Code - PD000435-ECU
Date - November 25, 2020

Project Document
of the Asian Infrastructure Investment Bank

Sovereign-backed Financing

Republic of Ecuador
Corporación Financiera Nacional COVID-19 Credit Line Project

(under the Covid-19 Crisis Recovery Facility)

Currency Equivalents
(As of November 17, 2020)

Currency Unit – United States Dollars (USD)

Borrower's Fiscal year
Jan. 1 - Dec. 31

Abbreviations

AFD	French Development Agency
AIIB	Asian Infrastructure Investment Bank
AOA	AIIB Articles of Agreement
BCE	Central Bank of Ecuador
CAF	Development Bank of Latin America
CFA	AIIB-WB Co-financing Framework Agreement
CFN	Corporación Financiera Nacional
CLA	Project Co-Lenders' Agreement
COPCI	Organic Code of Production, Commerce, and Investments
COVID-19	Coronavirus Disease 2019
DA	Designated Account
DFIL	Disbursement and Financial Information Letter
DSA	Debt Sustainability Analysis
E&S	Environmental and Social
ESF	World Bank's Environmental and Social Framework
ESEL	AIIB's Environmental and Social Exclusion List
ESMS	Environmental and Social Management System
ESP	AIIB's Environmental and Social Policy
ESS	WB's Environmental and Social Standards
FI	Financial Intermediaries
GDP	Gross Domestic Product
GRS	Grievance Redress Service
IAM	Independent Accountability Mechanism
IBRD	International Bank for Reconstruction and Development
IDB	Interamerican Development Bank
IFAC	International Federation of Accountants
IFI	International Financial Institution
IFR	Interim Unaudited Financial Report
IMF	International Monetary Fund
ISIC	International Standard Industrial Classification
KFW	Kreditanstalt für Wiederaufbau
LIBOR	London Inter-bank Offered Rate
M&E	Monitoring and Evaluation
MSMEs	Micro, Small and Medium Enterprises
NGF	National Guarantees Fund
NPL	Nonperforming Loans
PCT	Project Coordination Team
PFI	Participating Financial Intermediaries
POM	Project Operations Manual
PPM	Project-affected People's Mechanism
SBF	Sovereign-backed Financing
WB	World Bank
WTO	World Trade Organization

Contents

1. Summary Sheet

Republic of Ecuador
Corporación Financiera Nacional COVID-19 Credit Line Project

Project No.	PD000435
Guarantor	Republic of Ecuador
Borrower	Corporación Financiera Nacional B.P. (CFN)
Sector / Subsector	FI / Financial Intermediary
Project Objective	To promote access to finance and address the liquidity constraints faced by private micro, small and medium enterprises (MSMEs) in response to the COVID-19 crisis in Ecuador.
Project Description	The Project is proposed to be supported under AIIB's COVID-19 Crisis Recovery Facility (the Facility) and will be co-financed with the World Bank (IBRD) (the Lead Co-financier). The Project aims at developing and improving financial products to promote access to finance for productive purposes for MSMEs and strengthening the institutional capacity of the Borrower, Corporación Financiera Nacional B.P. (CFN), in the context of the COVID-19 crisis[1]. The Project will comprise the following 4 components: • Component 1 – Strengthening the institutional capacity of CFN • Component 2 – Development and Improvement of Financial Products to Promote Access to Finance for MSMEs • Component 3 – Credit Line Intermediated by CFN to Participating Financial Intermediaries (PFIs) for on-lending to MSMEs • Component 4 – Project Management AIIB will co-finance on a parallel basis Component 2(b) "Capitalization of National Guarantee Fund (NGF) for special COVID-19 program" and Component 3, under specific AIIB criteria. Under the Project, AIIB will provide through the Borrower, short-term liquidity financing for MSMEs in the form of partial credit guarantees and/or credit lines to mitigate the impacts of the economic crisis induced by the COVID-19 pandemic. The WB loan agreement was already signed on Jul. 28, 2020.

[1] WB/IBRD. 2020. Promoting Access to Finance for Productive Purposes for MSMEs (P172899). Link.

<table>
<tr><td>Implementation
Period of AIIB loan</td><td>Start Date: January 2021
End Date: February 2023</td></tr>
<tr><td>AIIB Loan Closing Date</td><td>February 28, 2023</td></tr>
<tr><td>Cost and Financing Plan</td><td>The total project cost is up to USD310 million, with parallel co-financing by AIIB and the WB/IBRD. See Section 2.D.

<table>
<tr><th>Source</th><th>Total Cost</th><th>AIIB</th><th>WB/ IBRD</th></tr>
<tr><td>Component</td><td></td><td></td><td></td></tr>
<tr><td>1. Institutional Capacity</td><td>3</td><td>-</td><td>3</td></tr>
<tr><td>2. NGF capitalization</td><td>52</td><td>10</td><td>42</td></tr>
<tr><td>2.a. Technical assistance</td><td>2</td><td>-</td><td>2</td></tr>
<tr><td>2.b. Capitalization of NGF for COVID-19 program</td><td>30</td><td>10</td><td>20</td></tr>
<tr><td>2.c. Capitalization of NGF for Standard program</td><td>20</td><td>-</td><td>20</td></tr>
<tr><td>3. MSME Credit Lines</td><td>253</td><td>40</td><td>213</td></tr>
<tr><td>4. Project management</td><td>2</td><td>-</td><td>2</td></tr>
<tr><td>Total project costs</td><td>310</td><td>50</td><td>260</td></tr>
<tr><td>Percentage</td><td>100%</td><td>16%</td><td>84%</td></tr>
</table></td></tr>
<tr><td>Size and Terms of AIIB loan</td><td>Loan Size: USD50 million.

Terms:
Sovereign-Backed Fixed Spread Loan.
Final Maturity Date: February 15, 2026.
Average maturity: between 40-60 months.
Repayment: disbursement-based</td></tr>
<tr><td>Co-financing</td><td>World Bank/IBRD (lead co-financier): USD260 million</td></tr>
<tr><td>Environmental
and Social Category</td><td>World Bank Category: Moderate Risk
Equivalent to FI if AIIB's ESP were applicable.</td></tr>
<tr><td>Risk (Low/Medium/High)</td><td>High</td></tr>
<tr><td>Conditions of Effectiveness (AIIB loan)</td><td>Execution of a Project Co-lenders’ agreement (CLA).
The Environmental and Social Management System (ESMS) has been adopted in a manner acceptable to the Bank.
The Project Operations Manual (POM) is adopted in form and substance in a manner acceptable to the Bank.</td></tr>
<tr><td>Key Covenants / Conditions for Disbursement (AIIB loan)</td><td>Standard covenants and conditions precedent for Sovereign-Backed financing transactions.</td></tr>
<tr><td>Retroactive Financing (Loan % and dates)</td><td>The Borrower may request to finance eligible expenditures incurred and paid before the date of signing of the Loan Agreement, but on or after May 20, 2020, up to an aggregate maximum not to exceed USD5 million for the AIIB loan (10 percent of AIIB contribution).</td></tr>
</table>

Policy Assurance	The Vice President, Policy and Strategy, confirms an overall assurance that AIIB is in compliance with the policies applicable to the Project (granted on November 6, 2020).

President	Jin Liqun
Vice President	Konstantin Limitovskiy, Investment Operations, Region 2
Director General	Supee Teravaninthorn, Investment Operations Technical Department, Region 2
Manager	Gregory Liu, Technical Department, Region 2
Project Team Leader	Gabriel Alfredo Giacobone, Infrastructure Sector Economist
Co-Project Team Leader	Francisco Fortuny, Senior Investment Operations Specialist
Team Members	Benedetta Magnaghi, Procurement Associate Bernardita Saez, Senior Counsel Giacomo Ottolini, Principal Procurement Specialist Henri de Branche, Senior Environment and Social Specialist Marcin Sasin, Senior Economist Shonell Robinson, Financial Management Specialist

2. Project Description

A. Project fit under the Covid-19 Recovery Facility

1. **Background**. COVID-19 has spread rapidly in Ecuador, with 164,908 confirmed cases and over 12,608 deaths (around 9,300 cases and 715 deaths per 1 million population)[2]. The WHO has recently declared Latin America as the new epicenter of the pandemic[3], as nearly all the countries have been severely affected by the outbreak. In April 2020, the health and funeral services of the port city of Guayaquil were overwhelmed, as the city experienced extremely high mortality. The country also shares the border with Peru and has close interaction with Brazil, two of the most affected countries in the region.

2. Emergency measures put in place by the country to mitigate the spread of the pandemic include the closing of schools and universities, public spaces and non-critical businesses; the halting of public transportation; and the imposition of a nationwide lockdown. These measures have disrupted labor markets, international value chains, and the trade of intermediate inputs to production.

3. Ecuador is a crude oil producer; oil accounted for 40 percent of Ecuador exports and 22 percent of fiscal revenues in 2019. The COVID-19 pandemic has severely affected oil revenues. As of August 2020, oil export revenues have dropped by 46 percent as compared with 2019. The contraction is mostly explained by a plunge in international oil prices. The COVID-19 outbreak has aggravated the downward cycle in the crude oil market that started in 2014. Current prices are around USD42 a barrel,[4] a 60 percent drop from 2014 prices. Futures markets indicate that oil prices will remain below USD45 a barrel through 2023.[5]

4. **Macroeconomic constraints**. After sustaining a period of stable, significant economic growth during 2001-2014, which was fueled by high oil prices, the economy of Ecuador is facing several challenges in 2020. The country has been accumulating large macroeconomic imbalances and exhibits the need for structural reforms. Due to its dollarized economy, Ecuador cannot rely on currency depreciation to respond to a real shock. The dollarization framework requires a sustainable fiscal path and limits the ability to carry out expansionary monetary policies. The government responded to the crisis by implementing austerity measures while reallocating resources to emergency spending. However, in the absence of fiscal space, the authorities are left with few policy instruments, such as mobilizing credit through public banks

5. According to IMF projections, GDP is expected to contract by 11 percent in 2020. This drop of output would result in large external financing gaps of 7.9 percent of GDP in 2020 and 4.0 percent of GDP in 2021, to be filled by external financing.[6]

6. The government is committed to addressing fiscal and external imbalances in the medium term once the immediate impact of the pandemic is overcome. Furthermore, the government has taken steps to ensure the sustainability of public debt (see **Annex 4**). It has obtained debt restructuring from private creditors and assurances of debt relief from bilateral creditors. Financing has been secured for 2020, with good prospects for

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[2] As of October 30, 2020, according to the WHO.
[3] Link.
[4] WTI prices, according Federal Reserve of St Louis data. Link
[5] MarketWatch data. Link
[6] IMF Country Report No. 20/286.

additional financing from both bilateral creditors and International Financial Institutions (IFIs) going forward.

7. **Liquidity constraints caused by COVID-19.** The COVID-19 crisis is making it increasingly difficult for micro, small, and medium enterprises (MSMEs) to meet operational expenses such as payroll, supplies, rent, and utilities, or procure necessary goods and services to maintain their productive capacity. As of 2020Q2, over 75 percent of loans were used to cover working capital needs. Banks have been restricting access to credit. The main reasons are a perceived increase in portfolio risk, along with a deterioration in economic prospects, which would, in turn, affect firms' ability to repay their debts7. The financial metrics suggest that the financial system remains solvent, profitable, and liquid8. However, an increased demand for credit to manage a temporary shock will create pressure on the banking system's balance sheet.

8. **Country Priority.** On June 16, 2020, the Government of Ecuador approved the *Reactivate Ecuador* program, which consists of a USD1.15 billion package of financial measures to be implemented through entities of the public and private financial sector to alleviate the economic impact of COVID-19 by financing working capital needs. Priority is given to MSMEs and the cooperative sector[9]. The Program is financed entirely by IFIs and development banks. Reactivate Ecuador will provide 36-month tenor loans to MSMEs at a preferential interest rate (of up to 5 percent)[10]. It will also extend partial credit guarantees (PCG) for up to 80 percent of loan size.

9. **Project's alignment with AIIB's COVID-19 Recovery Facility (the Facility).** The proposed Project is aimed at promoting access to finance and addressing liquidity constraints of MSMEs in response to the COVID-19 crisis. One objective of the Facility is to address liquidity constraints for clients in infrastructure and other productive sectors. One of the instruments contemplated by the Facility is lines of credit to FIs which, in the context of the current crisis, could focus on the provision of working capital and liquidity support to corporate as well as MSME clients[11].

10. **Strategic fit for AIIB.** According to the Strategy on Financing Operations in Non-Regional Members (the Strategy), the Bank may consider investments outside of the Region that significantly benefit Asia, with the objective to support trade and connectivity with Asia, giving priority to projects meeting this Principle[12]. Moreover, and notwithstanding the limitations on the scope for the Bank's non-regional investment as stated in the Strategy, the Decisions to Support the AIIB COVID-19 Crisis Recovery Facility (the Decision), establishes that non-regional members of the Bank are eligible to benefit from financing under the Facility[13], subject to the ceiling for non-regional investment stipulated in the Strategy.

11. Although Asia and Latin America are far in distance, trade between Ecuador and Asia has doubled in the last decade and exhibits a very dynamic trade activity, with an average annual growth rate (CAGR) of 8.4 percent between 2010 and 2019 (see **Annex 5**). Asia has become the second-largest trading partner for Ecuador[14]. A liquidity and solvency crisis in Ecuador is expected to have a negative impact in trade by reducing

[7] Central Bank of Ecuador. March 2020. *Quarterly Report on Supply and Demand for Credits*.
[8] See Project Assessment - Economic and Financial.
[9] Decree n. 1070/2020.
[10] See Press Release by *Secretaría General de Comunicación de la Presidencia*. Link.
[11] Paper on the Decisions to Support the AIIB COVID-19 Crisis Recovery Facility, paragraph 15.1.
[12] Strategy on Financing Operations in non-regional Members, paragraph 1.i.
[13] Decisions to Support the AIIB COVID-19 Crisis Recovery Facility, paragraph 4.
[14] According to Central Bank of Ecuador data, Ecuador exports to Asia represented 18 percent of total exports on a 5-year average, while imports from Asia represented 27 percent of total imports on average for the same period.

the volume of exports and imports, restricting the availability of intermediate inputs and final goods, and diverting domestic resources to a less-efficient trading partner. The proposed Project aims to provide liquidity for MSMEs to cover working capital needs, increasing the survival rate of firms, and their ability to maintain trade volumes with Asia. The AIIB loan will concentrate its support on sectors exhibiting a significant trade volume with Asia (see **Annex 2** for a detailed description of the Facility and **Annex 5** for the identification of eligible sectors for the AIIB loan). The 15 percent ceiling of total approved Bank financing, as set forth in the Strategy for Non-regional member, would not be reached as a result of the approval of the Project.

12. **Value addition by AIIB.** AIIB's financing will help alleviate the country's financial constraints due to the pandemic, focusing on the private sector. AIIB's contribution will focus on supporting the Asia-Ecuador trade during the COVID-19 crisis. The participation of AIIB will supplement the Government of Ecuador and WB Program initiatives and open a new line of financial support to a member at a time of severe crisis. The project provides AIIB the opportunity to demonstrate its value to its non-regional Members in response to this COVID-19 crisis.

13. **Value addition to AIIB.** The Project will be the first loan to the Republic of Ecuador from the Bank and the first AIIB-financed project in Latin America. This project will help to position the Bank as an additional international financing partner in the region. Additionally, the partnership with the WB offers an opportunity to open the Bank's business in the Republic of Ecuador with an established financing institution and benefit from its experience and policies during the design and supervision of the Project.

14. **Co-financing.** The Project will be co-financed by the World Bank (WB) and AIIB. The WB will finance the Project through the International Bank for Reconstruction and Development (IBRD) under the name "Promoting Access to Finance for Productive Purposes for MSMEs" (approved by WB Board on July 1, 2020)[15]. The Project will be implemented under the existing Co-financing Framework Agreement (CFA) between the two Banks. A Project Co-Lenders' Agreement (CLA) will be agreed to specify the services to be provided by the WB.

15. **Coordinated international financial assistance.** The Project is part of a package of financial assistance from international partners, including the International Monetary Fund (IMF)[16], Interamerican Development Bank (IDB)[17], WB[18], and Development Bank of Latin America (CAF)[19] under the Reactivate Ecuador program and other initiatives.

B. Project Objective and Expected Results.

16. **Project Objective (PO).** The Project objective is to promote access to finance and address the liquidity constraints faced by private micro, small and medium enterprises (MSMEs) in response to the COVID-19 crisis in Ecuador.

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[15] WB. 2020. Ecuador: Promoting Access to Finance for Productive Purposes for MSMEs (P172899). Link.
[16] IMF, Emergency assistance to address the COVID-19 pandemic. Link
[17] IDB, Global Credit Program for Safeguarding the Productive Fabric and Employment. Link; Support to the provision of health and social protection services. Link; Big Data for Efficient Management Against COVID-19. Link
[18] WB, Second Inclusive and Sustainable Growth. Link; Ecuador COVID-19 Emergency Response Project. Link
[19] CAF, CAF approves USD 400 million to face the health and economic crisis generated by COVID-19 in Ecuador. Link

17. **Expected Results.** The Results Monitoring Framework (included in **Annex 1**) follows the WB Results Framework. Project Indicators include:

- Number of sub loans and Partial Credit Guarantees (PCGs) provided to MSMEs
- Number of MSMEs receiving sub loans and PCGs with AIIB funds
- NPL ratio in the sub loan portfolio

Indicators will be periodically measured by the WB during implementation to ensure the Project is progressing in accordance with the implementation plan.

18. **Expected Beneficiaries.** There will be three direct beneficiaries of the Project, namely (i) CFN; (ii) the PFIs; and (iii) the beneficiary MSMEs. AIIB's contribution will focus on bringing benefits to Asia by providing liquidity support to MSMEs operating in the tradable sector, either by trading directly, or by forming supply chains in sectors that trade intensively with Asia.

- A strengthened **CFN** is expected to enhance the efficiency of its lending, while improving its operating performance and the quality of its assets. The Project will also help crowding in private financial institutions to assist MSMEs. This operation will specially support the second tier (apex) on-lending. The National Guarantees Fund (NGF) will be capitalized, thus expanding access to finance for MSMEs. By expanding the loan portfolio through PFIs, CFN will be able to broaden its scope and cover more geographical locations without increasing its operating costs.

- **PFIs** will benefit from access to credit lines and PCG, thus helping them expand their portfolio and grow in sectors and areas previously unserved. Moreover, PFIs will benefit from technical assistance to strengthen their capacity to make them eligible institutions, including support to create or strengthen their ESMS capacity. At least 15 PFIs will participate in the Project.

- **MSMEs** will be the Project's main beneficiaries. MSMEs will benefit by accessing finance for liquidity support through PFIs in the form of credit lines and PCG (see **Annex 1**). Financial support is expected to positively affect the survival rate of MSMEs, thus supporting economic growth and employment through the COVID-19 crisis. It is also expected that 50 percent of MSMEs receiving sub-loans will be owned and/or led by women. The **tradable sector**, specifically firms trading with Asian countries, will specially benefit from AIIB contribution. For the AIIB tranche, the Facility will be exclusively available for firms currently exporting from or importing to Asia, or that are a part of value chains that trade intensively with the region.

C. Description and Components

19. **Overview.** The Project consists of four components: (1) Strengthening the institutional capacity of CFN; (2) Development and improvement of financial products to promote access to finance for MSMEs; (3) Credit line intermediated by CFN to PFIs for on-lending to MSMEs; and (4) Project management. AIIB contribution will only focus on activities under Sub-component 2.b. of Component 2 and Component 3, which are closely aligned with the Bank mandate and current policies.

20. **Component 1** - Strengthening the institutional capacity of CFN (USD3 million, IBRD). This component will provide technical assistance and capacity building to CFN,

through: (a) the design of a corporate governance strengthening plan and a business plan, (b) the design and implementation of a monitoring and evaluation strategy to measure the effect of access to credit on final borrowers, (c) the design of an NPL resolution strategy, and (d) the strengthening of PFIs' operational capacity.

21. **Component 2** - Development and Improvement of Financial Products to Promote Access to Finance for MSMEs (USD52 million - USD42 million, IBRD; USD10 million, AIIB). This component will support CFN to provide financing for productive purposes to MSMEs. The component consists of three sub-components:

(a) **Subcomponent 2a – Technical assistance (USD2 million, IBRD).** This subcomponent comprises technical assistance to (i) strengthen risk management system and pricing policy of the National Guarantees Fund (NGF), which is managed by CFN, and (ii) design, test and evaluate new financial products for MSMEs with scale-up potential, such as climate resilience financial products, specialized products for female-owned MSMEs, IPAM-owned MSMEs and FinTech.

(b) **Subcomponent 2b – Capitalization of NGF for special COVID-19 Program (USD30 million - USD20 million, IBRD; USD10 million, AIIB)**. This subcomponent will capitalize on a special emergency guarantee program under NGF to alleviate the economic effect of the COVID-19 crisis on productive MSMEs, by guaranteeing PFI loans to provide the necessary liquidity, working capital, and investment[20] required to maintain productive activity.

(c) **Subcomponent 2c – Capitalization of NGF for standard programs (USD20 million, IBRD).** This subcomponent will support the standard operations of the NGF, by capitalizing the NGF, which will, in turn, use the capital to provide guarantees to PFIs that will lend to beneficiary MSMEs.

22. **Component 3 – Credit Line Intermediated by CFN to PFIs for on-lending to MSMEs (USD253 million - USD213 million, IBRD; USD40 million, AIIB).** This component will support CFN to establish and expand second tier (or apex) lending to serve MSMEs through the commercial and the cooperative banking sector. Under this component, the Project will finance the provision of lines of credit to eligible private PFIs, which will, in turn, on-lend to eligible private MSMEs for working capital and investment[21] purposes.

23. **Component 4 – Project Management (USD2 million, IBRD).** This component will support CFN to execute the Project and will include (i) recruitment and training of team members, including procurement, financial management, environmental and social specialists, (ii) acquisition of equipment and furniture for the Project Coordination Team; (iii) Monitoring and evaluation activities, and study tours for relevant CFN staff; (iv) preparation and implementation of a stakeholder and citizen engagement plan, including the implementation of a grievance redress mechanism; (v) development and delivery of a communication strategy; (vi) Project's financial audits.

[20] Investment expenditures will not be eligible under the AIIB loan.
[21] Investment expenditures will not be eligible under the AIIB loan.

D. Cost and Financing Plan

24. **Project cost.** The total project cost is USD310 million. The WB will provide USD260 million. AIIB financing consists of a loan of USD50 million on a parallel basis.

Table 1. Project cost and Financing Plan.

Component	**Total Cost**	**Source (USD Million)**	
		AIIB	**IBRD**
Component 1. Strengthening the Institutional Capacity of CFN	**3**	**-**	**3**
Component 2. Development and Improvement of Financial Products to Promote Access to Finance for MSMEs	**52**	**10**	**42**
2.a Technical assistance	*2*	*-*	*2*
2.b Capitalization of NGF for special COVID-19 program	*30*	*10*	*20*
2.c Capitalization of NGF for standard programs	*20*	*-*	*20*
Component 3. Credit Line Intermediated by CFN to PFIs for on-lending to MSMEs	**253**	**40**	**213**
Component 4. Project Management	**2**	**-**	**2**
Project Cost	**310**	**50**	**260**

25. **Loan and sub loans maturities.** The AIIB loan will be structured as a facility with a final maturity date of five years from the date of signing of the loan agreement, and an availability period of twenty-five months from the date of signing of the loan agreement. All sub-loans under the AIIB loan will have a maximum maturity of 36 months. The maturity is expected to accommodate the underlying direct sub-loans. **Annex 2** provides detailed information about the facility.

26. **Loan and sub loan pricing.** The AIIB loan will follow the General Conditions for Sovereign-backed Loans[22] and pricing[23] applicable to SBF loans, which are uniform. The sub-loans' pricing and maturity will be determined by CFN and the PFIs according to market conditions, subject to maximum maturity requirements. The cost of on-lending to PFIs will include, at a minimum, the cost of funding to CFN plus an on-lending margin reflecting administrative costs, a credit risk premium associated with the PFI. Meanwhile, sub borrower costs will cover the cost of PFI funding, plus PFI operating costs and a credit risk premium. Commercial interest rates in the Republic of Ecuador are subject to ceilings, as described in **Section 3.B**.

E. Implementation Arrangements

27. **Institutional arrangements and Implementation period.** A Loan Agreement will be signed with the Borrower and a Guarantee Agreement with the Republic of Ecuador. The Project implementation in respect of the AIIB loan is expected to last twenty-five months from the signing of the Loan Agreement, from 2021Q1 to 2023Q1[24].

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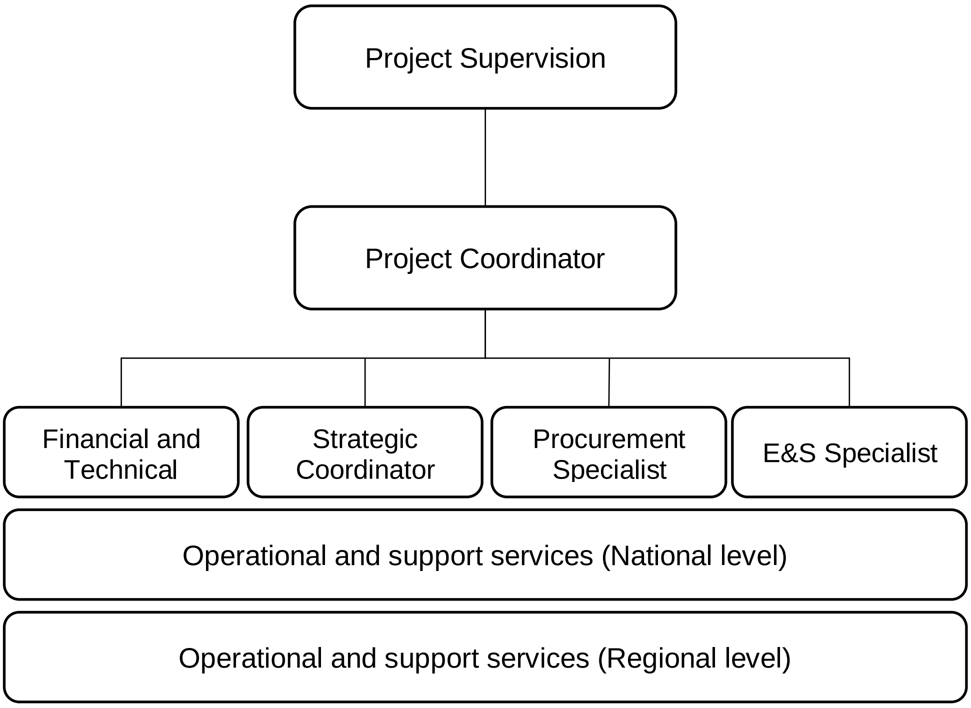
[22] General Conditions for Sovereign-Backed Loans. Link.
[23] Pricing Policy for Sovereign-Backed Products. Link.
[24] Meanwhile, the Project implementation in respect of the WB loan is expected to last 66 months.

28. **Project Coordination Team.** A Project Coordination Team (PCT) within CFN will be responsible for the overall Project implementation, including fiduciary, safeguards, monitoring, and evaluation (M&E) activities.

29. The responsibilities of the PCT will include: (i) coordinating the implementation of project activities; (ii) coordinating the procurement, financial management, disbursements, and environmental and social aspects of the Project in accordance with the provisions of the Loan Agreement; (iii) preparing and implementing the Project Operations Manual (POM); (iv) monitoring the progress of the projects and the intermediate results indicators as per the Results Framework; (vi) preparing project reports; (vii) acting as the focal point for the AIIB and the WB teams.

30. The PCT will be composed of CFN key staff at the central and regional units. PCT will make use of CFN's organizational chart to appoint representatives from the different departments, who will act as focal points and will comply with the roles and responsibilities set in the POM.

Figure 1. Project Coordination Team



Source: Project Operations Manual (draft).

31. **Project Implementation.** PFIs will assess risk for each sub loan based on their ESMS and underwriting criteria. PFIs will subsequently report to CFN's PCT on their compliance with the terms and conditions of their allocation of AIIB funds, alignment with the applicable policies and contractual requirements, and compliance by the beneficiary sub-borrowers with their sub-loan agreements. CFN will systematize and report the information on a semi-annual basis (see **Annex 2** for a detailed description).

32. **AIIB's Implementation Support.** The WB, as the lead co-financier, will take the lead in supervising the Project, in accordance with WB's applicable policies and procedures and a Project CLA, to be signed between AIIB and the WB following the existing Co-financing Framework Agreement between the two institutions.

33. **Procurement.** It is not expected that AIIB's loan, which is limited to providing support for working capital and liquidity financing (Components 2b and 3), will involve any procurement of goods and services. Procurement for goods and services related

to components 1, 2a and 4, will be financed by the WB (not by AIIB) and will be carried out in accordance with WB policies, specifically as defined by WB Procurement Regulations for IPF Borrowers[25].

34. **Retroactive financing.** The Borrower may request to finance eligible expenditures incurred and paid before the date of signing of the Loan Agreement, but on or after May 20, 2020, up to an aggregate maximum not to exceed USD5 million for the AIIB loan (10 percent of AIIB's contribution), in line with the WB loan agreement, which provides for retroactive financing back to the same date. The same environmental, social, financial management, and procurement requirements applicable to the Project will apply to all retroactively financed expenditures.

35. **Financial Management.** CFN Financial Business and Deposits Department (*Gerencia de Negocios Financieros y Captaciones*) will be responsible for overall project financial management. The Department is adequately staffed and experienced in implementing projects financed by multilateral development banks and bilateral development agencies, such as CAF and *Agence Française de Développement* (AFD). However, this will be the first time CFN will be implementing a WB-financed project.

36. The Project requires a robust financial system, as it requires effective monitoring of a decentralized sub loan portfolio. For the capitalization of NGF, CFN will be required to open an exclusive bank account for each fund (Subcomponents 2b and 2c). The POM will set the rules and procedures for financial management.

37. **AIIB Monitoring.** Subject to travel disruptions caused by the COVID-19 pandemic, AIIB will carry out periodic monitoring visits to CFN to oversee the implementation of the Project. No technical assistance is envisaged from AIIB. However, AIIB will benefit from the implementation of the WB's technical assistance and capacity building activities.

38. **Disbursements**. The WB's disbursement guidelines and procedures shall be used for the Project disbursement, in line with the CFA. The advance payment method will be primarily used, while the reimbursement method will be reserved for retroactive financing (see above). Under the advance method, a segregated designated account (DA) in US dollars will be opened for each of AIIB and WB and maintained by CFN in the Central Bank of Ecuador (BCE). Funds deposited in the DA will follow guidelines and procedures described in the Disbursement and Financial Information Letter (DFIL), which shall detail the authorized signatories, methods of disbursement, DA arrangements, the process of submitting claims, and other terms and conditions of disbursements related to the Project.

39. The Borrower will submit a withdrawal application via the WB Client Connection platform[26]. WB will receive and review the payment order and notify AIIB that it is in proper order and eligible for financing. Disbursement of the AIIB loan will not be pari passu to the WB disbursements.

40. Disbursements will be report based**.** The DA will have a variable ceiling based on a six-month forecast. Withdrawals from the DA will be carried out against payments under sub-loans and for capitalization of the NGF. Transfer of funds will follow the terms and conditions established in the financing agreement between CFN and each PFI individually. All transfer of funds will be made through the interbank payment system (SPI).

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[25] Link.
[26] Client Connection platform. Link

3. Project Assessment

A. Technical

41. **Project Design.** The Project will provide liquidity support to the private sector through the provision of PCGs and second tier (apex on-lending) loans. The Project will also provide technical assistance to CFN and the PFIs to strengthen their implementation capacity and increase their productivity and allocative efficiency.

42. All components of the project are deemed technically viable. Second-tier lending is one of the most effective and least distortionary forms of direct government intervention in credit markets[27], while the provision of PCGs is a widely used public policy tool to mobilize MSME financing. The instruments deployed will be designed based on market principles. Rather than crowding-out private creditors, CFN will help to develop financial markets by providing financing at maturities that are otherwise unavailable to this segment.

43. **Project's appropriateness to the needs and capacity of the beneficiary.** Founded in 1964, CFN is Ecuador's oldest and largest public bank. The institution is authorized, regulated, and supervised by the Superintendence of Banks of Ecuador (SBE). CFN is owned by the BCE and is part of the national public banking system, alongside BanEcuador and Banco del Estado / Banco de Desarrollo. The objective of the institution is to provide access to finance to the productive sector through a set of financial products, specifically: i) direct loans (first-floor credit lines); ii) on-lending (second tier); iii) provision of PCGs[28]. CFN's organizational structure is in line with applicable regulations, observing the separation of functions and internal control systems.

44. CFN manages the National Guarantees Fund (NGF), a public credit guarantee scheme established in 2013. In the last three years, NGF has extended 4,430 guarantees for a total value of USD 148 million, helping to mobilize USD 223 million of financing to MSMEs, especially in the manufacturing sector. NGF operates as a "Trust" managed by CFN through a dedicated unit. NGF has its corporate governance framework and is supervised by the SBE. An assessment conducted by the WB has found broad compliance by NGF with internationally accepted principles for the design, implementation, and evaluation of PCG schemes for MSMEs[29].

45. **Technical and managerial capacity of the beneficiary.** CFN is experienced in working with IFIs and other agencies. There are currently three projects being implemented with international funding sources (two of them with CAF[30] and one of them with AFD[31]). The Borrower is currently under loan negotiations with other multilateral institutions and development banks, such as the IDB and KfW.

46. **Pre-qualified PFIs.** As a part of the Stakeholder Engagement Plan, CFN has identified 41 institutions which would be potentially eligible PFIs. Nearly all of them (40 out of 41) have provided financial assistance to MSMEs in the last three years. It is expected that a limited number of PFIs will be finally selected as partner institutions. It

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[27] Eslava, M. (2012). Second-tier government banks and firm performance: micro-evidence from Colombia. IDB working paper series, 294.
[28] Decree No. 868/16, Art. 4.
[29] See Link.
[30] Programa Progresar II relacionado con el Cambio de la Matriz Productiva (USD 50 million) and CFN Factoring (USD 20 million) Projects. Link.
[31] Post-earthquake rebuilding Project (USD65 million). Link.

is anticipated that the AIIB loan will be channeled through larger, more experienced PFIs that require limited assistance.

B. Economic and Financial Analysis

47. **Banking sector overview.** The banking sector in Ecuador exhibits some limitations in terms of providing financial support for private firms. The credit to GDP ratio in Ecuador is low compared with neighboring countries such as Peru, Chile, or Colombia[32]. The banking sector represents nearly 80 percent of the financial system's assets. In addition, the cooperative sector has gained relevance, with about 450 cooperative financial institutions serving over 7 million clients. CFN is the largest public financial institution of Ecuador, accumulating approximately 30 percent of the assets, 26 percent of the loan portfolio, 28 percent of the deposits, and 36 percent of the capital of this segment. The public banking sector represents approximately 15 percent of the total assets and loans, 10 percent of the total deposits, and 36 percent of the capital of the banking system, including private and public entities.

48. **Interest rate controls.** Ecuador introduced interest rates caps for market segments in 2007. There are currently 23 administered interest rates ceilings in the banking system.[33] This segmentation may entail a high degree of complexity in terms of administration, as well as provide incentives to arbitrage. While lending ceilings appear to be binding in some segments, analysis and simulations carried out by the lead co-financier have shown that effective lending rates for loans to SMEs have been historically set below the respective caps, implying that the presence of interest caps is not expected to affect the implementation of the Project.

49. **The COVID-19 crisis and its impact on access to finance.** Indicators suggest that financial institutions have been restricting access to credit in response to the COVID-19 outbreak. Deposit and credits aggregates have shown diverging growth trajectories. Based on information from the Superintendence of Banks of the Republic of Ecuador, the system remains liquid and solvent, at the cost of restricting access to credits for the private sector. The public banks followed a slightly different dynamic during the crisis; credit has grown by 5 percent during the last 12 months, and it has not contracted significantly during the COVID-19 crisis. Therefore, NPL are expected to rise temporarily (see **Figure 1**).

50. **Access to finance for MSMEs.** Firms in Ecuador are small-sized, young, and present high mortality rates (see **Annex 5**). Evidence suggests that access to finance is one of the most critical obstacles to growth. According to the 2017 Enterprise Survey[34], access to finance is among the top three business environment obstacles for firms in Ecuador. Because of their size, firms have limited collateral to offer to banks. Other barriers could also explain their limited ability to receive financial assistance, such as lack of financial education at the management level. On the supply side, private banks are often reluctant to lend to MSMEs for risk management reasons and prefer to offer products to large corporations. Access to finance is critical to firms to be able to survive the COVID-19 crisis. Available data suggest that firms are facing liquidity constraints; 42 percent of companies and over 50 percent of MSMEs had difficulty paying their debts during the second quarter of 2020. The main reason behind this is that sales revenues do not allow firms to cover payments; furthermore, accounts receivable have not been adequately recovered[35].

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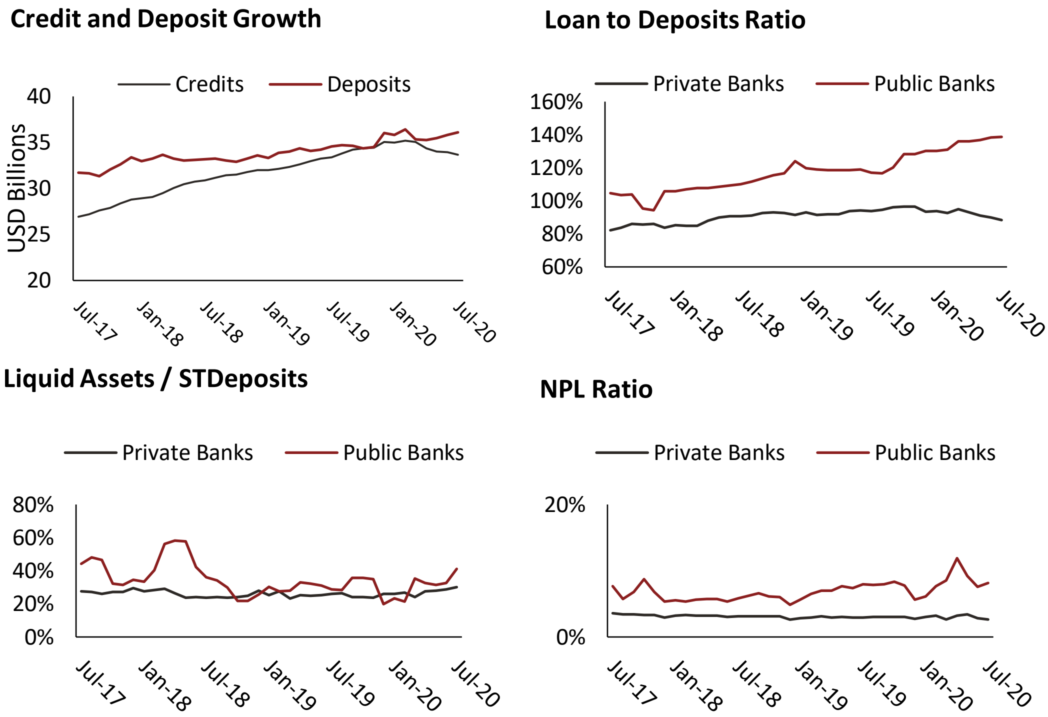
[32] World Bank, World Development Indicators 2019.
[33] Central Bank of Ecuador reference interest rates. Link
[34] Ecuador 2017 Country Profile. Link.
[35] Central Bank of Ecuador. Quarterly Report of Supply and Demand for Credits, 2020Q2. Link

Figure 1. Banking sector financial indicators.



Source: AIIB; Superintendence of Banks of Ecuador.

51. **Key performance indicators.** Economic and financial analysis focuses on the financial soundness, portfolio quality, and risk management capabilities of the Borrower, together with a review of the preliminary pipeline. In addition, the economic analysis considers sovereign credit risk and debt sustainability analysis (DSA).

52. **Financial soundness, portfolio quality and risk management.** CFN is a regulated and publicly owned financial institution. It is the largest public financial institution in the Republic of Ecuador and represents approximately 30 percent of the total assets and 36 percent of the capital of the public banking system after its recent recapitalization. CFN is rated by the SBE as "A" (mid-range).[36] NGF has a rating of AAA-. The Borrower has relevant policies and corporate governance bodies covering its risk management, compliance, audit, and asset-liability management functions. CFN follows accounting standards and rules set by the Regulator (SBE), and its accounts are audited annually. As of June 30, 2020, CFN reported assets of USD3,421 million, composed primarily of loans (44 percent, mainly corporate financings to the primary sector and manufacturing industries) and investments (primarily public sector debt securities).[37] CFN is funded by demand deposits (80 percent of liabilities) and presents strong liquidity (available funds to short term deposits stand at 42 percent). CFN has equity of USD1,629 million (regulatory equity of USD981million) and a capital adequacy ratio of 43.2 percent, well over the minimum requirement of 9 percent. CFN presents stable net interest and financial margins, but its profitability has declined considerably in 2019 and 2020 and reached near-break-even levels on the back of substantial provisioning. CFN presents higher portfolio delinquencies (7.7 percent) than its private sector peers, and the Borrower is implementing new credit processes and receiving technical assistance

[36] The SBE rating indicates that the institution "is strong, has a solid financial track record and is well received by its funding providers. […] It is however possible that the institution presents certain weaknesses". See SBE Ratings and Methodology. Link.
[37] CFN also holds the country's participation in CAF – Banco de Desarrollo de America Latina.

to manage the risk of its portfolio. See **Annex 3** for further analysis and comparable peers.

53. **Sovereign credit risk and DSA.** In March 2020, the financial markets lost confidence in Ecuador's capacity to honor large debt redemptions, leading to a request for a debt standstill followed by rounds of renegotiation with bondholders and bilateral creditors. The country's credit rating was downgraded to *default.* In August 2020, the country secured a landmark deal with private bondholders on a total of USD17.4 billion of debt (98 percent of bondholder support), shifting the average maturity of outstanding bond from six to thirteen years, introducing an 8.3 percent haircut on the nominal principal, and an interest holiday until late 2021. The agreement was supported by austerity measures affecting civil service wages and fuel subsidies, as well as legislation on debt targets. Ecuador has also secured debt relief from official creditors and additional financing assurances from IFIs. The developments opened the way for a large new IMF program, which has been approved in October. The current rating of the Republic of Ecuador stands at B- according to Fitch and S&P. Moody's maintains the rating Caa3. See **Annex 4** for further details.

C. Fiduciary and Governance

54. **Procurement.** AIIB's loan (Component 2b, guarantees, and Component 3, credit line) will be limited to supporting working capital and liquidity financing. No procurement is envisaged under these components, and AIIB's Procurement Policy and Procurement Instructions to Recipient will, therefore, not be applicable. Procurement for goods (IT equipment, software, and office furniture) and services (consulting services focused on CFN and NGF strengthening plan, and non-consulting services such as surveys and organization of events) related to World Bank-financed Components 1, 2a (technical assistance), and 4 (project management) will be conducted by CFN in accordance with WB's Procurement Regulations for PFI Borrowers. Considering the low complexity of the procurement, no significant issue is expected to arise.

55. **Financial Management.** The financial management assessment of CFN that was conducted concluded that the proposed financial management arrangements are deemed adequate for the size and nature of the Project activities. The overall financial management risk is, however, assessed to be High. The key risk factors are: (i) although CFN has implemented other multilateral financed projects, has no experience implementing WB financed projects. Therefore, this may impact implementation until the PCT gets acquainted with WB procedures. (ii) The Project involves decentralized implementation arrangements, including significant participation of third parties (PFIs and MSMEs). (iii) Lastly, for the capitalization of the NGF for the Special COVID-19 Program and for Standard Programs, there is a need for enhanced procedures to ensure that the capitalized funds will used for the intended purposes. These key risk factors will be mitigated by: (i) staffing of CFN with qualified professionals with experience implementing projects financed by other multilateral institutions. (ii) technical assistance and capacity building to be financed by the WB and (iii) a detailed POM to ensure that the mechanisms, criteria, and procedures, are adequate for the monitoring of sub loan, the capitalization of the NGF, as well as the provision of timely and reliable financial information.

56. **Budgeting and Financial Information Systems.** CFN will follow local procedures regulated by Organic Code of Planning and Public Finances (COPLAFIP)[38], Financial and Monetary Organic Code and Superintendence of Banks for the programming, formulation, and execution of annual budgets. A separate budgetary line under the CFN's Policy Budget will be created to allow appropriate monitoring and

[38] Link.

control of budget resources from different sources and project expenditures. CFN's annual budget (including the project) will be approved by CFN's Board and then by the Policy and Monetary and Financial Regulation Board. Timely recording of approved budget and issuance are managed in the PCIE system, while actual transactions will be recorded through the COBIS accounting information system. COBIS credit module will provide detailed information on the credit lines operations with PFIs; however, it does not provide automatized information on the use of the funds documented by PFIs which will be carried out manually. Regarding capitalization of funds, the NGF uses the CFN's guarantee module to manage and control credit guarantees issued for PFIs. The accounts are prepared on an accrual basis, and in accordance with the chart for financial institutions issued by SBE.

57. **Internal controls and Internal audits.** The Project will be included in the internal control environment of CFN. In addition, the Project's daily activities and procedures will be guided by the POM. CFN is subject to internal audit reviews carried out by the Internal Audit Unit. This unit would conduct reviews with the aim of ensuring that the funds are used for the intended purposes. The WB has assessed the Unit's capacity and determined that it possesses an adequate ability to perform its work with appropriate independence.

58. **Financial Report.** CFN will be required to provide to the WB and AIIB semi-annual Project interim financial reports (IFR) and annual Project audit reports. The semiannual IFRs will capture AIIB and World Bank sources of finance and will be due not later than 45 calendar days at the end of each semester. The report will include: (i) Sources and uses of funds; (ii) Cumulative investments; (iii) Consolidated report on PFIs and sub-loans; (iv) Reconciliation of the DA; and, (v) Notes to the Project financial statements. CFN will be required to provide financial reporting on the use of the funds, according to POM financial management arrangements. In addition, each PFI will provide periodic financial information to CFN in accordance with the financing agreement signed.

59. **External Audits.** The Financial Statements of CFN are audited annually by an external auditor approved by the Audit Committee of CFN's Board. The Project accounts will also be audited by an independent private external auditor deemed acceptable to the WB and AIIB under audit TORs agreed with them. Annual audit report (audited financial statements and management letter) shall cover the fiscal year of the Borrower and be presented to the Bank no later than six months after the Borrower's financial year end. Such will report on both sources of finance and be audited, in accordance with International Standards on Auditing (ISAs) issued by the International Federation of Accountants (IFAC). The audit costs will be financed using the loan proceeds from the WB.

60. Governance and Anti-corruption. AIIB is committed to preventing fraud and corruption in the projects it finances. For this Project, the WB's Anti-corruption Guidelines shall apply which are materially consistent with AIIB's Policy on Prohibited Practices (2016). However, the Bank reserves the right to investigate, directly or indirectly through its agents, any alleged corrupt, fraudulent, collusive, coercive or obstructive practices, and misuse of resources and theft or coercive practices relating to the Project and to take necessary measures to prevent and redress any issues in a timely manner, as appropriate.

D. Integrity

61. **Financial Crime and Integrity Due Diligence (FCIDD) and Know Your Client (KYC).** Integrity searches have been performed in both English and Spanish on the Borrower, CFN, as well as its board representatives, senior management, and key

counterparties to ensure that their integrity is sound. CFN is a state-owned entity (SOE) and several members of its board and management have been identified as politically exposed persons (PEPs) in the databases consulted. CFN has KYC and Anti-Money Laundering policies and procedures in place, and is subject to the relevant regulatory framework of Ecuador.[39] The Borrower is subject to the oversight of SBE and market scrutiny through the listing of securities in the stock exchanges of Quito (BVQ) and Guayaquil (BVG).

E. Environmental and Social

62. **E&S Policy, Standards, and Categorization.** The Loan will be co-financed with the WB as the lead co-financier, and the Project's environmental and social (ES) risks and impacts have been assessed in accordance with the WB's Environmental and Social Framework (ESF). To ensure a harmonized approach to addressing the ES risks and impacts of the Project, and as permitted under AIIB's Environmental and Social Policy (ESP), the WB ESF will apply to the Project in lieu of AIIB's ESP. AIIB has reviewed the WB ESF and is satisfied that: (a) it is consistent with AIIB's Articles of Agreement and materially consistent with the provisions of AIIB's ESP, including the relevant ES Standards; and (b) the monitoring procedures that are in place are appropriate for the Project.

63. The WB has categorized the ES risks of this Project as "Moderate" (which is equivalent to Category FI if AIIB's ESP were applicable). The Project will involve the extension of a loan to CFN for onward financing (through loans or PCGs) to PFIs, which in turn will be required to extend sub-loans to ultimate beneficiaries in accordance with eligibility criteria and other conditions set out in the POM. Sub-loans under the AIIB loan will be disbursed by PFIs to eligible MSMEs exclusively for operating expenses, including payroll, rent, utilities, and goods and services. PCGs to be provided by CFN to PFIs will support existing and new liquidity loans for the same purposes to MSMEs whose business activities are judged to be of moderate or low ES risks.

64. **Environmental and Social Aspects**. Although AIIB's loan will only cover sub-loans for operating expenses, the WB's loan may finance sub-loans that involve investments. The typical ES risks and impacts associated with the sectors of MSMEs supported under the Project are expected to be limited and site specific, for example related to occupational health and safety, employment conditions, and in some instances waste management, air emissions and wastewater discharge and, for agricultural commodities production, management of natural resources. CFN has created a list of sectors that would exclude from financing under this facility enterprises engaged in those sectors. The list is complemented by eligibility criteria that would exclude financing of higher ES risk activities, such as land acquisition, new primary production activities that would require the expansion of the beneficiary's current physical footprint and other activities that may induce adverse impacts on community health and safety, critical habitat and natural resources, Indigenous Peoples, vulnerable people and cultural resources. Consequently, the ES risks and impacts of the beneficiary's activities and ES risk exposure of the PFIs can readily be addressed through standard mitigation measures and compliance with national laws. The PCT will undertake the selection and monitoring of, and coordination with, the PFIs. The PFIs will be responsible for verifying the beneficiary's eligibility and confirming that the proceeds of AIIB's loan are only used for eligible expenses, as well as reporting to CFN on these matters.

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[39] Ley Orgánica de Prevención, Detección y Erradicación del delito de Lavado de Activos y Financiamiento de Delitos. July 21, 2016. Link.

65. **Environmental and Social Instruments and Capacity**. CFN's Environmental and Social Management System (ESMS) addresses its direct lending but is not aligned with the requirements of the WB's ESF, nor does it cover second-tier PFIs' further on-lending. Consequently, CFN will design and implement an ESMS for this second tier credit line under the Project in accordance with the WB's requirements, which include a screening and categorization process for assessing the ES risk level of each of the PFI proposed sub-loans and PFI loans for which CFN will provide a guarantee. In line with the WB Loan Agreement, the ESMS shall be ready for implementation no later than the earlier of (a) 90 days after effectiveness of the WB loan agreement and (b) the effectiveness of the AIIB Loan Agreement. The ESMS will be commensurate with the nature and magnitude of the ES risks and impacts of PFI subprojects, the types of financing, and the overall risk aggregated at the portfolio level. The ESMS will include at a minimum the following elements: (a) ES policy; (b) ES procedures to screen subprojects against an ES exclusion list and other eligibility criteria and assign a risk category; (c) systems/processes for due diligence to evaluate, monitor, review and manage ES risks and impacts of subprojects; (d) organizational capacity and competence to carry out the above activities; and (e) external communications and reporting mechanisms on ES performance of subprojects. The PCT will be strengthened and trained in implementing the ESMS, monitoring ES performance of PFIs and sub-loans, and reporting to the WB and AIIB.

66. **Non-discrimination and Gender.** CFN lending policies, criteria and procedures and related capacity will be assessed and improved as needed so that the institution does not discriminate against Indigenous Peoples or vulnerable and minority groups. According to the last Economic Census, 50 percent of Micro-sized enterprises were owned (or managed) by women. Meanwhile, female participation in ownership/management for SMEs was only 30.3 percent[40]. Female participation in SMEs can be further improved, especially for medium-sized firms. The Project will aim to support female-headed MSMEs[41] through providing female entrepreneurs with equal access to finance. It is expected that 50 percent of MSMEs receiving financing will be owned or managed by women. The monitoring results framework and M&E strategy will be used to confirm consistency between these objectives and resource allocation.

67. **Stakeholder Engagement, Consultation, and Information Disclosure.** CFN recognizes the need for an effective and inclusive engagement with all the relevant stakeholders, including private banks and financial cooperatives and the MSMEs at large. Therefore, a comprehensive stakeholder engagement plan has been prepared for the Project and disclosed,[42] and consultations have been initiated in February 2020. Initially, CFN will design and implement a communications strategy to provide information to PFIs and MSMEs about the available financial products, and the corresponding ES requirements, including disclosure of the draft instruments to be prepared by CFN as per the Environmental and Social Commitment Plan (ESCP) prepared for the Project[43]. Once a PFI has been included in the Project and has developed adequate ES procedures, relevant information on subprojects supported under this Project shall be disclosed by the PFI and/or CFN on their respective websites. CFN plans to carry out field visits to Project beneficiaries to assess the impact of access to finance and monitor the implementation of the ESMS by PFIs. However, given the COVID situation, further restriction on holding face-to-face engagements shall be addressed by relying on digital communication tools.

[40] National Economic Census, 2010.
[41] Defined as female-owned, women as main shareholders, board members or in management positions.
[42] CFN Stakeholder Engagement Plan. Link.
[43] Link.

68. **Project Grievance Redress Mechanism**. Communities and individuals who believe that they are adversely affected as a result of this Project, may submit complaints to the existing Project-level grievance redress mechanism (GRM) established by CFN and to be enhanced in accordance with the WB's ESF.

69. **Independent Accountability Mechanism (IAM).** As noted above, the WB's ESF will apply to this Project instead of AIIB's ESP. Pursuant to AIIB's agreement with WB, AIIB will rely on WB's corporate Grievance Redress Service (GRS)[44] and its Independent Accountability Mechanism, the Inspection Panel[45], to handle complaints relating to ES issues that may arise under the Project. Consequently, in accordance with AIIB's Policy on the Project affected People's Mechanism (PPM), submissions to the PPM under this Project will not be eligible for consideration by the PPM.

70. **Monitoring and Supervision Arrangements.** CFN will rely on information provided by PFIs, collected in the scope of their initial assessment and monitoring of sub-borrowers'/borrowers' ES performance. CFN will be required to: (i) maintain a comprehensive database comprising all relevant ES information; (ii) support PFIs in implementing the ESMS until it is satisfied they have the adequate capacity and experience to do so independently; (iii) conduct sample-based ES post reviews of selected sub-loans/loans; and (iv) report to AIIB and WB on the ES characteristics of the Project's portfolio on a regular basis using an agreed template. AIIB will conduct post reviews of the selection and implementation of sub-loans as part of its regular supervision, including engagement with the PFIs, review of their records and potentially site visits and detailed review of the ES documentation of selected sub-borrowers/borrowers.

[44] Information on the WB's Corporate GRS is available at: http://www.worldbank.org/en/projects-operations/products-and-services/grievance-redress-service.
[45] Information on the WB's Inspection Panel is available at: http://www.inspectionpanel.org.

F. Risks and Mitigation Measures

Table 2: Summary of Risks and Mitigating Measures

Risk Description	Assessment Rating	Mitigation Measures
Political and governance risk • Political uncertainty due to upcoming parliamentary and presidential elections (Feb 2021) • Changes in CFN corporate strategy • SOE status	*High*	• Strong alignment between Project activities and the government's COVID-19 response program (Reactivate Ecuador initiative). • Low likelihood of reversal amid the emergency. • The WB loan takes a very long-term view (>20 years maturity) whereas the AIIB loan is near-term focused (5 years tenor). • Technical staff appointed in CFN's PCT
Macroeconomic risk • Inability to complete fiscal consolidation and structural reforms • Weak economic recovery in 2021 • Low and volatile oil prices • Limited access to international financial markets	*High*	• Donor budget support from IMF and potentially other financiers. • Private creditors have accepted a restructuring of the country's sovereign debt as of August 2020, leading to a rating upgrade • The Project aims to benefit the non-oil sector, hence contributing to maintaining the diversification.
Sector strategies and policies risk • Redefinition of roles and practices of public banks	*Medium*	• The government has in place an integrated COVID-19 response policy with measures that include support for MSMEs and the financial sector.
Institutional capacity risk • The Borrower is unable of implementing the Project as approved • Risk of integrity breaches • PFIs lack implementation capacity	*Medium*	• The PCT is experienced in cooperating with several IFIs. • The Project includes a technical assistance program to develop the second tier (on-lending) business model. • The POM will include fiduciary and integrity undertakings • Potentially eligible PFIs have already been identified by CFN.
Financial management risks • The Project implies decentralized management of financial resources by PFIs and MSMEs	*High*	• Adequate mitigation measures shall be established and closely monitored to ensure that the residual project risk remains acceptable, including: (i) a formal internal control framework described in the Project Operations Manual; (ii) the project financial statements to be audited

- Flow of funds involving several channels before reaching the final beneficiaries - Limited monitoring capacity due to the impact of the COVID-19 pandemic		by independent auditors, and on terms of reference acceptable to AIIB and the WB.
Environmental and Social risk - Direct environmental risks are limited as the Project will primarily finance MSMEs - Social risks may arise from the Project's focus on formal MSMEs, and the challenge in ensuring small businesses in rural areas with less connectivity have equal access to funding under the Project - PFIs do not have experience in developing and implementing ES screening and other requirements as part of the ESMS	*Medium*	- CFN will enhance its ESMS and ES capacity with WB support, and ensure that selected PFIs have the capacity to adopt and implement the ESMS. The ESMS will include disclosure requirements and outreach to existing and potential beneficiaries of this facility. - PFI sub-loans' environmental and social risks and impacts are expected to be site-specific, temporary and can be addressed through standard mitigation measures and compliance with national laws. - CFN has created a sectoral exclusion list that will be expanded to reflect the WB requirements in the updated ESMS. - Through screening against the exclusion list and other eligibility criteria, PFIs will not support any land acquisition and resettlement, activities involving adverse impact on cultural heritage or on Indigenous Peoples or vulnerable groups. Eligible sub-projects are thus estimated to present low and moderate ES risk profiles, that can be managed through compliance with regulatory requirements. - CFN and WB will assist PFIs in complying with ES requirements. CFN will report on a regular basis to AIIB on the implementation of the ESMS across PFIs and sub-borrowers.
Asset Quality Deterioration of the quality of the sub loan portfolio as evidenced by NPL ratio and other metrics	*High*	- CFN will only assume the credit risk of the PFIs. - POM will require the financial soundness of PFIs. - Second-tier financing exhibits lower NPL ratio than first tier (direct loans)

Annex 1: Results Monitoring Framework.

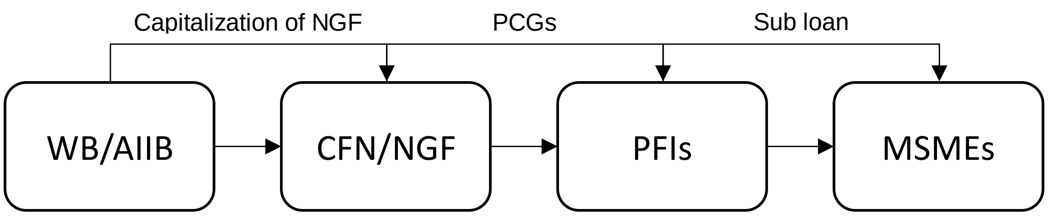
Project Objective:	To promote access to finance and address the liquidity constraints of private micro, small and medium enterprises (MSMEs) in response to the COVID-19 crisis in Ecuador									
Indicator Name	**Unit of measure-ment**	**Base-line Data**	**Cumulative Target Values**					**End Target**	**Frequency**	**Responsible Party**
		2020								
			YR1	**YR2**	**YR3**	**YR4**	**YR5**			
Portfolio Level Indicators (all components)										
1. Number of sub loans disbursed with AIIB funds	Number	0	150	350	350	350	350	**350**	Annual	Borrowers
2. Number of partial credit guarantees provided to MSMEs with AIIB funds	Number	0	300	700	1,000	1,000	1,000	**1,000**	Annual	Borrowers
Capitalization of NGF for special COVID-19 program (Component 2b)										
4. Number of MSMEs receiving partial credit guarantees with AIIB funds	Number		240	560	800	800	800	**800**	Annual	Borrowers
Credit Line Intermediated by CFN to PFIs for on-lending to MSMEs (Component 3)										
6. Number of MSMEs receiving sub loans financed with AIIB funds	Number	0	120	280	280	280	280	**280**	Annual	Borrowers
7. Nonperforming loans (NPL) in the Sub-loan portfolio*	%	0%	<10%	<10%	<10%	<10%	<10%	**<10%**	Annual	Borrowers

MSMEs = micro, small and medium-sized enterprises, NGF = National Guarantees Fund, PCG = Partial Credit Guarantee.
* Additionally, NPL ratio is required to be less than ½ of CFN's first tier lending to MSMEs NPL ratio

Annex 2: Detailed Project Description

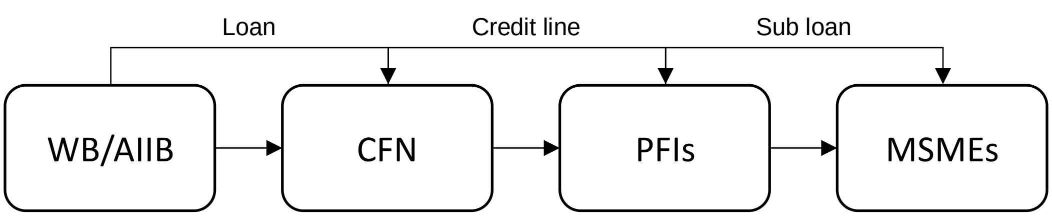
1. **Guarantees program description.** Subcomponent 2b will finance the capitalization of the NGF for a special guarantee program to respond to the liquidity challenges of MSMEs posed by the COVID-19 outbreak[46]. Once NGF is capitalized, CFN, through NGF, will enter first into a Participation Agreement with each eligible PFI, then, into a PCG Agreement with each respective PFI and the eligible MSME. The NGF will then be ready to issue PCGs to qualified PFIs lending to MSMEs. **Figure 4** below describes the process.

Figure 2. Partial Credit Guarantees (PCG) Structure



2. **Credit lines description.** Component 3 will finance the provision of lines of credit by CFN to eligible private PFIs, which in turn will on-lend to eligible MSMEs. CFN will assume the credit risk of the PFIs, while PFIs will assume the credit risk of the MSMEs, as presented in **Figure 5** below.

Figure 3. Credit Line Structure



3. **Eligible beneficiaries.** The Project adopts eligibility conditions for PFIs and MSMEs. AIIB has adopted additional eligibility conditions according to Strategic Alignment requirement.

4. **Eligibility criteria for PFIs.** Eligible PFIs must satisfy the expectations in terms of their financial standing and health and their ability to withstand downside risks. Furthermore, PFIs must demonstrate strong capacity to implement the project according to MDB standards and have an Environmental and Social Management System (ESMS) that meets the criteria established in the Project's environmental and social documents.

[46] As compared with the capitalization of NGF for standard programs i.e. Subcomponent 2c, PCGs are expected to have a smaller average size (USD30,000 vs USD40,000, according to CFN estimations).

5. **Eligibility criteria for Sub-borrowers.** Eligible sub-borrowers are MSMEs according to the official definition in the Organic Code of Production, Trade, and Investments, COPCI (Book III, Title I, Chapter I, Article 53) and its regulations (Article 106). MSMEs must comply with the legal requirements established in Ecuadorian regulations, demonstrate that they were liquid and solvent before the crisis and do not have as their main activity any of those mentioned in the exclusion list applicable for this Project.[47]

6. **AIIB eligibility criteria.** MSMEs receiving financing from AIIB sources need to comply with additional requirements. The AIIB loan will seek to benefit enterprises whose operations are linked to the country's trade activity with Asia by providing financial assistance to two eligible target Groups:

- **Group 1:** MSMEs are registered export/import firms before the National Customs Service[48] and must demonstrate relevant trade with Asia. The company must provide evidence that the export and/or import activity is an essential part of its commercial activity.

- **Group 2:** MSMEs are a part of target sectors where intensive trade with Asia exists. To identify eligible sectors for Group 2 sub loans and guarantees, CFN BP will classify economic activities in Ecuador according to the International Standard Industrial Classification of all economic activities (ISIC), rev. 4[49]. Group 2 preliminary value chains and eligible activities have been identified by the Borrower (See **Annex 5** for the sectoral analysis).

Table 2. Classification by Strategy

Group	Description	Eligible Activities
Group 1	The company must be a registered exporter and/or importer and must show a relevant percentage of trade with Asia. The company must provide evidence that the export and/or import activity is an essential part of its commercial activity.	Any economic activity, except for those included in the Exclusion List.
Group 2	The company must be a part of the supply chain of a target sector where intensive trade with Asia exists.	Eligible activities according to intensity of trade with Asia following ISIC v4 classification, except for activities included in the Exclusion List.

[47] To be based on the exclusion lists of IFC/WB as well as AFD and CAF. To be presented in the POM.
[48] SENAE in Ecuador.
[49] ISIC rev. 4. Link.

7. **ES Risk Assessment.** To assess ES risk level for sub loans, CFN will consider a list of economic activities according to ISIC rev. 4 and classify sub-loan applications by taking into account: i) the Project exclusion list; ii) WB risk level definitions (high, substantial, moderate and low)[50]; iii) the characteristics of each sub-loan, including (but not limited to) firm size, use of loan proceeds, main economic activity, geographic location and loan size. A risk level will be assigned to the sub-loan (high, substantial, moderate, or low). The Project will only finance moderate and low environmental and social risk sub-loans.

8. **Exclusion list applicable to sub-borrowers and use of proceeds.** The POM will adopt an exclusion list consistent with WB's ESF, AIIB' and other pertinent policies to delineate the subprojects that will not be eligible for financing. The Borrower and sub-borrower must commit not to use the proceeds for any activities under the Project exclusion list. The Project will not support any land acquisition and resettlement.

9. **Eligible expenses**. For Components 2 and 3, the Facility will be assigned for working capital and investment needs. For working capital loans, the assistance will finance limited types of operational expenses, such as: (i) payroll costs; (ii) supplier invoices; (iii) rent; and (iv) utility expenses. Any remaining proceeds will be returned. AIIB will only provide support to address working capital needs.

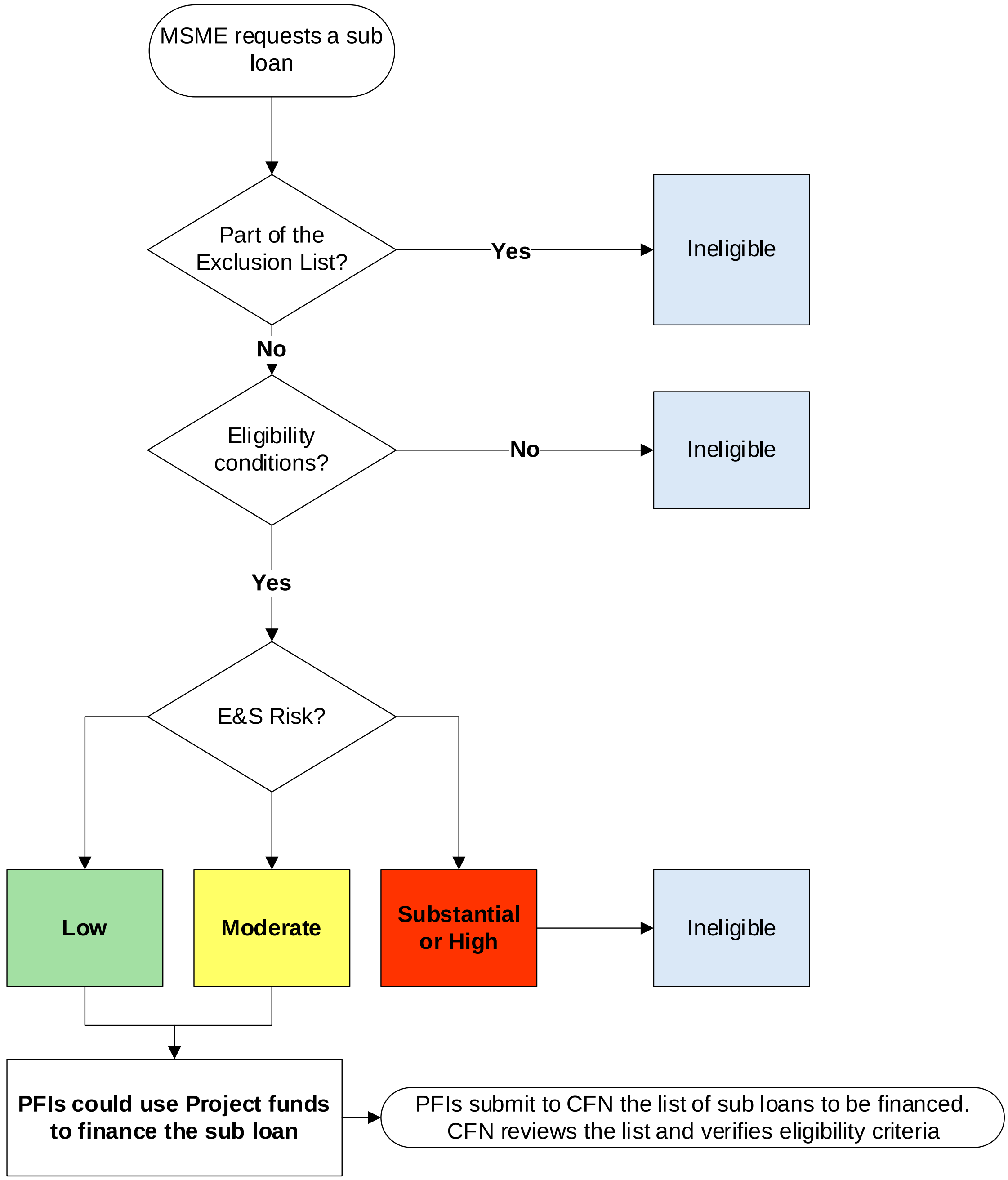
10. **Sunset clause for AIIB.** AIIB contribution is a direct response to the COVID-19 crisis. The Facility is temporary in nature and will close after operating for a defined period, i.e. PFIs will be able to extend credits only for a limited period of time.

11. **Final maturity for AIIB sub-loans.** AIIB will, through PFIs, only finance sub loans and guarantee sub-loans with a final maturity of up to 36 months during the loan availability period, in line with the proposed guidelines for liquidity finance.

12. **Monitoring & Evaluation (M&E).** CFN will periodically collect information on the use of Project funds under components 2b, 2c, and 3 through PFIs and will monitor the progress of the indicators of the Project. PCT will build a database with information on the MSMEs that have received financial assistance under the Project. The baseline information would be collected during the sub-loan application and will be analyzed during the Project implementation phase. The PCT will carry out periodic analysis of the portfolio of sub-loans granted and will measure the contribution of the Project taking into account factors such as the financed economic sector, the geographic location, and size of the population where the MSME carries out the productive activity financed by the Project. These results will be presented as part of the semi-annual progress reports.

[50] World Bank Environmental and Social Directive for Investment Project Financing. Link.

Figure 4. Screening of sub-loans.



Annex 3: Borrower Corporate and Financial Profile

1. **Structure.** CFN heads the group formed by the following entities: (1) Financial Group Banco del Pacífico S.A. (transferred from BCE to CFN in 2011)[51], (2) Seguros Sucre S.A., an insurance company, (3) Recycob S.A., a debt recovery company, and (4) Valpacifico S.A. and Fidupacifico S.A., two affiliates.

2. **Board and Management**. CFN's Board of Directors is composed of representatives from different ministries, while its president is a permanent delegate of the Presidency of the Republic of Ecuador.[52] The organizational structure[53] of CFN presents separation of functions and internal control systems, as required by the relevant regulations. CFN has governance oversight structures and committees covering Asset-Liabilities Management (ALM), Compliance, Risk Management, and Audit, and report to the Board monthly.

3. **Assets**. As of June 30, 2020, CFN accumulates assets of USD3,421 million, down from USD3,762 million from a year previous. The structure of CFN's assets remains relatively stable; credit portfolio and investments represent 44 percent and 12 percent of the total, respectively. The bulk of CFN loans (99 percent) are commercial or productive sector and concentrate on medium and large-size enterprises, mainly in the Guayaquil and Quito areas. Over 70 percent of the loans benefit primary industries (e.g. agriculture, forestry, fisheries) and manufacturing activities. Other assets (e.g. the participation of CFN in Banco del Pacífico Group, Seguros Sucre, CAF[54], among others) amount to USD 1 billion as of June 30, 2020 (29 percent).

4. **Liabilities**. As of June 30, 2020, CFN presents liabilities of USD1,787 million down from USD2,103 million in the year previous, comprised of demand deposits from the public (USD1,424 million) and liabilities vis-à-vis external financial institutions and MDBs (USD227 million). The structure of CFN's liabilities remains in line with previous periods, with term deposits representing approx. 80% of the liabilities. Approx. 36 percent of the deposits are long-term (365 days).

5. **Equity and capital adequacy.** As of June 2020, the net equity of CFN was USD1,629 million, in line with 2019 levels. The regulatory capital of CFN was USD 981 million (June 2019: USD 1,004 million), while the assets (and contingents) weighted by credit risk were USD2,270 million, reaching a "Capital Asset Ratio" (CAR) of 43.2 percent, in excess of the regulatory minimum.[55]

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[51] Executive Decree No. 941 of November 18, 2011, BCE.
[52] List of CFN Board Members. Link.
[53] Organizational and Management structure of CFN. Link.
[54] Since September 15, 1995, CFN is the owner of one series "A" share, title No. 003, of the capital stock of CAF - Banco de Desarrollo de América Latina, and 6,053 series "B" shares, which gives it the right to maintain one principal and one alternate director as representative of the Ecuadorian State.
[55] The solvency and financial prudence standards require that CFN maintains, at all time, a ratio of technical equity and risk-weighted assets and contingencies of 9%; and that the technical equity is not less than 4% of total assets plus contingent liabilities.

Table 3. Financial Statements and Performance Indicators (USD thousands).

Code	Account	2017	2018	2019	6M 2019	6M 2020	% var
	Profit and Loss Account						
5	Financial Income	318,488	325,293	344,238	184,089	132,202	-28%
51	Interest Income	168,291	173,839	184,119	90,931	88,289	-3%
41	Interests Paid	69,524	63,250	58,427	29,265	28,239	-4%
	Net Interest Margin	**98,767**	**110,588**	**125,691**	**61,666**	**60,049**	**-3%**
52	Commissions Earned	118	257	160	128	42	-67%
54	Revenue from Services	1,391	1,521	1,275	618	562	-9%
42	Commissions Paid	1,001	1,466	1,256	463	537	16%
53	Financial Profits	5,284	5,132	2,838	1,912	1,602	-16%
43	Financial Losses	1,242	965	424	230	959	317%
	Gross Financial Margin	**103,317**	**115,066**	**128,285**	**63,632**	**60,759**	**-5%**
44	Provisions	53,216	63,387	208,760	110,956	67,135	-39%
	Net Financial Margin	**50,101**	**51,679**	**- 80,475**	**- 47,324**	**- 6,376**	**-87%**
45	Operating Expenses	49,313	38,575	36,144	16,780	15,383	-8%
	Intermediation Margin	**788**	**13,104**	**- 116,619**	**- 64,104**	**- 21,759**	**-66%**
55	Other Operational Income	93,722	117,088	124,527	63,640	30,171	-53%
46	Other Operational Losses	1,398	3,591	22,009	10,286	2,170	-79%
	Operational Margin	**93,111**	**126,601**	**- 14,101**	**- 10,749**	**6,242**	**-158%**
56	Other Income	49,682	27,457	31,319	26,858	11,536	-57%
47	Other Expenses and Losses	9,022	7,298	10,834	10,416	13,613	31%
	Earnings Before Taxes	**133,772**	**146,760**	**6,385**	**5,693**	**4,165**	**-27%**
	Net Earnings	**133,772**	**146,760**	**6,385**	**5,693**	**4,165**	**-27%**
	Balance Sheet						
11	Available funds	134,267	83,892	141,057	78,991	194,320	146%
13	Investments, net	1,128,747	914,734	552,777	873,915	403,563	-54%
14	**Loan Portfolio, net**	**1,436,919**	**1,562,524**	**1,566,907**	**1,590,412**	**1,504,535**	**-5%**
1499	*(Provision for irrecoverable loans)*	*-93,284*	*-95,929*	*-227,931*	*-188,548*	*-283,156*	*50%*
16	Accounts receivable	211,760	227,553	233,852	244,961	268,656	10%
17	Realizable assets from foreclosure	1,919	4,227	4,534	4,707	3,059	-35%
18	Goods, Equipment	37,022	47,665	44,809	45,894	43,777	-5%
19	Other Assets	866,272	893,535	976,227	923,071	1,003,640	9%
	Total Assets	**3,816,906**	**3,734,129**	**3,520,163**	**3,761,951**	**3,421,550**	**-9%**
21	Obligations with customers	1,916,075	1,795,195	1,571,875	1,811,937	1,434,239	-21%
25	Accounts payable	45,036	42,410	35,749	36,641	35,728	-2%
26	Financial obligations	225,686	161,238	185,866	170,919	227,712	33%
28	Obligations convertible into shares	82,622	82,622	84,085	82,622	84,085	2%
29	Other liabilities	15,872	1,956	3,275	1,729	5,691	229%
	Total Liabilities	**2,285,291**	**2,083,421**	**1,880,849**	**2,103,848**	**1,787,455**	**-15%**
31	Share capital	621,946	621,946	641,946	641,946	714,993	11%
33	Legal reserve	134,218	147,595	162,271	162,271	162,910	0%
34	Other equity contributions	440,746	445,736	482,815	448,845	413,309	-8%
35	Surplus from valuation	7,028	21,038	19,609	19,559	12,182	-38%
36	Retained earnings	327,677	414,392	332,672	379,788	326,537	-14%
	Total Equity	**1,531,616**	**1,650,707**	**1,639,315**	**1,652,410**	**1,629,930**	**-1%**
	Total Liabilities and Equity	**3,816,906**	**3,734,129**	**3,520,163**	**3,756,259**	**3,417,385**	**-9%**
6	Contingent liabilities	166,090	159,150	83,654	118,850	84,536	-29%
7	Memorandum accounts	19,763,144	21,923,889	22,825,108	22,813,959	23,076,652	1%
	Financial Performance Indicators						
	Solvency						
	Regulatory Equity / Risk Weighted Assets	44%	45.45%	43.03%	43.67%	43.21%	
	Structure and Asset Quality						
	Non-Performing Assets / Total Assets	8.83%	9.36%	5.95%	9.82%	6.02%	
	Performing Assets / Liabilities	162.44%	172.96%	188.30%	171.06%	193.43%	
	Delinquency and Provisioning						
	Loan Delinquency, Commercial Loans	8.94%	7.94%	6.69%	13.01%	7.68%	
	Loan Provisioning, Commercial Loans	65.94%	73.01%	189.86%	81.16%	204.55%	
	Efficiency						
	Estimated Operating Expenses / Av. Assets	1.28%	1.01%	0.97%	0.89%	0.88%	
	Staff Expenditures / Average Assets	0.61%	0.57%	0.55%	0.53%	0.57%	
	Profitability						
	Return on Average Equity (ROE)	9.57%	9.76%	0.39%	0.69%	0.51%	
	Return on Average Assets (ROA)	3.50%	3.93%	0.18%	0.30%	0.24%	
	Financial Intermediation						
	Loan Portfolio (Gross) / (Deposits)	79.86%	92.38%	114.18%	98.18%	124.64%	
	Financial Efficiency						
	Estimated Intermediation Margin / Av. Equity	0.05%	0.86%	-7.07%	-7.76%	-2.66%	
	Estimated Intermediation Margin / Av. Assets	0.02%	0.34%	-3.13%	-3.40%	-1.25%	
	Portfolio Returns						
	Portfolio Returns, Commercial Loan Portfolio	7.86%	7.92%	8.95%	8.22%	8.29%	
	Liquidity						
	Available Funds / Total Short-Term Deposits	35.36%	13.15%	22.97%	16.89%	42.20%	
	Equity Vulnerability						
	NPA / Equity	9.27	8.13	7.50	14.23	8.76	
	Fk = (Equity+NI–Extra. Earnings) / Assets	38.83%	43.47%	45.68%	43.36%	47.42%	

Source: Balance Management System.

Annex 4: Sovereign Credit Fact Sheet and Debt Sustainability Analysis

A. Background

1. **Context.** Ecuador is an upper-middle-income country[1] with income per capita of USD6,183[2] and a population of 17.3 million, as of 2019. Ecuador is one of the largest oil exporters in Latin America. The country is also an important producer of primary goods (such as bananas and shrimp) and metals (such as gold). Income transfers from Ecuadorians abroad are also important for the economy.

2. **Dollarization limits the available policy space and increases the costs of inconsistent policies.** Ecuador dollarized in 2000 following years of macroeconomic volatility. Dollarization has been very effective at reducing inflation, providing a policy anchor, and restoring credibility of the currency. However, dollarization's positive contribution to macroeconomic stability and growth comes at certain costs. With monetary policy not available, fiscal policy must stand ready to bring about the adjustment. Liquidity in the system must normally be accumulated through current account surpluses, derived from a competitive export sector. Insufficient net flows would lead to a liquidity crunch and high interest rates and would jeopardize the system.

B. Recent Economic Developments and Outlook

3. **Economic circumstances and policies became increasingly inconsistent with the dollarization regime.** Between 2004 and 2014, Ecuador experienced a period of fast economic growth and development on the back of high oil prices. However, with the decline in oil prices since 2014 this public-sector driven model has become unsustainable. Macroeconomic policies—including high fiscal deficits, rising public debt and central bank financing of government—become increasingly incompatible with the dollarized system currently in place. External imbalances and central bank financing caused a sharp decline in Ecuador's international reserves to levels well below those needed to protect system liquidity and support dollarization[3]. In the real sector, robust wage increases, supported by oil income and a 50 percent hike in the minimum wage, were in excess of the productivity growth.[4] Together with the appreciation of the USD this led to a serious deterioration in competitiveness.

4. **Since 2017 the new administration has been trying to reverse the course.** The government is aiming at modernizing economic management and making a transition to a private-sector-led growth. A new law improved incentives for domestic and foreign investment, introduced new fiscal rules to guide debt towards sustainable levels and reinstated (partially) the prohibition of central bank financing. These measures, along with some rebound in oil prices, slowed the buildup of public debt, and helped muddle through,

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[1] According to World Bank classification. Link.
[2] According to World Bank. Link.
[3] By 2017 gross reserves had fallen to USD2 billion, or about 12-15 percent of the IMF's adequacy metrics (and have since remained at these levels), insufficient even to cover the deposits of the banking sector. Net reserves were negative.
[4] Compared with regional peers, Ecuador's minimum wage in USD terms was one of the lowest in 2000 and the highest in 2019.

but were insufficient to fully restore external viability. Double-digit gross financing needs proved to be untenable as liquidity pressures started to reemerge. Ecuador turned to the IMF.

5. **The 2019 IMF program, along with the USD10 billion financing package mobilized around it, was a milestone for Ecuador.** The program—the first in 15 years—offered a respite from expensive market financing and presented an anchor for economic reforms. However, the parliament rejected an emergency package of economic reforms that included the IMF-recommended changes to economic legislation. The IMF program was recalibrated in December 2019 to allow more time to build consensus around the reforms.

6. **Economic activity was already slowing before the current crisis.** Growth in 2019 was virtually zero, mainly due the impact of fiscal consolidation and competitiveness issues. This situation is exacerbated by a very low level of international reserves, which put the dollarized system at risk.

Table 4. Ecuador: key economic indicators.

Key economic indicators	**2018a**	**2019e**	**2020p**	**2021p**	**2022p**
GDP growth (% change)	1.3	0.1	-11.0	4.8	1.3
Inflation (average, % change)	-0.2	0.3	0.0	1.0	2.3
Current account balance	-1.2	-0.1	-2.0	-0.1	0.3
Overall fiscal balance 1/	-3.2	-3.2	-8.9	-2.9	0.6
Nominal gross public debt 1/	46.1	51.8	68.9	67.4	65.8
Public gross financing needs	10.5	10.3	16.1	8.1	4.2
Gross international reserves (USD billion) 1/	2.2	2.9	2.5	3.3	5.0

Source: IMF Country Report 20/286. 1/ IMF definition
Notes: In percent of GDP, except where indicated otherwise

7. **The 2019 IMF program went off-track due to slippages and the Covid-19 pandemic and was replaced with a larger, redesigned IMF program in October 2020.** The 2019 program was cancelled to make room for IMF's emergency financing and allow for debt restructuring to take place. The new, 2020 program aims at backstopping Ecuador's liquidity in the near term, catalyzing additional support from bilateral and multilateral partners and supporting a program of reforms to economic management institutions that would ensure improved fiscal performance and longer-term debt sustainability.[5]

C. Debt Sustainability Analysis

8. **Ecuador's debt vulnerabilities are related to difficulties in adjusting to lower oil prices after a decade of fiscally unsustainable development policies.** During 2007-17, under an economic boom on the back of high oil prices, the public sector became a main

[5] The key measures include: (i) operationalizing the recently-revised organic budget law to strengthen fiscal discipline and transparency through better financial management and a fiscal rules framework; (ii) tax reform (including a VAT increase) to boost revenues from low levels; (iii) revisions to the central bank code to finally prohibit all monetary financing and quasi-fiscal operations as well as strengthen the international reserves framework; and (iv) other reforms to improve economic management (e.g. procurement reform, debt management) and competitiveness (SOEs reform, business climate).

driver of economic growth, expanding from 21 to 44 percent of GDP during 2006-14. In addition, fuel subsidies consumed as much as 3 percent of GDP. As revenues declined rapidly in 2014, the government adjusted by cutting investment spending, while current spending was less affected. Despite the consolidation measures, fiscal deficit increased significantly and was financed with expensive commercial debt and various non-standard means. As a result, public debt rose sharply from 27 percent of GDP in 2014 to 45 percent in 2017 and further to above 50 percent of GDP in 2019.

9. **Ecuador's debt carrying capacity is lower than usual.** Public debt is about 50 percent and gross financing needs about 15 percent of GDP—many countries rated similarly on creditworthiness are typically able to sustain heavier burdens. For market access countries, such as Ecuador, the IMF normally uses thresholds of 70 and 15 percent of GDP for the debt level and gross financing needs respectively, beyond which it flags for debt vulnerabilities. In the case of Ecuador, IMF recommends that a prudent debt ceiling in Ecuador be no more than 40 percent of GDP, and gross financing needs be kept below 6 percent of GDP. Several internal and external factors contribute to this situation, including dependence on volatile oil revenues, weak track record for a sustained fiscal consolidation, very low liquidity, and a history of sovereign defaults.[6]

10. **In March 2020, with low oil prices and the Covid-19 outbreak in full force, financial markets lost confidence that Ecuador could honor the large upcoming debt redemptions.** Spreads on Ecuador bonds shot up above 5,000 basis points, when it became apparent that Ecuador would not be able to meet the challenging 2022-30 Eurobond redemption schedule, or even afford current interest payments. By mid-year, according to the IMF, public debt has become unsustainable. The government issued a request for a debt standstill and an invitation to restructuring. The government also entered negotiations with China to restructure the existing obligations and obtain a new USD2.4 billion loan.

11. **In August 2020, after swift negotiations, Ecuador secured a landmark deal with private bondholders on a total of USD17.4 billion of debt.** An unprecedented 98 percent of bond holders voted in favor of the deal, reflecting the desire on their part to have a friendly restructuring. Under the agreement, the ten outstanding bonds maturing between 2020 and 2030 will be exchanged for three new bonds maturing between 2026 and 2040. The sovereign thus receives a 5-year grace period and the lengthening of the average maturity from about 6 to almost 13 years. The weighted average coupon rate on new debt will decline from 9.2 to 5.3 percent. The nominal haircut on the principal would be 8.3 percent. Interest payments will not resume until late 2021. **Furthermore, important legislation has been passed and consolidation measures announced.** Finally, the congress has come around to approve the previously-rejected IMF-mandated amendments to the organic budget law, which (among other measures to strengthen fiscal framework) introduce public debt targets—57, 45 and 40 percent of GDP for 2025, 2030 and 2032 respectively—along with specific measures aimed at achieving them. Additionally, Ecuador was able to secure assurances of debt relief and new financing from its main bilateral creditors.

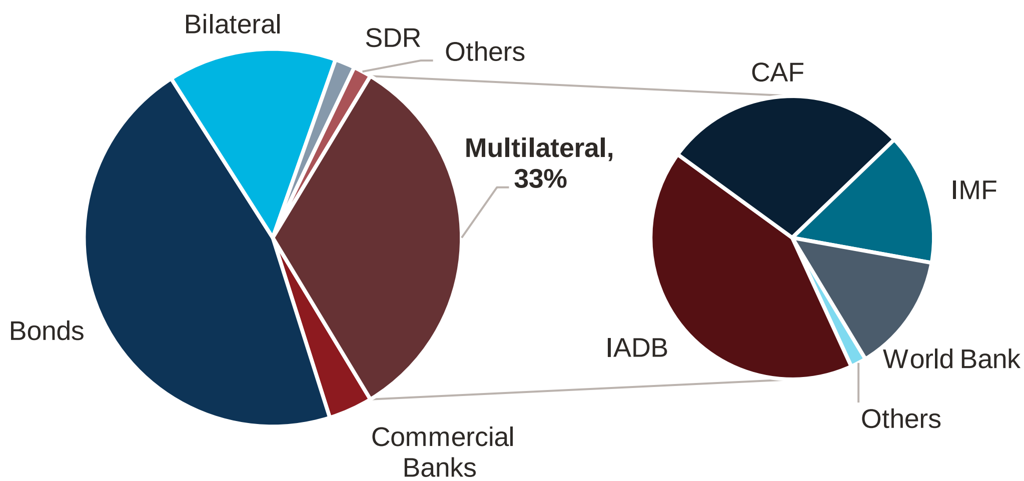
[6] Ecuador defaulted in 1999/2000, as a consequence of declining oil prices, natural disasters, a reversal of capital flows as well as loose fiscal and monetary policies. It also defaulted in 2008, despite a much stronger financial position, on a series of bonds that the government had proclaimed to be illegitimate. By S&P's measure, since coverage began, Ecuador's rating has been in the CCC range for almost half of the sovereign rating history. Even during times of high growth, high oil prices and low debt, the rating has never risen above B.

12. **This has opened the way for a new IMF program and led to an upgrade of Ecuador's sovereign rating.** With the debt restructuring, the required strengthening of the fiscal framework and official financing assurance the authorities were able to secure a new, exceptionally large (USD6.5 billion) program from the IMF, which is meant to serve as an anchor for reforms and further financial support from official sources. Based on these developments, Ecuador's sovereign rating were raised from default to B- by Fitch and S&P

Sustainability of Ecuador's Public Debt

13. **As of end-2019, Ecuador's public debt[7] was USD55.7 billion, or 51.8 percent of GDP.** About USD13 billion was domestic, including central bank financing, treasury paper held by public banks and the private sector, letters of credit, accounts payable, etc. External debt was about USD41 billion, of which USD19 billion was commercial debt (e.g., Eurobonds), USD13.5 billion was owed to various MDBs and USD5.9 billion to bilateral lenders, of which about USD5.5 billion to China.

Figure 5. Creditor composition of external debt.



Source: External Debt Bulletin, MOF (June 2020).

14. **According to latest, October 2020 IMF's projections, the economy is to shrink by 11.0 percent in real terms.** Growth is expected to rebound to 4.8 percent in 2021 and, by 2025, converge towards its potential (about 2.5 percent). Inflation is expected to average 1.3 percent. The overall fiscal deficit is expected to widen from 3.2 percent of GDP in 2019 to 8.9 percent in 2020. Subsequently, thanks to the anticipated decisive fiscal consolidation, the fiscal balance is to turn positive (a 2.3 percent of GDP surplus) by 2025. In terms of fiscal efforts, it translates to a 5.5 percentage points of GDP consolidation in the non-oil primary balance including subsidies between 2019 and 2025. Included in the assumptions is a moderate increase in oil prices (Ecuadorian crude) from USD35.6 to USD43.6 per barrel.

[7] IMF's definition of public debt comprises the consolidated debt of the non-financial public sector (central government and non-financial SoEs), plus all liabilities under oil-related financing, treasury certificates, central bank lending to the government, and other liabilities.

Macroeconomic assumptions	2018	2019	2020	2021	2022	2023	2024	2025
GDP growth (percentage change)	1.3	0.1	-11.0	4.8	1.3	1.7	2.0	2.3
Inflation (CPI percentage change)	-0.2	0.3	0.0	1.0	2.3	1.4	1.0	1.0
Oil prices (USD per barrel)	60.6	55.3	35.6	39.8	41.0	42.0	42.8	43.6
Non-oil primary balance, incl. subsidies (% of GDP)	-6.7	-5.3	-7.9	-4.6	-1.6	-0.1	0.2	0.2

Source: IMF Country Report 20/286 (Oct 2020)

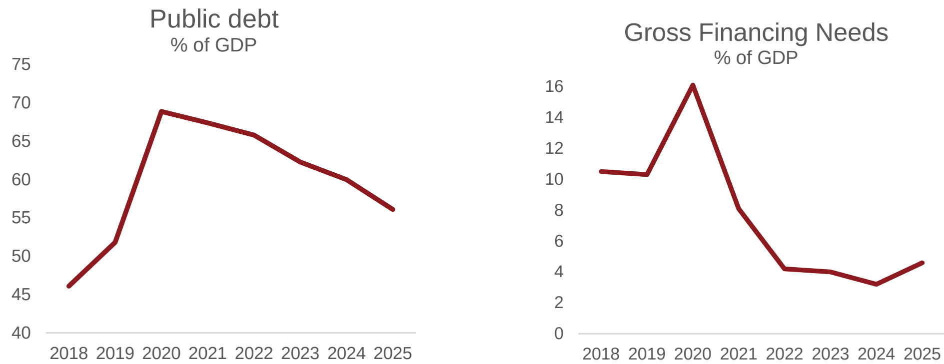
15. **According to the most recent DSA, prepared by the IMF in October for the new program, public debt is expected to increase from 51.8 in 2019 to 68.9 percent in 2020**, due to high deficit (8.9 percent of GDP). The deficit is the result of lower oil revenues (by USD3.2 billion), lower non-oil revenues (by USD4 billion) and COVID-19 mitigation expenditures (USD0.8 billion). A large, USD3.8 billion planned retrenchment in other spending (of which USD2.5 billion from current and 1.3 billion from capital spending) is still insufficient to offset the revenue collapse. Additional factor in the increase of debt burden is a 13.4 decline in the nominal GDP.

16. **That said, debt should start declining from 2021 onwards.** In the medium term, with a successful implementation of the program, debt is expected to decline to 56.1 percent of GDP in 2025. This would be in accordance with the recently-legislated debt limits, and on track to reach 45 percent of GDP in 2030 and 40 percent of GDP in 2032—i.e. levels deemed by the IMF as safe for Ecuador. Underpinning this debt reversal is a decisive fiscal consolidation. For 2021 the overall deficit is to shrink to 2.9 percent of GDP, or by USD 5.4 billion (of which: oil revenue increase of USD 1 billion, non-oil revenues increase of 1.7 billion and expenditure reduction of USD 2 billion). Additional 5-5.5 percent of GDP of deficit reduction will be needed by 2025.

17. **Gross financing needs are about 16 percent of GDP in 2020 but will decline to below 5 percent of GDP already by 2022.** —i.e. levels deemed by the IMF as safe for Ecuador. According to the IMF, the next 12 months are fully financed. Over 2020-21 IFIs are expected to provide USD6.8 billion, IMF USD5.5 billion and China USD2.4 billion. The restructuring of private bonds was instrumental in the alleviation of the liquidity constraint, providing as much as USD1.5-2 billion breathing space over 2021-25. The baseline scenario also assumes a gradual resumption of market access (USD0.5-2 billion) starting 2022.

18. **As of October 2020, the IMF assesses Ecuador's public debt to be sustainable with high probability**, under baseline projections. This is thanks to the successfully bond exchange, the financing assurances and good prospects for financing from official creditors as well as the envisaged fiscal consolidation.

Figure 6. Public debt and gross financing needs, in % of GDP



19. **The feasibility of the baseline scenario depends on how plausible the assumptions are, and the balance of risks and their mitigants.** Key factors include the following assumptions:

- ***Macroeconomic assumptions.*** Growth is assumed to rebound quickly as pandemic subsides and stabilize at above 2 percent afterwards. This is optimistic, given Ecuador's challenges and uncertainties regarding the duration and severity of the pandemic. Nevertheless, the oil outlook offers a certain upside potential, and there could be substantial confidence effect if the IMF program is implemented successfully.

- ***Feasibility of fiscal adjustment.*** A 5.5 percentage points of GDP fiscal consolidation is needed by 2024-25. Over 4-5 years this is technically doable, except that further deep cuts in non-oil infrastructure spending would undermine growth. However, the IMF reckons this assumption is not overly optimistic, given Ecuador's track record of fiscal consolidation under stress.

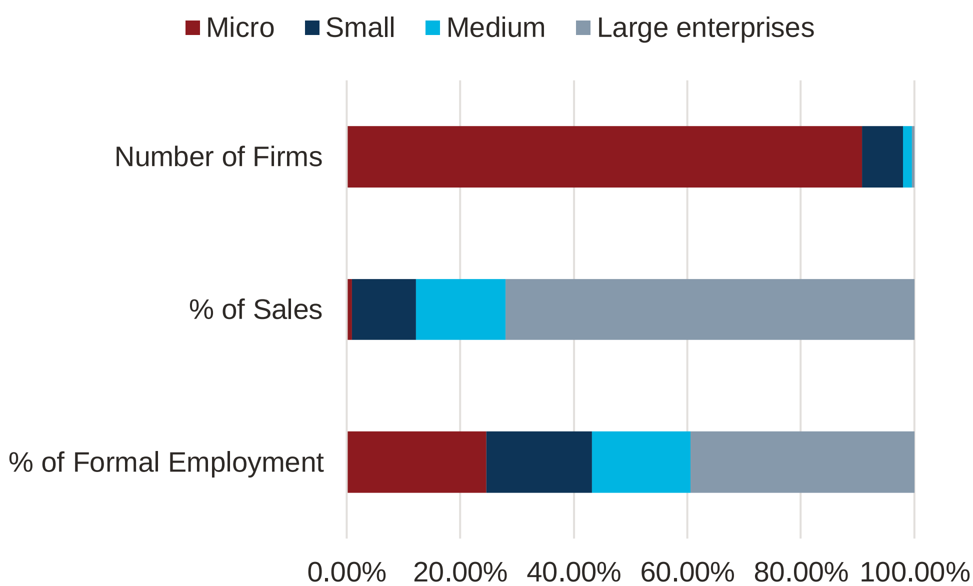
- ***Political will.*** Presidential elections scheduled for February 2021, will see a new government taking office mid-2021. Political and social tensions run high and the vote could become a fundamental referendum on the future course of policies. However, there is strong support for dollarization and fiscal prudence among the public and the political class. The IMF has engaged a broad range of presidential candidates, most of whom are reportedly supportive of program objectives.

- ***International support.*** There is a strong resolve among development partners to help Ecuador succeed (e.g. as evidenced by the large size of the IMF program), and many stakeholders are invested. Financing has been secured for the next 12 months, with good prospects for further financing.

Annex 5: The MSME Sector in Ecuador and trade with Asia

1. **Micro, Small and Medium-sized enterprises represent 99.5 percent of firms in Ecuador.** There are nearly about 900,000 registered firms in the country. 90 percent of registered firms are Micro-sized enterprises (less than 10 employees, less than USD100,000 of annual sales). Firms concentrate their activities in services and commerce; 42.7 percent of firms are oriented to services, while nearly 34.9 percent of firms are engaged in commerce. 10.4 percent of firms are involved in agriculture and fishing activities, 8.4 percent in manufacture, 3.4 percent in construction and 0.2 percent in extractive industries.

Figure 7. Distribution of firms, sales, and formal employment by firm size.



Source: Directorio de Empresas - DIEE 2018

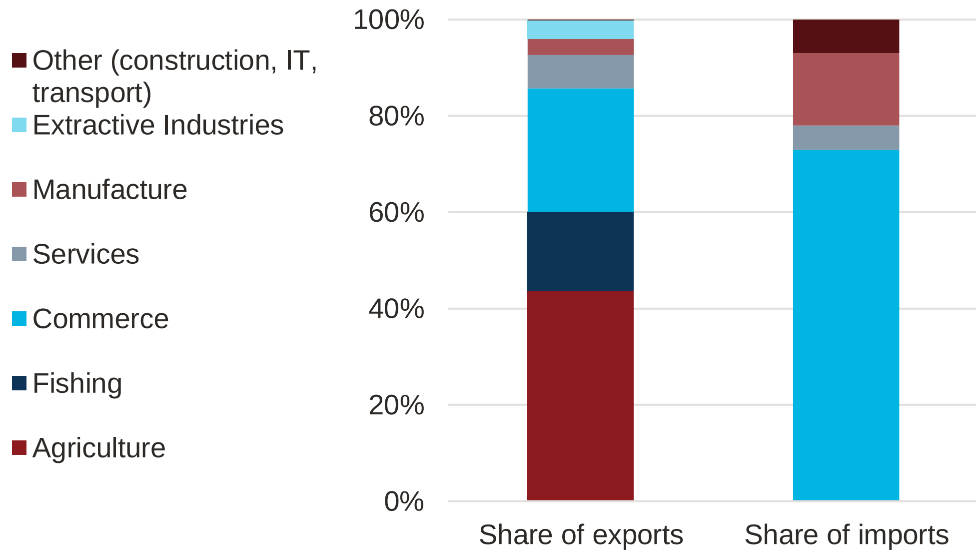
2. **53 percent of firms exporting to Asia and 70 percent of firms importing from Asia are MSMEs.** A total of 465 MSMEs exported to the Asian market in 2019, while 4,811 MSMEs imported from Asia. Exporter MSMEs belonged mainly to the primary (agriculture and fishing) and the commercial sector. Meanwhile, importer MSMEs were mostly engaged in commerce and manufacture.

3. **MSMEs exports to Asia consist of primary products.** Exports to Asia correspond to a reduced group of products, namely fish and crustaceans (such as crustaceans, shrimp, and prawns), fruits (such as bananas), flowers, wood and cacao. Most exported products are final goods for the Asian market.

4. **MSMEs imports from Asia are capital-intensive.** Most imports of Asian origin correspond to manufactured products, namely vehicles, electronic and telecommunications equipment, manufacture of plastics, manufacture of basic metals, medical equipment, manufacture of chemicals and chemical products. Generally speaking, imports consist of manufactured products employed as inputs or capital goods in the productive cycle, and final goods commercialized in the internal market. Around 68 percent of imported products are capital goods, raw materials, or intermediate input.

5. **Trade between Ecuador and Asia has fallen by 12.1 percent to date in 2020 as a result of the COVID-19 crisis[8].** As the country is working on new protocols and adopt biosecurity measures for the food industry, it is expected that trade disruption with Asia will continue in the short-term, thus affecting commodity prices and volumes[9]. Globally, trade was already slowing before the virus outbreak, which was caused by increasing trade tensions and a slower economic growth. Limited transportation routes and higher transportation costs, along with a reduction in aggregate demand will result in a significant shock to trade. The World Trade Organization (WTO) estimates that all regions will suffer a double-digit decline in exports and imports in 2020; global trade is expected to fall by between 13 percent and 32 percent in 2020[10]. Containing the fallout from the COVID-19 crisis, while preparing the economy for the recovery, is key to prevent an economic depression that would have long-lasting effects on trade and development.

Figure 8. MSMEs exports and imports with Asia, sectoral composition**.**



Source: Superintendencia de Compañías, 2018 (SUPERCIAS) and National Customs Service (SENAE), 2019.

6. **CFN has identified value chains with intensive trade with Asia**. Using bilateral trade data and value chain analysis, CFN has identified activities where there is a significant economic link between Ecuador and Asia.

[8] As of August 2020, according to Central Bank of Ecuador data. Total trade is defined as the sum of the value of FOB exports and CIF imports.
[9] On July 11, 2020, China suspended imports from three shrimp producers in Ecuador after having detected a sample of the new coronavirus in recent shipments. Ecuador is the world's second largest shrimp exporter and the top supplier to China.
[10] WTO Press Release n/855, 8 April 2020. Link

Table 5. Prioritized value chains.

Trade Intensity Order[11]	Value Chain	Trade Flow
1	Shrimp and prawn	Export
2	Banana	Export
3	Vehicles, parts, and accessories	Import
4	Cell phones and spare parts	Import
5	Cocoa	Export
6	Roses and other flowers	Export
7	Iron or steel products	Import
8	Image receiving devices	Import
9	Wood	Export
10	Tires and Wheels	Import
11	Frozen fish	Export
12	Computers	Import
13	Fertilizers	Import
14	Mixtures and aromatic hydrocarbons	Import
15	Motorcycles	Import
16	Vegetables	Export
17	Air conditioning machines and devices	Import
18	Copper waste and scrap	Export
19	Wood manufactures	Export
20	Coffee	Export
21	Textile articles	Export

Source: CFN.

[11] Trade intensity is calculated by considering the value of exports and/or imports with Asia for the selected economic activities.

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