It further obliges institutions making loans in excess of Col$ 5 million each (US$ 15,000) to consult the central credit reference system in Colombia maintained by the Colombian Bankers' Association before lending to a prospective borrower.

5. PFIs will be required to operate in conformity with the requirements of the Superintendency, as well as to ensure satisfactory organization, staffing, loan appraisal and supervision procedures for the Project in order to maintain their access to Project funds. The following sections highlight any additional eligibility requirements for their participation.

Corporacion Financiera Popular

6. Medium-term Objectives. In the face of the shortcomings in CFP's long run financial performance (see Annex 2), the Government, CFP and the Bank agree that CFP can best serve the smaller business community by adopting a major commitment to become a more efficient and financial autonomous organization which is able to compete with private sector intermediaries in serving the SME market. Under the proposed SME 5 Project, therefore, it is prepared to to give primary emphasis to quality improvements in CFP, mainly via modest loan portfolio growth rates, increased attention to workouts in the existing portfolio, and more administrative streamlining.

7. Since the Bank's appraisal mission for SME 5, CFP is complying with semi-annual targets which aim to compress administrative costs, further accelerate loan recoveries, and increase capitalization. By August 1988, it had recorded a net profit of Col$ 27.6 million against a budgeted loss of Col$ 19.9 million, reduced non-performing assets to 6.6 percent of total assets versus 7.7 percent at the end of 1987, and augmented its capital so as to bring its debt-to-equity ratio to 7.9:1.

8. 1989-90 Program. In the coming two years, CFP aims to (a) expand its new commitments at a pace of 5-7% per year in real terms and diversify the financial services it offers to SMEs, (b) further reduce non-performing loans and assets held in payment for arrears, (c) keep administrative costs under the annual national inflation level, particularly by continuing to reduce the present staffing levels, and (d) increase provisions from profits for non-performing assets. CFP envisions that its lending will continue to be oriented toward small firms, frequently producing goods for lower income consumers, such as in agro-industry, apparel, household goods and construction materials, and metal mechanical products. The following describe conditions, in addition to maintaining its good standing with the Superintendency of Banks, which the CFP must meet in order to maintain its eligibility as a PFI in the proposed Project (see Table 4.1).

9. Capitalization. Capital injections provided and budgeted in 1988 will restore CFP's debt-to-equity ratio to a projected 6.9 at the end of 1988. An additional amount (about Col$ 360 million) is required to ensure that CFP meets the present 6.0 ratio covenanted under SME 4. This will nevertheless be inadequate for the future given the likelihood that no significant profitability can be anticipated from CFP in the short run. The Bank will thus seek during negotiations, as a condition of first disbursement to CFP, confirmation that capital contributions to CFP have been made such that CFP complied with a 6:1 debt/equity ratio. It would also seek to ensure that capital contributions to CFP are adequate to keep its debt/equity ratio within the 6.0 target at December 31 over 1989-90. This is projected to require a total additional contribution of Col$ 2,100 million (US$ 5.5 million) for 1989-90.

10. Borrowing Program. CFP has prepared a medium-term borrowing program which reverses the increasing reliance of CFP upon Bank loans, and increases reliance upon internal resources and the local capital market without increased reliance on the forced investment resources of the FFI. CFP's funding strategy for 1989-90 calls for a decrease in its reliance on external credit lines (34 percent, mainly from the Bank) and the use of FFI (18 percent), a significant increase in the use of its "own" resources (primarily CDTs, equity contributions and loan recoveries, to 32 percent), and maintenance of the level of PROEXPO funds (13 percent). To help ensure implementation of this strategic shift, a ceiling would be placed on the commitment by CFP of the Bank's loan for SME 5 of up to 35 percent of total annual CFP commitments. This would apply within a total allocation to CFP from the Bank's loan of US$ 25 million for SMEs and US$ 3 million for microenterprises.

11. Interest Rates. Interest rates to SME clients for Bank funds under the proposed project would rise by 5 percentage points above the SME 4 Project to DTF + 6, approximating commercial market levels (see Table 4.2). Funds would be provided to CFP by BR at DTF + 1, providing a 0.5 percent increase in spread over SME 4 to help increase CFP's gross financial margins, its profitability and its ability to attract domestic market capital.

12. Administrative Costs. CFP's administrative costs are higher than many other financial institutions given the small firm and SME loan sizes involved. However, there remains scope for cost reductions and increased operating efficiency, particularly through further streamlining of its regional office network, further reductions in overall staff, and a shift in the costly provision of technical cooperation from its own administrative budget to its inclusion as part of SME loans. CFP therefore intends to (i) continue its decentralization program to regional offices while undertaking a review of the financial viability of those offices with low SME loan volumes, (ii) maintain the growth in total staff remuneration within the national inflation rate in the coming two years, and (iii) consider the establishment of a preinvestment financing facility (similar to the Bank's PPF). During loan negotiations, the Bank will seek CFP's agreement to budget for and attain in 1989 the 6.0 percent administrative cost to total average portfolio and to reach 5.5 percent in 1990.

13. SME Loan Restructuring. CFP has organized a team in its headquarters which joins with regional office staff to evaluate specifically the prospects for SME loans in substantial arrears and to recommend liquidation or restructuring. A more explicit and substantial effort is required, however. Thus, under the Restructuring Program of SMP 5, CFP will systematically increase staff resources devoted to workouts for subloans in substantial arrears in collaboration with the preparation by clients, with technical cooperation as required, of restructuring plans which can be supported by the Program. Overall, CFP undertakes to reduce its non-performing assets as a share of total porfolio from a projected 5.9 percent at the end of 1988 to 3.8 percent by end-1990.

Private Development Banks (CFs)

14. Colombia's 24 development banks (corporaciones financieras, or CFs) were established between 1959 and 1975 to provide medium and long term debt and equity financing to private productive enterprises, principally in the industrial sector. They are predominantly Colombian-owned and their shares are relatively widely held among banks, insurance companies and industrial enterprises. Nine of these CFs, accounting for more than half of the system's total net worth, have been beneficiaries of Bank Group financing. Bank DFC lending to Colombia via Banco de la Republic began in 1966 and, to date, nine loans totalling US$ 582.5 million have been intermediated by nine these CFs. They are characterized, in particular, by their specialized focus on the industrial sector and sound loan appraisal and supervision capacity.

15. Recent Financial Performance. These nine CFs are currently performing reasonably well, after consistent efforts since 1985 toward financial recovery in the wake of the international recession of the early 1980s. They have a sound overall capital structures, with an average debt-to-equity ratio in December 1987 of 7.6:1 (see Table 4.3). They have taken advantage, in particular, of financial reform measures to promote increased net worth by expanding equity holdings and the use of convertible bonds. Operational efficiency of the members of this group has been high, particularly in relation to the rest of Colombia's financial system, averaging 1.2 percent of total assets over 1985-87.

16. These CFs have also cleaned up their portfolios, with non-performing assets (arrears over one year) consequently falling over 1985-87 in absolute terms and in relation to total portfolio from 4.4 to 2.1 percent. Nevertheless, CF Colombiana continues to have a significant share of non-performing assets (7.0 percent in December 1987), associated mainly with the cement industry (Samper and Cementos Diamante). However, it has consistently generated profits approximating the modest average for the nine CFs (1.0-1.7 percent of total assets), and is well protected by collateral and bad debt provisions. Non-performing assets less provisions as a share of networth were 33.1 percent in December 1987. Total arrears of CF Occidente also persist at significant levels (5.9 percent of total portfolio in December 1987), though it is more vulnerable than CF Colombiana given lower coverage by provisions. Increased capitalization and more determined workout efforts are underway with the close scrutiny of

17. CF Reform Program. While CFs were intended as primarily long-term lenders and principal users of of BR rediscounts, the inflationary environment and high liquidity preferences of savers has made mobilization of medium and long term domestic resources extremely difficult. In 1975, CFs were given authority to issue short term term deposits (CDTs) to finance the working capital needs of productive enterprises. In practice, this provided an incentive to turn toward the short term end of the market in the absence of longer term instruments, competition from BR's subsidized credit and the higher profitability of CDTs than the spreads offered on rediscount facilities. CFs qualifying for the use of Bank funds have maintained a balance of short and long term loans in their portfolios according to guidelines (at least 50 percent of loans with maturities in excess of one year), though most other CFs have turned almost entirely to short-term credit operations. This has created a duality within the CF system which is clearly manifested in portfolio composition and quality, and in profitability (see Table 1.6).

18. In October 1987, the Government adopted a Reform Program consistent with earlier recommendations by the Bank aimed to reassert the original role of CFs as longer-term financiers and equity investors and to eliminate the duality in the system. It is designed, in particular, to increase CF profitability via the diversification in its markets and financial services. The Reform authorizes CFs to finance marketing cooperatives associated with SMEs, leasing companies, and to develop such services as factoring, underwriting, and enterprise restructuring advisory services. It also stipulates minimums requirements to help strengthen the capital structure of all CFs and an increase in the share of longer-term lending in their portfolios.

19. CF Eligibility Criteria. The Reform established the following three standards which all CFs must meet according to a phase-in schedule over 1988-90:

(a) specialization ratio - at least 50 percent of a CF's operations involving its own and BR rediscount funds must carry maturities in excess of one year;

(b) minimum capitalization of existing CFs of Col$ 700 million (US$ 2.1 million) by 1989 and Col$ 1,000 million (US$2.3 million) in 1990, and for new CFs Col$ 1,000 million; and

(c) a maximum debt to equity ratio of 10:1 instead of 15:1 previously.

These would be adopted as the minimum financial criteria for CFs to be eligible as PFIs under the SME 5 Project. The nine CFs currently participating in the DFC IX Project meet these standards and are among the initial financial intermediaries for the SME 5 Project. Other CFs which desire to participate will be subject to the same criteria.

Commercial Banks

20. The 28 commercial banks in Colombia accounted for 45 percent of the total assets of the banking system. They have a large network of nearly 2,000 branch offices which facilitate access to low cost demand,

savings and time deposits. As these represent about 80 percent (June 1988) of their sources of funds, about 70 percent of their loans also carry maturities of less than one year. These institutions have suffered from a variety of distortions in the financial sector - in particular, the forced investment and directed credit system, differntial interest rate policies - which have negatively influenced efficiency, profitability and capital structure.

21. These underlying problems were clearly exposed by the recession of the early 1980s, when banks had to confront (a) the major repayment problems incurred by their borrowers in the early 1980s, which were hit by the combination of high real interest rates and stagnating demand for their products, (b) the high debt-to-equity positions of many firms in the private sector, and (c) a high portfolio concentration of a limited number of firms and the consequences of relaxed credit standards which had been in use. The resulting financial crisis led to a prolonged deterioration in the system which was not reversed until 1985, and in the meantime led the Government to intervene in several major banks (Colombiana, Estado, Commercio, Tequendama and Trabajadores) in an effort to protect depositors and stem a banking crisis.

22. The profitability as a share of paid capital and legal reserves fell steadily from 30.4 percent in 1980 to negative levels in 1985, while non-performing assets in relation to paid capital and legal reserves rose from 28.5 percent to 189.9 percent. Net capital (paid capital plus legal reserves less non performing assets net of provisions/ paid capital and reserves) fell over this period from 82.5 to -35.2 percent.

23. Since then, net capital and total arrears as a share of total portfolio have returned to their 1982 level (56.8 percent and 13.9 percent, respectively, in June 1988). Debt-to-equity ratios average about 13:1. Eighteen of the 24 banks registered profits in the first half of 1988 and, overall, profitability is slowly returning to positive levels (8.0 percent as a share of paid capital and legal reserves in June 1988), though it remains low due to a continued significant share of non-performing assets (both arrears and forced investments) and high operating costs. Total administrative expenses as a share of total assets averaged 4.8 percent in June 1988 (on an annualized basis). Although non-performing assets have also fallen to an average of 6.6 percent of total assets over the first half of 1988, their level remains of concern and will require substantial further provisions from profits. Capitalization, while it has been a shared effort by the private sector and public programs, is expected to be shouldered in the future mainly by private capital and retained earnings.

24. Six of the banks which make up the initial PFIs rank substantially above the banking average with regard to profitability, net capital, and non-performing assets as a share of total assets (Table 4.4). The financial position of Banco de Colombia is substantially weaker, though it is actively working with the Government within a rehabilitation program and it is considered to be a sound PFI for the Project.

COLOMBIA
FIFTH SMALL AND MEDIUM SCALE ENTERPRISE PROJECT

FINANCIAL INDICATORS OF THE CORPORACION FINANCIERA POPULAR (CFP)

Actual or Estimated 1980-88 and Targets for 1989-90

	1980	1981	1982	1983	1984	1985	1986	1987	1988 Estimated	1989 Targets 6-30	1989 Targets 12-31	1990 Targets 6-30	1990 Targets 12-31
1. SOLVENCY AND CAPITAL STRUCTURE													
Debt / Equity	3.8	4.2	5.0	4.8	4.6	6.2	13.5	16.7	7.5	7.5	7.5	7.5	7.5
Foreign Borrowings / Total Borrowings	46.2	48.6	51.4	51.4	46.6	55.1	64.4	69.7					
World Bank Borrowings / Total Borrowings	33.2	37.5	44.1	45.0	40.9	51.0	60.2	64.4		35.0	35.0	35.0	35.0
Domestic Credit (CDTs) / Total Borrowings						4.4	6.7	5.3					
2. ANNUAL REAL GROWTH RATES 1/													
Loan portfolio	5.5	17.7	19.8	2.4	-11.6	-1.6	3.9	9.4	4.2		6.3		6.7
Total assets	15.4	10.3	24.8	0.2	-10.3	-1.9	-3.6	4.6	2.1		6.3		6.7
Equity	-19.9	0.8	4.5	4.8	-6.8	-11.0	-65.0	-19.8	199.0		6.3		6.7
3. PROFITABILITY													
Net Profit / Equity	7.1	7.3	3.0	2.7	3.3	-9.2	-51.9	-14.5	1.1		4.8		9.6
Net Profit / Total Assets	1.7	1.5	0.5	0.5	0.6	-1.3	-4.8	-0.9	0.2		1.0		1.6
Gross Financial Margin / Productive Assets	9.8	8.0	7.5	7.4	6.2	6.5	5.2	5.4	8.3				
4. RISK MANAGEMENT													
Arrears / Total Portfolio	8.4	9.7	9.2	14.4	16.8	15.5	16.1	13.9			10.0		8.3
of which:													
less than 360 days	4.1	5.7	4.9	7.2	7.5	6.3	6.3	6.2			5.2		4.5
more than 360 days	4.3	4.0	4.3	7.2	9.3	9.2	9.8	7.7	5.9		4.8		3.8
5. OPERATING EFFICIENCY													
Operational Expenditures / Avg Total Assets	6.7	7.1	6.7	6.5	7.1	7.6	8.3	7.2	6.9	6.5	6.0	5.7	5.5

1/ Adjusted by the national accounts deflator for fixed capital formation.

Annex 4
Table 4.1

COLOMBIA
FIFTH SMALL AND MEDIUM SCALE ENTERPRISE PROJECT

Table 4.2

INTEREST RATE STRUCTURE FOR SME 4 AND SME 5

Actual for 1985-88 and Projected for 1989-90

	Mar 85	Mar 86	Mar 87	Mar 88	June	Aug	1989	1990
	Actual						Projected	
Inflation (12-mo YY CPI)	22.8	22.7	20.4	26.3	30.3	29.6	24.0	24.0
Nominal Deposit Rate 1/								
(90-day CDTs)	26.6	25.4	25.7	29.2	29.9	26.9	26.0	26.0
(90-day DTF)	28.9	25.8	26.1	26.6	29.9	26.9	26.0	26.0
Effective Deposit Rate 1/								
(90-day CDTs)	34.5	30.1	30.4	35.3	36.5	32.0	30.8	30.8
(90-day DTF)	35.0	30.6	31.0	34.5	36.5	32.0	30.8	30.8
Foreign Interest Rate (IBRD ir Col$ equiv)	45.1	53.2	34.4	26.1	31.0	33.1	32.1	32.1
Effective Prime Lending Rate (DTF + 3)	39.0	34.3	34.7	39.7	41.0	36.3	35.9	35.9
Average New Loan Rate By Commercial Banks	44.0 2/	39.7	41.0	42.5	43.0	43.1	42.0	42.0
Real Effective Interest Rates								
Deposit Rate	12.2	7.9	10.6	6.2	6.2	2.4	6.8	6.8
Prime Lending Rate	16.2	11.6	14.3	13.4	10.7	6.7	11.9	11.9
Average Lending Rate	21.2	17.0	20.6	16.2	12.7	13.5	18.0	18.0
Effective Margins								
Prime Rate - DTF	4.0	3.7	3.7	5.2	4.5	4.3	5.1	5.1
Average Rate - DTF	9.0	9.1	10.0	8.0	6.5	11.1	11.2	11.2

1/ DTF rate was consolidated with more broadly based CDT rate in June 1988.
2/ Estimated

COLOMBIA
FIFTH SMALL AND MEDIUM SCALE ENTERPRISE PROJECT

INTEREST RATE STRUCTURE FOR SME 4 AND SME 5

Actual for 1985-88 and Projected for 1989-90

	Mar 85	Mar 86	Mar 87	Mar 88	June	Aug	1989	1990
	Actual						Projected	
A. On-lending Rates to SMEs								
SME 4 3/								
World Bank								
Average Effective Rate to 9/87 (DTF + 2 afterward)	32.0	31.3	31.4	37.4	38.4	35.0		
FFI								
Effective Rate to 9/87 (DTF + 2 afterward)	30.8	30.8	30.8	37.4	38.4	35.0		
SME 5 (For loans with a 4-year maturity)								
World Bank (from 1990)								
Effective Rates - Max DTF + 5							38.1	38.1
FFI								
Effective Rates - Max DTF + 4							36.6	36.6
Rates for SME 4 & SME 5 World Bank line (max) Relative To:								
Inflation	9.2	8.6	11.0	11.1	8.1	5.4	14.1	14.1
DTF	-3.0	0.7	0.4	2.9	1.9	3.0	7.3	7.3
Prime Rate	-7.0	-3.0	-3.3	-2.3	-2.6	-1.3	2.2	2.2
Average Commercial Rate		-8.4	-9.6	-5.1	-4.6	-8.1	-3.9	-3.9

3/ Applies to loans for major metropolitan areas

COLOMBIA
FIFTH SMALL AND MEDIUM SCALE ENTERPRISE PROJECT

Table 4.2

INTEREST RATE STRUCTURE FOR SME 4 AND SME 5

Page 2 of 2

Actual for 1985-88 and Projected for 1989-90

	Mar 85	Mar 86	Mar 87	Mar 88	June	Aug	1989	1990
	Actual						Projected	
B. Interest Rates from BR to Intermediary								
SME 4								
World Bank (SME rate - 4.5%)								
Effective Rate to CFP	25.8	25.2	25.2	30.9	31.9	28.6		
FFI (DTF - 2.5 after 10/87)								
Effective Rates	26.1	26.1	26.1	30.9	31.9	28.6		
SME 5 (For loans with a 4-year maturity)								
World Bank (from 1990)								
Effective Rate to CFs (DTF)							30.8	30.8
Effective Rate to Banks (DTF + 1)							32.2	32.2
FFI								
Effective Rate to CFs (DTF-1)							29.5	29.5
Effective Rate to Banks (DTF)							30.8	30.8
C. Interest Rates from World Bank to BR for SME 4 & SME 5 loans								
IBRD Rate in Col$ Terms	46.5	58.4	40.6	34.8			30.8	30.8

COLOMBIA
FIFTH SMALL AND MEDIUM SCALE ENTERPRISE PROJECT

INTEREST RATE STRUCTURE FOR SME 4 AND SME 5

Actual for 1985-88 and Projected for 1989-90

	Mar 85	Mar 86	Mar 87	Mar 88	June	Aug	1989	1990
	Actual						Projected	
D. Effective Margins for Financial Intermediaries								
SME 4								
World Bank								
Margin for CFP	6.2	6.1	6.2	6.5				
FFI								
Margin	4.7	4.7	4.7	6.5				
SME 5 (For loans with a 4-year maturity)								
World Bank (from 1990)								
Maximum Margin for CFs							7.3	7.3
Maximum Margin for Banks							5.9	5.9
FFI								
Maximum Margin for CFs							7.1	7.1
Maximum Margin for Banks							5.8	5.8
E. Effective Margins for BR								
SME 4								
Margin on World Bank Loan	-20.7	-33.2	-15.5	-3.9				
SME 5 (For loans with a 4-year maturity)								
World Bank (from 1990)								
Margin for CFs							0.0	0.0
Margin for Banks							1.4	1.4
FFI								
Maximum Margin for CFs							-1.3	-1.3
Maximum Margin for Banks							0.0	0.0

Annex 4
Table 4.3

COLOMBIA
FIFTH SMALL AND MEDIUM SCALE ENTERPRISE PROJECT

RECENT FINANCIAL INDICATORS OF DEVELOPMENT BANKS (CFs) PARTICIPATING IN SME 5, 1985-87

	1985	1986	1987	1985	1986	1987
	1. SOLVENCY			2. OPERATIONAL EFFICIENCY		
Development Bank -	Debt-to-Equity Ratio			Operational Expenditures / Total Assets		
Caldas	7.0	5.0	6.0	1.6	1.4	1.7
Colombiana	8.7	8.7	7.4	1.3	1.3	1.5
Nacional	8.3	8.1	7.3	1.1	0.9	1.0
Norte	10.7	9.1	8.5	1.4	1.2	1.3
Occidente	11.0	9.2	10.4	1.3	1.4	1.5
Progreso	4.9	3.5	6.7	3.0	2.6	1.7
Santander	7.6	7.0	8.4	1.8	1.8	1.5
Suramericana	7.4	7.5	9.2	1.8	1.4	1.2
Valle	7.7	8.2	7.0	1.6	0.9	0.9
Weighted Average of 9 CFs 1/	8.4	8.0	7.7	1.3	1.2	1.2
3. PROFITABILITY						
	Net Profit / Total Assets			Net Profit / Equity		
Caldas	0.4	-0.2	0.5	2.8	-10.9	3.5
Colombiana	0.7	1.2	1.7	6.0	10.4	12.5
Nacional	1.0	1.0	2.7	8.5	14.2	22.8
Norte	0.4	0.3	0.8	4.2	2.9	7.1
Occidente	0.2	-2.2	-2.5	2.2	-21.8	-28.0
Progreso	0.4	0.4	0.8	2.4	1.9	6.2
Santander	2.4	1.0	1.2	19.3	7.9	10.6
Suramericana	2.0	2.4	2.2	16.2	19.6	22.5
Valle	1.7	2.0	3.2	13.3	10.7	23.6
Weighted Average of 9 CFs	1.1	1.1	1.7	9.1	8.3	13.4
4. RISK MANAGEMENT						
	(NPA - NPA Provisions) / Equity			NPA / Total Portfolio		
Caldas	69.1	30.0	25.2	8.8	6.8	2.1
Colombiana	64.0	41.7	33.1	7.1	7.9	7.0
Nacional	25.7	21.2	7.0	3.0	2.7	0.9
Norte	34.4	18.3	17.6	2.8	1.5	0.9
Occidente	94.0	92.7	55.0	4.3	4.5	3.0
Progreso	55.9	15.3	6.5	1.6	1.4	0.3
Santander	33.3	34.1	21.8	3.5	4.6	2.4
Suramericana	47.3	15.1	5.7	5.9	1.1	1.0
Valle	12.7	8.7	4.6	1.9	1.4	0.7
Weighted Average of 9 CFs	40.5	26.8	17.3	4.2	3.4	2.1

Source: Colombian Bankers Association NPA = Non-Performing Assets (arrears over 360 days)
1/ Weighted by total assets of each institution at December 31, 1987

Annex 4
Table 4.4

COLOMBIA

RECENT FINANCIAL INDICATORS OF COMMERCIAL BANKS PARTICIPATING IN SME 6, 1980-87

	1980	1981	1982	1983	1984	1985	1986	1987	1988 (June)
1. SOLVENCY									
	Net Capital (Paid Capital + Legal Reserves - NPA + NPA Provisions)/(Paid Capital + Legal Reserves) (%)								
Banco de Bogota	96.0	91.8	76.8	47.8	9.4	-8.8	-55.7	-45.4	17.1
Banco Cafetero	59.8	54.2	35.8	-135.3	-5.0	-14.3	21.4	42.5	46.2
Banco de Colombia	76.1	59.6	34.9	28.8	-3883.1	-1796.9	8.6	64.2	73.2
Banco Comercial Antioqueno	99.6	98.6	81.8	72.1	25.3	48.7	47.6	82.9	83.7
Banco Occidente	99.9	99.1	93.7	91.5	779.2	81.8	96.3	96.8	97.4
Banco Popular	72.2	72.8	38.1	-23.7	-116.7	-141.9	-84.4	-33.1	11.6
Caja Social de Ahorros	97.3	92.1	96.6	95.0	97.8	95.8	96.3	96.5	96.5
Weighted Average of 7 Banks 1/	79.4	73.6	53.4	-3.5	-670.2	-437.7	-3.1	29.6	50.8
Weighted Average of 7 Banks (excl Colombia)	80.7	77.8	59.0	-13.3	74.9	-19.6	-5.1	19.0	43.9
2. PROFITABILITY									
	Net Profits / Paid Capital + Legal Reserves (%)								
Banco de Bogota	27.2	29.0	29.1	34.0	18.5	-25.5	47.3	16.9	56.3
Banco Cafetero	29.4	32.9	12.2	1.3	-16.3	-18.9	13.7	18.6	2.6
Banco de Colombia	29.3	33.1	30.9	25.0	-99.1	-12777.8	-72.8	-28.7	-64.9
Banco Comercial Antioqueno	28.8	28.1	29.2	41.7	52.6	86.4	112.0	32.8	69.2
Banco Occidente	62.0	38.3	36.6	29.2	58.4	66.5	54.7	28.7	60.2
Banco Popular	22.8	29.9	17.7	11.2	8.6	12.4	28.2	23.4	15.5
Caja Social de Ahorros	94.6	79.6	56.5	60.6	60.0	69.2	116.1	34.3	62.5
Weighted Average of 7 Banks	32.7	31.1	25.3	21.7	-10.9	-3007.5	15.7	8.6	16.1
Weighted Average of 7 Banks (excl Colombia)	33.7	31.4	23.5	20.4	13.7	10.6	43.0	29.1	33.2
3. RISK MANAGEMENT									
	Non-Performing Assets / Paid Capital and Reserves (%)								
Banco de Bogota	18.3	19.1	41.9	84.4	145.6	223.7	388.2	295.5	157.2
Banco Cafetero	58.4	57.1	86.0	278.0	164.1	178.2	121.6	112.4	96.8
Banco de Colombia	31.2	48.2	77.0	94.0	3700.7	13432.4	477.0	510.9	553.4
Banco Comercial Antioqueno	2.6	5.0	25.2	44.2	104.2	14.9	184.9	184.0	75.9
Banco Occidente	4.7	4.3	11.3	17.4	2.9	22.9	12.1	14.1	5.8
Banco Popular	46.1	47.2	93.6	181.0	317.8	385.5	372.2	288.9	203.6
Caja Social de Ahorros	5.0	10.6	6.4	11.6	9.9	14.0	16.8	16.8	21.9
Weighted Average of 7 Banks	29.2	36.7	63.8	135.9	999.4	3315.5	280.7	254.7	220.6
Weighted Average of 7 Banks (excl Colombia)	28.5	33.1	59.7	148.7	162.2	189.9	219.6	175.2	117.6

Source: Colombian Bankers Association

NPA = Non-Performing Assets (arrears over 360 days)

1/ Weighted by total assets of each institution at December 31, 1987

Staff Appraisal Report

Colombia

Fifth Small and Medium Scale Enterprise Project
Microenterprise Program

Introduction

1. Microenterprises are estimated to involve about 40 percent (4.6 million people) of the economically active population in Colombia, in particular those who are in the lowest income segments in society. Some 500,000 urban and 500,000 rural microenterprises operate across the country, which are basically small income-generating units owned and managed by entrepreneurs, frequently employing other family members, and usually include no more than a total of 20 workers. About 40 percent of such enterprises carry out production-oriented activities, which are heavily domestic resource-oriented, while another 40 percent are commercial entities and the remainder are service-oriented.

2. Private sector support for microenterprises is readily identifcable since the late 1970s, while the Colombian Government has focused explicitly on them in its development policy-making since the mid-1980s. The Government's basic aim is to increase the net income of microenterprises and the overall socio-economic well-being of families depending upon these units. In the current second National Microenterprise Development Plan (1988-90), coordinated by the National Planning Department (DNP), the strategy has shifted from promoting employment creation to increasing productivity of existing enterprises by (a) expanding channels for financial and technical assistance and aiming to progressively set the stage for relationships with formal credit market, (b) focusing on particular constraints, such as materials supply, product marketing, and the acquisition of appropriate technologies, and (c) mobilizing an increased levels of savings. Consideration is also being given to whether the legal and regulatory framework should be modified to promote a more neutral business environment.

NGO Support for Microenterprises

3. Advantages. One of the main steps distinguishing the Government's second Plan for microenterprises from the first is its aim to expand the number of non-governmental organizations (NGOs) affiliated from 14 to 37. Specialized NGOs are better adapted to supporting microenterprises than most formal banks. They entail a lower level of complexity, bureaucracy and transaction costs, thus reaching microenterprises with modest budgets and overheads appropriate to the small scale of loans to microenterprises.

They maintain direct contact with such enterprises, often have unparalleled knowledge about their needs, and can develop solid relationships with them. They are in general also better equipped to promote local participation, to spur the use of low-cost technologies, and can induce savings through their programs.

4. Models of NGO Support in Colombia. Two main models of NGO support for microenterprises have emerged in Colombia. The traditional Carvajal model, buoyed by a network of private foundations in 24 cities around the country, has been the central approach to microenterprise development during the first half of the 1980s. It focuses on those microenterprises in business for at least two years, on substantial training (particularly in business administration) as a prerequisite for credit, and on continuous follow-up technical assistance. This approach has tended to support those microenterprises which have already attained some strength and size in production-oriented activities, and the more successful microentrepeneurs with modest levels of education and an ability to pay for the training. Credit is subsidized (23% per annum vs commercial rates exceeding 40%) and collateralized generally by a personal guarantee or mortgage. Default rates of the credit programs are as low as three percent.

5. An alternative, achieving growing recognition in recent years and highlighted in the Government's second Plan, is that of the Solidarity Group in Colombia (Asociacion Grupos Solidarios de Colombia). It tends to focus on microenterprises in lower income strata than the Carvajal model and to stress easy, timely credit in small amounts without high transaction costs or substantial training as a prerequisite. Since 1983, this program has been supported by Accion International/AITEC. Accion maintains an agreement with Solidarity for 1987-90 to provide financial support of about US$480,000 for local staff, design and production of training materials, and for training workshops.

6. The core of Solidarity's programs is the provision of credit at rates approximating market interest rates (about 36%). This covers the operational costs of the NGO and is backed by group guarantees. The average default rate of such programs is 0.8%, lower than those with subsidized credit. Training programs are, however, provided free of cost. They vary from two mandatory introductory sessions on credit and accounting to more emcompassing issues of basic business management. The success of the program is derived largely from careful screening of microenterprises and from monitoring and evaluation. Progress workshops serve, among other things, as means of regular personal contacts between staff and microentrepreneurs and as early warning mechanisms to detect problems.

Microenterprise Program under SME 5

7. Objectives. The basic objective of the Program is to increase microenterprise income, improve record keeping, workshop productivity and

product diversification. The Colombian foundations using the Carvajal model have been and are currently receiving considerable assistance from the Inter-American Development Bank (IDB) in this field. The SME 5 Project seeks to complement this effort by providing support for those NGOs who are not participating in the IDB program but have proven to be successful without the use of credit subsidies and mandatory training services. The Program's design, as described below, would basically aim to minimize administrative costs to microenterprises and provide adequate protection to lenders.

8. Second-tier Banking Institutions. Responsibility for managing the Program on behalf of the borrower for the project, Banco de la Republica (BR), would be the Corporacion Financiera Popular (see Annex 2 of the SAR for a description) and Caja Social de Ahorros (CSA). CSA has the motivation, organization and experience to carry out this work. It has a large branch network which appears to operate efficiently in this field. CSA has worked out an effective relationship with microenterprise borrowers and is able to do so with low administrative costs. The CSA's record in debt collection is excellent.

9. Management of the Program by the two institutions would basically entail (a) qualification of NGOs, (b) setting guidelines agreed with the NGO for microenterprise selection, approval and supervision, (c) quarterly reviews of proposed lending programs, (d) quarterly tranche disbursements, and (e) repayment monitoring. They would not duplicate the accounting systems, approval process for each loan and the large number of transactions of participating NGOs. Safeguards against loss to these institutions would be maintained by establishing a specific recovery rate (90% of interest and principal obligations due), below which they would have the right to suspend all lending activity to the NGO, and the collective guarantees of participating microenterprises. These would be supported by an information system to track NGO portfolio performance and by two introductory credit and bookkeeping orientation sessions for microenterprises in which there was an absence of a basic accounting system in place. Second-tier institutions would supervise on a sample basis the performance of NGO loans to microenterprises.

10. Participating NGOs. Under the Program, NGOs would basically act as (a) financial intermediaries, (b) suppliers of technical knowledge to local beneficiaries, and (c) cofinanciers of microenterprise projects. NGOs would do all the selection, appraisal, approval, monitoring and supervision work for such loans, which would be supported financially by their own fees to clients. The following types of NGOs would be eligible under the Program:

(a) associations, partnerships, cooperatives with more than ten members in the same subsector, and other entities registered with the second National Microenterprise Development Program with objectives to promote microenterprise development through credit, training and technical assistance; and

(b) trading companies operating solely for the provision of inputs for and product marketing of microenterprises, and which are also associated with the second National Microenterprise Development Program. Such companies may also provide technical assistance for product design, quality control, packaging and related issues.

Those qualifying under the current IDB project, insofar as its credit remains available for commitment, would not be eligible under this Program.

11. Subject to the conclusions of an evaluation currently underway, NGOs belonging to the Solidarity Group are expected to be the main participants in the Program. Its members have progressively increased from five (Corporacion Accion por Antioquia, Cooperativea Multiactiva de Dessarrollo Social, Fundacion Familiar, Fundacion Banco Mundial de la Mujer, and Corporacion Fondo de Apoyo de Empresas Asociativas) to eleven. The microenterprise programs of Solidarity currently reach about 15,000 direct beneficiaries, of which about 60% are women, and about 40,000 indirect beneficiaries. About 40 percent are enterprises with a few individuals which accumulate small amounts of capital, mainly in manufacturing operations producing clothing, food products, leatherworks, handicrafts and repair activities. Another 20 percent of its enterprises are larger manufacturing operations with up to 10 employees. Loans for fixed assets range from US$400-1,000 for up to 2 years and for working capital average US$100 for 1-6 months. Savings by clients of 0.5-1.0% of the loan amount per month is compulsory, and forms a pool for a guarantee fund for loans and for emergency loans. The savings of about 5,000 active microenterprises totaled US$107,500 in May 1988 ($21 per person versus an average loan of $95), and total savings of the Solidarity Group amounted to US$245,000.

12. The Women's World Banking (WWB) program in Colombia, as one example of the NGOs affiliated with Solidarity Group, began in 1982 based upon analyses that credit, training and consultancy services were the most pressing needs of women as well as men microentrepreneurs. It has three affiliates in Colombia and is supported by the headquarters of WWB in New York. While its operations are directed primarily at women working in microenterprises, 27% of its beneficiaries were men as of June 1988. Its main aims are to facilitate access of such enterprises to credit, create employment and incorporate Colombian women and their families into the formal national economy. Through the Solidarity Group program, it has to date reached 650 women and 324 men in 277 active groups with working capital credits from US$ 17-670 each with interest rates of 3% per month for 2-6 months. Loans are collateralized by the guarantee of a group of a minimum of three potential beneficiaries. WWB also has other activities, such as the credit card program and several individual credit programs for fixed assets (up to US$ 1600 for 12 months), women starting new microenterprises and domestic calamities. These are supported by training and close contact with borrowers.

13. NGO Evaluation Criteria. Other NGOs can become eligible to participate as financial intermediaries during the implementation of the Program, subject to confirmation by the World Bank, if they meet the following criteria:

(a) socio-economic objectives consistent with the overall objectives of the SME 5 Project and an absence of conflicting political, religious or other aims;

(b) regional or national scale of support for microenterprise development, as shown in the trends in the numbers, coverage and success with microenterprises served;

(c) a demonstrated ability to design activities which can be subsequently sustained by beneficiary communities;

(d) managerial and technical capacity adequate to satisfactorily intermediate the Bank's resources under the Microenterprise Program, particularly with respect to its organization and field staff used to identify, select, appraise and supervise microenterprise borrowers;

(e) a sound repayment record of credits offered to date, and adequate accounting and information infrastructure to provide early warning of non-payment; and

(f) adequate fee income, spreads and financial reserves in relation to administrative costs and credit risk; and

(g) a significant level of funding of microenterprise investments by enterprise owners, the NGO itself and possibly local private banking sources, and an absence of heavy dependence on official sources.

14. Financial Terms and Conditions. The Program would be financed by the World Bank's loan for the SME 5 Project up to US$ 3 million. Microenterprise loans would reflect the full cost associated with the provisions of these funds: (a) the cost of World Bank funds channelled from BR to the second-tier intermediary at DTF-1% point in 1989 and DTF from 1990, (b) the administrative cost and risk to the second-tier intermediaries, and (c) the intermediation cost of the NGO. They would carry maturities of up to 36 months, with up to 3 months of grace and quarterly amortization. Participating NGOs would bear the credit risk of microenterprise loans. The Bank's loan would be limited to 40% of the total prior year's lending program of qualifying NGOs in order to ensure the mobilization of other (particularly local private) sources of support.

15. The following expenditures would be eligible for 100% rediscount by the Program:

(a) fixed assets, working capital and technical assistance requirements of microenterprises financed by the NGO loan; and

(b) technical assistance to strengthen the capacity of NGOs to provide credit and technical assistance, in such areas as staff training, data managment systems, monitoring and evaluation of development programs.

16. Second-tier banks would carry out supervision visits as deemed necessary and NGOs would be required to provide quarterly reports on the condition of the Program's portfolio, semi-annual statements of overall financial condition, and annual audited financial statements.

17. Procurement of fixed asset requirements would be by local shopping or direct contracting as appropriate. Statements of Expenditures prepared and certified by the NGO would constitute acceptable documentation for disbursement purposes. Separate accounts would be kept by the second-tier institution and NGO for the Program and audited by independent auditors acceptable to the Bank.

Staff Appraisal Report

Colombia

Fifth Small and Medium Scale Enterprise Project

A. Terms and Conditions of Colombia's SME Directed Credit Line
The Fondo Financiera Industrial (FFI)
(mm = millions)

	Existing FFI	Proposed FFI
1. Enterprise Eligibility		
(a) Maximum total assets	Col$140 mm (US$467,000)	Col$300 mm (US$1 mm)
(b) Minimum investment by SME	20% of total (existing) 30% of total (new)	Identical Identical
(c) Minimum equity	30% of total assets	Identical
2. Maximum SME Loan	Col$70 mm (US$0.23 mm)	Col$ 150 mm (US$0.5 mm)
3. Explicit Exch.Risk to SME	No	No
4. Eligible Expenditures	New Imported Fixed Assets (F.A) New Local FA Increm & Free-standing WC	Identical Used Imp FA Identical Identical
5. Terms BR to PFI	DTF-2.5% (3 main cities) DTF-4.5% (other areas) Maturity & grace same as SME loan 85-90% rediscount	DTF-1 (CFs) DTF (Banks) DTF-1 (CFs) DTF (Banks) Identical 80% rediscount Remaining 20% of SME loan amount from PFI with min 4-yr maturity

Terms and Conditions of Colombia's SME Directed Credit Line
The Fondo Financiera Industrial (FFI)
(mm = millions)

	Existing FFI World Bank	Proposed FFI FFI
6. Terms PFI to SME	DTF+2.0 (3 main cities)	DTF+4.0 max for 4 yr. loan, up DTF+5.0 max. for 10 yr. loan
	DTF+0.5 (other areas)	Same as above
	Fixed assets up to 5 years maturity & grace set case-by-case	Fixed Assets - 4-10 yrs maturity & 1-3 yrs grace
	Perm & free-standing WC max 3 yrs & up to 6 months grace	Maximum 3 yrs. and up to 1 yr of grace
7. Administration BR to PFIs		
(a) Automatic rediscount	All: Col$2 mm (US$6,700)	By class: 1 CFs & CFP Col$83 mm (US$250,000) 2 CFs Col$41 mm (US$120,000) 3 CFs & Bks Col$ 27 mm (US$80,000)
(b) Ex Ante Auto Redisc't Info requirements	Detailed credit application form	1-page credit Standard rediscount request Promissory note
(c) Financial Analysis employed	Cash flow max US$0.25 mm IRR over US$0.25 mm	Cash flow max. US$0.1 mm IRR over US$0.1 mm
(d) Ex Post Monitoring	Production targets	SME repayment of at least 90% due Semi-annual BR supervision visits

8. Capitalization Required	Above 70/30 debt/equity, 100% of SME loan amount within maturity of loan	Above 50/50 debt/equity, 100% of SME loan amount within maturity of loan
9. Production Targets	All loans subject to BR investigation & disqualification of 2nd loan requests if production	If working capital component in excees of 20% of SME loan, production below targets triggers investigation by BR.
10. Cancellation of approved rediscount	At discretion of BR	According to 5 basic criteria only (i) SME in excess of total asset ceiling and outside sector definition; (ii) minimum equity less than 30% of total assets at time of SME loan approval; (iii) less than 20-30% of investment financed by SME; (iv) SME loan proceeds not used for proposed investment; (v) inaccurate information supplied in loan documentation.

Comparative Terms and Conditions for
B. Proposed World Bank and Fondo Financiera Industrial Credit
(mm = millions)

	World Bank	FFI
1. Enterprise Eligibility		
(a) Maximum total assets	Col$300 mm (US$937,000)	Identical
(b) Minimum investment by SME	20% of total (existing) 30% of total (new)	Identical Identical
(c) Minimum equity	30% of total assets	Identical
2. Maximum SME Loan	US$0.5 mm	Identical
3. Explicit Exch.Risk to SME	No	No
4. Eligible Expenditures	Imp. FA, dir/indir & new or used New Local FA Perm WC Technical Cooperation Restructuring Plans Microenterprises	Identical Identical Identical Free Standing WC
5. Terms BR to PFI (for minimum SME loan maturity of 4 yrs.)	1989 DTF-1% (CFs) DTF (Banks) 1990 DTF (CFs) DTF+1% (Banks) Maturity & grace same as SME loan	Identical Identical DTF-1% (CFs) DTF (Banks) Identical
	80% rediscount	Identical
	Additional 20% of SME loan amount from PFIs with maturity same as rediscount amount.	Identical

Comparative Terms and Conditions for
Proposed World Bank and Fondo Financiera Industrial Credit
(mm = millions)

	World Bank	FFI
6. Terms PFI to SME (for minimum SME loan maturity of 4 yrs.	1989 DTF+4.0 max (CFs)	Identical
	DTF+4.0 max (Banks)	Identical
	1990 DTF+5 max. (CFs)	DTF+4 max (CFs)
	DTF+5 max (banks)	DTF+4 max (Banks)
	Fixed assets & rest. 4-10 yrs maturity & 1-3 yrs grace	Identical
	Permanent W.C. max 5 yrs maturity max 1 yr grace	Perm & free-standing working capital max 3 yr. maturity max 1 yr. grace
7. Administration		
(a) Automatic Rediscount		
WB to BR	Max US$0.40 mm	
BR to PFIs By class:		
	1 CFs/CFP US$0.25 mm	Identical
	2 CFs US$0.12 mm	Identical
	3 Cfs/Bks US$0.08 mm	Identical
(b) Ex Ante Rediscount Information Required	1-page credit info Standard redis't apl Promissory note	Identical
(c) Financial Analysis	Cash flow max US$0.1 mm	Identical
	IRR over US$0.1 mm	Identical
(d) Ex Post Monitoring	SME repayment of at least 90% due	Identical
	Semi-annual BR supervision visits	Identical
8. Capitalization Required	None	Above 50/50 debt/equity,
	100% of SME loan amount within maturity of loan	

9. Production Targets	None in excess of 20% of SME loan, actual production below targets triggers investigation by BR loan proceeds	Working capital component
10. Cancellation of Approved rediscounts	5 basic criteria only	Identical

STAFF APPRAISAL REPORT
COLOMBIA

FIFTH SMALL AND MEDIUM SCALE ENTERPRISE PROJECT
COMPARISON OF FEATURES OF THE PAST AND PROPOSED BANK LOANS TO COLOMBIA FOR SMEs

Category	Loan 1071-CO	Loan 1451-CO	Loan 1834-CO	Loan 2464-CO	Proposed Fifth Loan
Borrower	BR	BR	BR	BR	BR
Date of Agreement	1/75	9/77	12/80	9/84	---
Size of Loan	US$5.5 mm	US$15 mm	US$32 mm	US$40 mm	US$80 mm
% of Subloan reimbursed by the Bank	90%	Lower of 100% of subloan of total fixed assets cost	Up to 100% of subloan or 90% of total subproject costs	Up to 100% of subloan or 90% of total subproject costs	Up to 80% of subloan and up to 80% of subprojects cost for existing firms or 70% for new firms.
Agency Responsible for performance	CFP	CFP	CFP	CFP	Qualifying developments (CFs) and commercial banks.
Interest Adjustment to changes in rate of inflation	None	None	Yes	Yes	Yes
Approval of subloan by the Bank (free limit)	Col$1.5 mm	US$100,000	US$100,000 (US$20,000 for technical assistance)	US$100,000	US$400,000
Working capital financial	None	None	Up to US$9 mm	No special allocation	No special allocation
Rate of Interest to intermediary for investment projects	10.5% (pesos) 7.75% (US$)	17-18.5% pesos	20.75-21.25% (adjustable pesos)	DTF -2.5	DTF -1.0 to DTF +1.0
Rate of interest to CFP for technical assistance projects.	12% (pesos)	12% (pesos)	12% (pesos)	N.A.	N.A.

STAFF APPRAISAL REPORT
COLOMBIA

FIFTH SMALL AND MEDIUM SCALE ENTERPRISE PROJECT
COMPARISON OF FEATURES OF THE PAST AND PROPOSED BANK LOANS TO COLOMBIA FOR SMEs

Category	Loan 1071-CO	Loan 1451-CO	Loan 1834-CO	Loan 2464-CO	Proposed Fifth
Subloan Terms	4-10 years	4-10 years	Normally 4-10 years fixed assets, except 3-5 years pure working capital	Normally 4-10 yrs.	4-10 years max. 5 years for perm. working capital
Grace period of subloan	1-3 years	1-3 years	1-3 years	1-3 years	1-3 years
Cash flow analysis	Not required	Required for loans exceeding Col$0.5 mm	Required for exceeding Col$0.5 mm	Required for loans exceeding Col$2.0 mm (plus the financial rate of return	Cash flow up to US$0.1. mm IRR over US$0.25 mm
Financial Intermediary spread	5.5% (pesos) 5.25% (US$)	5.5 - 7%	4.75-5.25% (pesos)	4.5 - 5% (pesos)	5% for CFs, 4% for commercial banks.
Maximum Debt/Equity ratio required for financial intermediary	4.0:1	5.5:1	6.0:1	6.0:1	CFP 7.5:1; other CFs 10.0:1, Banks 15.0:1
Beneficiary	50% to enterprises with assets below Col$10 mm, 50% to enterprises with assets between Col$1-20 mm	50% allocated to enterprise assets below US$30.06 mm, 50% to enterprises with assets below US$0.65 mm	10% to enterprises with assets below US$100,000; 42% to enterprises with assets below US$0.65 mm.	Enterprises with total assets below US$790,000 equivalent. However, expected subloan distribution among size of enterprises would be in line with Ln. 1834-CO.	Total assets of less than US$1 mm equivalent

STAFF APPRAISAL REPORT
COLOMBIA

FIFTH SMALL AND MEDIUM SCALE ENTERPRISE PROJECT
COMPARISON OF FEATURES OF THE PAST AND PROPOSED BANK LOANS TO COLOMBIA FOR SMEs

Category	Loan 1071-CO	Loan 1451-CO	Loan 1834-CO	Loan 2464-CO	Proposed Fifth
Initial Loan Technical Assistance allocation	US$500,000	US$100,000	US$600,000	US$0.40 mm	N.A.
Average investments financed	US$50,000	US$65,000	US$50,000	US$65,000	US$115,000
Subloan rate of interest	24% (pesos) 1.3% (US$)	24% (pesos)	26% adjustable (pesos)	Floating rates based on a weighted average of: (a) CFT and 3 percentage points and (b) adjustable rate determined between BR and IBRD with a 2 percentage points difference depending on location of subprojects.	DTF +6% max.
Average subloan amount	US$17,900	US$24,000	US$20,000	US$25,000	US$57,000

Colombia

Fifth Small and Medium Scale Enterprise Project

Guidelines for the Restructuring Program

Background

1. The recessionary period of the early 1980s encompassed a very serious decline among many SMEs in debt service capacity and real investment rates, combined with increasing real rates of interest and a tendency for formal banking institutions to shift their modest SME lending to larger-scale industries. These problems have been slowly alleviated since the mid-1980s with rapid overall growth rates of the industrial sector in Colombia. Nevertheless, a significant share of non-performing SME loans continue to resist resolution among those institutions with all or a significant share of their portfolio in this area (6.3 percent of CFP's average total assets in 1987, or twice the average for development banks, and 5.8 percent for Banco Popular). In addition, the operational efficiency of many segments of SME production is expected to be able to benefit from reconfiguration of the production structure and its support systems.

Objectives and Target Groups

2. A restructuring investment is a set of substantial adjustments to an enterprise's existing operations aimed to make it economically efficient and financially self-sustaining. Enterprise restructuring distinguishes itself from investments aimed purely at the expansion of productive capacity of financially healthy entities. Basically, two groups of enterprises are targets for the Restructuring Program under the Project: (a) those which have satisfactory financial performance but have significant scope to increase operational productivity and profitability within existing capacity; and (b) those which require significant reconfiguration of their operations and must also be returned to financial health. Undertaking restructuring in cases (a) and (b) also is directly linked to improving the portfolios of banks and other creditors associated with the enterprise. Such exercises would probably take place in connection with financial engineering of the financial structure of the firm.

Restructuring Measures

3. Restructuring is likely to include both "hardware" and "software" components and cover one or more of the following areas: modernization and rehabilitation of plants; changes in technology; changes or diversification of product lines; reorganization of production, marketing and distribution; and changes in human resource skills, levels and/or uses. Where changes in the financial structure of the enterprises are also required, eg., when

substantial losses have been incurred, agreements are frequently sought in which both debtor and creditors would share in the solution. A typical workout would have some or all of the following financial characteristics: (a) the provision of new equity and/or quasi-equity from shareholders' own resources and from the Project's resources, (b) write offs of part of the accumulated penalties and interest due on existing loans, (c) conversion of part of the debt to equity, (d) rescheduling of debt consistent with the SME's new cash flow projections, (e) new financing for the purchase of fixed assets and for other expenditures (see para 8-12) constituting the new investment.

Enterprise Eligibility

4. To be eligible for the Restructuring Program, enterprises first have to meet the eligibility criteria for the SME 5 Project, ie., that they operate within manufacturing, mining and related service industries with total assets of less than US$ 1.0 million equivalent. In addition, such enterprises must demonstrate (a) an inability to meet current or long-term liabilities, or (b) their readiness to undertake restructuring investments designed to lead to increased factor productivity of the existing facilities of the enterprise.

Restructuring Plan

5. Candidates for restructuring will be actively sought by PFIs among their own portfolios and other sources. PFIs will act in partnership with those enterprises identified, usually also with the help of consultants under the Project's technical cooperation component, to develop a restructuring plan for each enterprise. Where several PFIs are involved, one will be appointed lead bank to act as interlocutor and negotiator in the exercise. Each plan should highlight at least four elements - production, marketing, financial and management plans - and layout in detail the restructuring measures to be undertaken by the enterprise.

6. PFI financing of investments under a restructuring plan is subject to the same procedures and free limits for approval under the Project's rediscount facility where expenditures to be financed are confined to those traditionally eligible under previous Bank-financed SME projects: machinery and equipment, spare parts, construction and/or purchase of industrial facilities, and permanent working capital. Where categories of expenditures outlined in paras. 8-12 are involved, ex ante examination and approval is required by BR and the Bank.

7. Each plan must be accompanied by financial statements reflecting agreement between creditors and equity partners, in particular on the enterprise's net worth and outstanding liabilities. Where applicable, each plan should indicate the explicit willingness of equity partners to put up additional capital or accept dilution of their ownership in the firm, and the readiness of creditor banks to accept losses, postponement of interest income, or whatever steps are indicated. Restructuring investments must achieve a FRR of at least 11 percent, consistent with all other investments supported by the Project.

Restructuring Expenditures Eligible for Financing

8. It is unlikely that the expenditures traditionally financed by the Bank, which are most common to the expansion of productive capacity, will cover all the requirements of industrial restructuring exercises. Therefore, under this component of the proposed Project, the range of eligible expenditures and financial instruments will be broadened.

9. Restructuring Activities. The process of reorienting the operations of an enterprise to make it more efficient and self-sustaining may require confronting problems of overcapacity, new product development, redeployment of labor, major changes in technology employed, etc. To facilitate this effort, the Bank's loan will finance under an approved enterprise restructuring plan (a) applied research and development costs to establish new product lines, (b) worker retraining, and relocation in cases where restructuring affects the skill composition and size of the work force, (c) permanent working capital to cover expenditures of all physical production inputs (instead of only spare parts) over a time-slice within the restructuring plan timetable, based upon the complete production cycle from purchase of production inputs to sales receipts; and (d) the marketing and distribution costs under the restructuring plan which are above current expenses of an enterprise and associated with such items as (i) trade fairs, exhibits and other promotion campaigns, and (ii) investments in distribution systems. Such financing would be subject to verification through documentation required to support statements of expenditures.

10. Equity and Quasi-Equity Investments. The Project will seek to make a contribution to the mobilization of domestic equity by permitting the World Bank's loan to finance up to 80% of equity investments by PFIs or individuals, as long as such investments amount to no more than 50% of the total new equity financing for the restructuring plan on the SME. The amount financed by the Bank's loan will also be limited to not more than 30 percent of the total outstanding equity of the enterprise including the project. Such financing can be provided to the PFI as shareholder, where permitted by law (CFs), or onlent to individual or enterprise shareholders under an acquisition arrangement or an issue of new shares.

11. The investor will be charged an interest rate and given terms on rediscounted Bank loan funds used which will be identical to the Project's credit program. Terms and conditions for equity and quasi-equity instruments will be negotiated on a case-by-case basis between investor and representatives of the enterprise.

12. The proceeds of the loan must be used for the procurement of additional goods and services for the enterprise under a restructuring plan rather than purely for the transfer of ownership of existing assets or the

repayment of existing indebtedness. Similar to equity financing, loan proceeds could be injected by PFIs as subordinated and/or convertible debt as a means of attracting other financing for a restructuring plan and strengthening the capital structure of an enterprise, providing the possiblility of higher levels of return, etc.

Annex 8

COLOMBIA

FIFTH SMALL- AND MEDIUM-SCALE ENTERPRISE PROJECT

TECHNICAL COOPERATION PROGRAM

Outline of Terms of Reference

1. Technical cooperation (TC) costing a total of US$0.2 million, to be borne by the Government, would be included in the Project to prepare under the aegis of BR in-depth studies on public policies likely to have a significant influence on the performance of SMEs. These studies will distinguish "natural" limitations on SMEs due to the relative absence of economies of scale in relation to large firms from those which are explicitly introduced by public policies. They are intended support a dialogue with the Government and to develop recommendations as required to modify the regulations and policies infuencing capital intensity of enterprises, business establishment, and operations, so as to help establish a more neutral policy environment for SME development.

2. Detailed terms of reference will be prepared following a review of the results of a series of industrial sector studies already underway for a Bank industrial sector memorandum. However, the following subjects are presently expected to be examined to determine the implications of regulations, documentation, procedural requirements, and enforcement on market entry and cost to SMEs in relation to large firms:

(a) Government industrial policy incentives and practices directly influencing the capital intensity of firms under the Colombian Investment, Trade, Commercial and Tax Codes--for example, with respect to customs exemptions on imported equipment, tax holidays based upon fixed asset depreciation, and subsidized credit;

(b) the financial burden of non-wage benefit requirements in the Labor Code and their implications for the legalization of small enterprises;

(c) building and operating permits, as well as other major municipal regulations in Colombia's four major urban areas; and

(d) the major financial and operating policies and practices of power, water supply, and transportation services in these areas.

ANNEX 9

COLOMBIA

STAFF APPRAISAL REPORT

FIFTH SMALL AND MEDIUM SCALE ENTERPRISE PROJECT

ESTIMATED QUARTERLY DISBURSEMENT SCHEDULE FOR THE PROPOSED BANK LOAN 1/
(US$ Million)

Bank Fiscal Year and Quarter		Disbursements in Quarter	Cumulative and Disbursement
FY89			
	June 30. 1989	0.3	0.2
FY90			
	September 30, 1989	0.8	1.1
	December 31, 1989	2.5	3.6
	March 31, 1990	3.0	6.6
	June 30. 1990	3.4	10.0
FY91			
	September 30, 1990	4.0	14.0
	December 31, 1990	4.6	18.6
	March 31, 1991	5.4	24.0
	June 30, 1991 2/	6.7	30.7
FY92			
	September 30, 1991	7.2	37.9
	December 31, 1991	7.2	45.1
	March 31, 1992	6.9	52.0
	June 30, 1992	6.4	58.4
FY93			
	September 30, 1992	5.2	63.6
	December 31, 1992	4.0	67.6
	March 31, 1993	3.4	71.2
	June 30, 1993	3.2	74.2
FY94			
	September 30, 1993	3.0	77.2
	December 31, 1993 3/	2.8	80.0

1/ Based on average disbursement profiles under the previous four loans.
2/ Estimated end date for submission of subloans.
3/ Closing Date

Colombia

Fifth Small and Medium Scale Enterprise Project

Key Reporting Indicators for Project Implementation.
(To be prepared by agency and timetable noted below)

A. Credit Program

(Semi-annually, except as noted, by Banco de la Republica and Participating Financial Intermediaries)

1. Number of new participating financial intermediaries (PFIs);

2. Number of subproject investments financed by each PFI and characteristics of each - new or existing enterprise, business activity, asset and employee size, location, local or export market orientation;

3. Financing plan of SME investment and utilization of proceeds - fixed investment, working capital, construction, technical cooperation.

4. SME loan characteristics - interest rate, grace period and maturity;

5. Average subloan application processing time;

6. Earnings performance - interest income and operating expenses (including overhead charges) from SME portfolio (annually);

7. SME risk management and collection performance - overdue interest and principal, provision for losses, write-offs and recoveries; comparison with overall portfolio quality

B. Technical Cooperation

(Semi-annually, by Banco de la Republica and Participating Financial Intermediaries)

1. Number and cost of TC operations with SMEs;

2. Purpose - management and adminstration, production, marketing, quality control, bulk purchasing, etc.;

3. Estimated contribution to SME performance;

4. TC operations for CFP to improve project appraisal and supervision, data bank and publications;

C. Evaluation (sample 10 percent of total SME loans and equity investments financed by SME 5 project)

(End of Project, by Banco de la Republica in collaboration with Participating Financial Intermediaries)

1. Sales and profitability trends since SME loan approval, including FRR and ERR calculations

2. Employment creation - number of new employees hired per investment, total number of employees of enterprise, and investment cost per employee

3. Average wage rate and efficiency changes for restructuring loans

Annex 11

COLOMBIA

Fifth Small and Medium Scale Enterprise Project
Documents Available in the Project File

A. Sector Related Reports

1) Pinto, Juan S. and Arango, Juan F. La Pequeña y Mediana Industria en Colombia. Situación y Perspectivas. Universida Externado de Colombia, Bogotá, 1968. Also, additional DANE date for 1984-85 provided by ACOPI.

2) Cortes, Berry, and Ishaq. Success in Small and Medium Scale Enterprises: The evidence from Colombia. The World Bank, 1987.

3) Hammond, . Colombia Private Sector Investment Paper (draft). The World Bank, September 1988.

4) El Ejemplo Colombiano en la Agilización del Crédito de Fomento a la Pequeña y Mediana Industria. ACOPI, 1988.

5) Evolución Reciente de las Exportaciones Manufactureras. Banco de la República, 1987.

6) Plan Nacional Para El Desarrollo de las Microempresas. Departamento Nacional de Planeación, 1984 y 1988.

7) Informe de la Misión de Preparación de un Quinto Crédito para la Pequeña y Mediana Industria en Colombia. Eduardo Moyano, December 1986.

8) Línea de Crédito para la Pequeña y Mediana Empresa, Proyecciones de Demanda. Banco de la República, 1988.

B. Project Participation Financial Intermediaries.

1) Informe Financiero Comparativo, 1985-87.

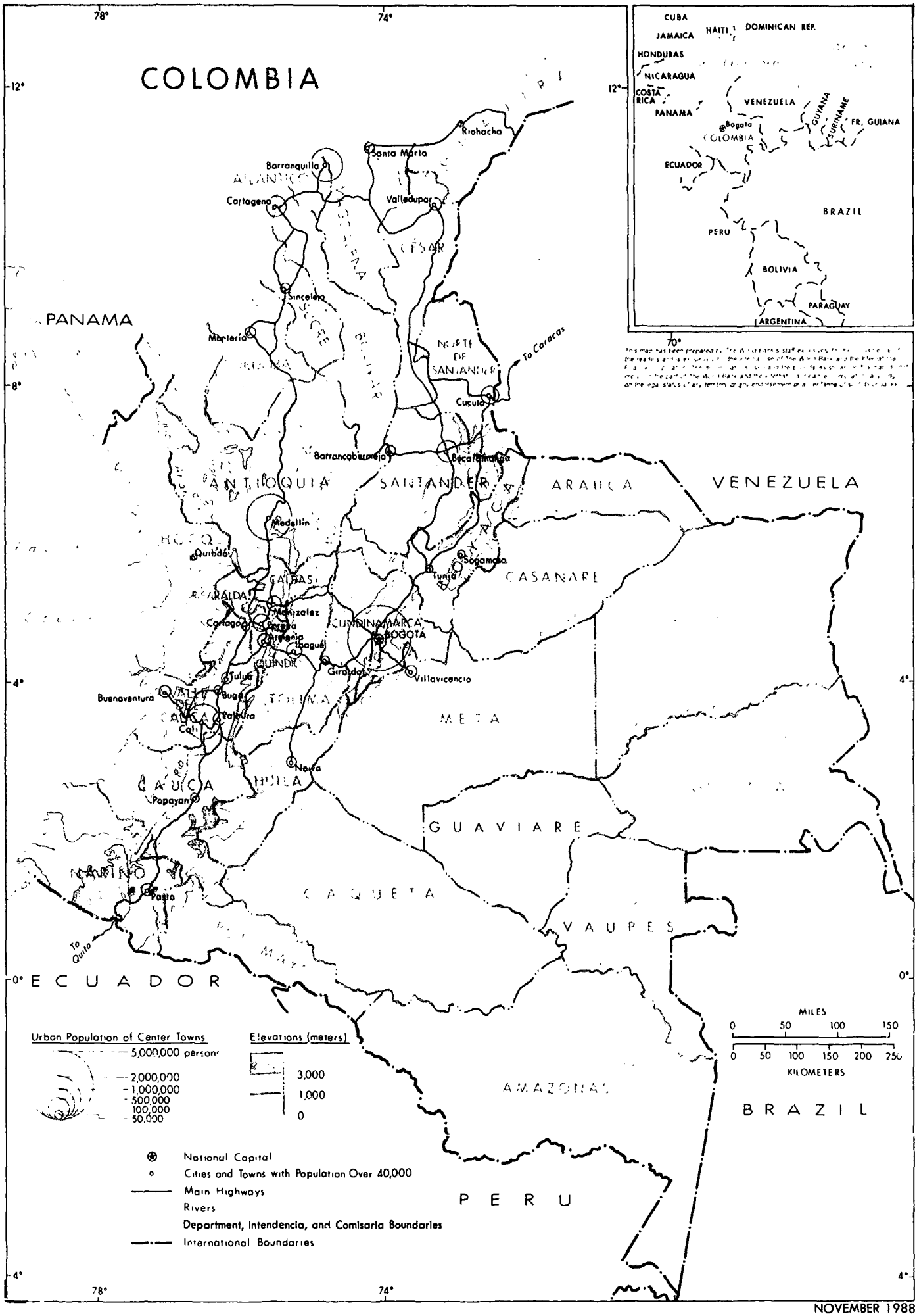
2) Programación de Crédito, 1988-91.

3) Informe Anual del Estado de la Cartera, 1987.

4) Plan Estratégico de Acción de Cartera, 1988.

5) Reforma a las Corporaciones Financieras, Banco de la República, 1988.

6) Operaciones de la Corporaciones Financieras, Banco de la República, 1988.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PANAMA
VENEZUELA
ECUADOR
PERU
BRAZIL
CUBA
JAMAICA
HAITI
DOMINICAN REP.
HONDURAS
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COSTA RICA
PANAMA
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SURINAME
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Valledupar
CESAR
Sincelejo
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ANTIOQUIA
SANTANDER
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Tulua
Buenaventura
Buga
Palmira
Cali
TOLIMA
META
Neiva
HUILA
CAUCA
Popayan
GUAVIARE
NARIÑO
Pasto
CAQUETA
VAUPES
To Quito
AMAZONAS
78°
74°
70°
12°
8°
4°
0°
Urban Population of Center Towns
5,000,000 persons
2,000,000
1,000,000
500,000
100,000
50,000
Elevations (meters)
3,000
1,000
0
MILES
0 50 100 150
0 50 100 150 200 250
KILOMETERS
National Capital
Cities and Towns with Population Over 40,000
Main Highways
Rivers
Department, Intendencia, and Comisaria Boundaries
International Boundaries