DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

MEXICO

EXPANDED CCLIP TO SUPPORT BUSINESS DEVELOPMENT IN MEXICO

(ME-X1010)

PROGRAM TO PROMOTE THE DEVELOPMENT OF SME SUPPLIERS AND CONTRACTORS FOR THE NATIONAL OIL INDUSTRY—FIRST PROGRAM UNDER THE CCLIP

(ME-L1051)

LOAN PROPOSAL

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Proposed resolution

ELECTRONIC LINKS
REQUIRED
1. Annual work plan Not applicable
2. Monitoring and evaluation arrangements http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=2083679
3. Procurement plan http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=2211805
4. Environmental and Social Management Report (ESMR) http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=2226756
OPTIONAL
1. Government measures in response to the crisis http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=2083684
2. Financing for the SME sector http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=2079424
3. Survey on Mexican oil industry suppliers http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=2090695
4. NAFIN institutional overview http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=2083228
5. NAFIN financial statements http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=2082872
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7. Bancomext financial statements http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=2089040
8. Summary of financial risks http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=2081832
9. Operating Regulations http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=2088628
10. CTF Investment Plan for Mexico http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=2189820

ABBREVIATIONS

Bancomext	Banco Nacional de Comercio Exterior
CCLIP	Conditional credit line for investment projects
CIF	Climate Investment Fund
CNBV	Comisión Nacional Bancaria y de Valores [National Banking and Securities Commission]
CO_2e	Carbon dioxide equivalent
CTF	Clean Technology Fund
GHG	Greenhouse gas
LIBOR	London Interbank Offered Rate
MSMEs	micro, small, and medium-sized enterprises
MT	metric tons
NAFIN	Nacional Financiera, S.N.C
OECD	Organization for Economic Cooperation and Development
PEMEX	Petróleos Mexicanos
SMEs	Small and medium-sized enterprises
tCO_2e	tons of carbon dioxide equivalent
TIIE	Interbank Equilibrium Rate

PROJECT SUMMARY

MEXICO
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PROGRAM TO PROMOTE THE DEVELOPMENT OF SME SUPPLIERS AND CONTRACTORS FOR THE NATIONAL OIL INDUSTRY—FIRST PROGRAM UNDER THE CCLIP
(ME-L1051)

<table>
<tr><th colspan="6">Financial Terms and Conditions</th></tr>
<tr><td colspan="3"><u>For the CCLIP</u>
Borrowers Nacional Financiera, S.N.C. (NAFIN) and Banco Nacional de Comercio Exterior S.N.C. (Bancomext)</td><td>Term of the CCLIP:</td><td>10 years</td></tr>
<tr><td colspan="3"></td><td>Amortization period for the first program:</td><td>25 years</td></tr>
<tr><td colspan="3"><u>For the first program:</u>
Borrower: NAFIN
Executing agency: NAFIN
Guarantor: United Mexican States</td><td>Grace period for the first program:</td><td>5 years</td></tr>
<tr><td colspan="3"></td><td>Disbursement period for the first program:</td><td>3 years</td></tr>
<tr><td colspan="3"></td><td>Interest rate:</td><td>LIBOR</td></tr>
<tr><td>Source</td><td>CCLIP</td><td>Program</td><td>Inspection and supervision fee:</td><td>*</td></tr>
<tr><td>IDB (Ordinary Capital)</td><td>Up to
US$1.2 billion</td><td>Up to
US$301 million</td><td>Credit fee:</td><td>*</td></tr>
<tr><td colspan="3"></td><td colspan="2">Currency: U.S. dollars from the Single Currency Facility.
Conversion to Mexican pesos: Local Currency Facility (document GN-2365-6)</td></tr>
<tr><th colspan="6">Project at a glance</th></tr>
<tr><td colspan="6">Objective/description of the CCLIP:
The general objective of the CCLIP is to make Mexican companies more competitive by channeling medium- and long-term financing for investment projects in different sectors.
Objective/description of the first program: To help make the small and medium-sized enterprise (SME) sector within the national oil industry's value chain more competitive by channeling medium- and long-term financing to that segment, as well as financing for projects to reduce greenhouse gas (GHG) emissions associated with the national oil industry. The specific objectives will be to (i) support the strategy to promote the development of suppliers and contractors for the national oil industry; (ii) support the development of SME suppliers and contractors within the oil sector's value chains, complementing the actions of the Trust Fund to Promote the Development of National Suppliers and Contractors for the State Oil Industry; (iii) consolidate and develop the financing market for Mexican SMEs; (iv) finance private projects to increase energy efficiency and reduce GHG emissions associated with the oil industry; and (v) strengthen NAFIN's capacity to develop financing markets for SMEs and support the structuring of strategic projects (paragraph 1.34).</td></tr>
<tr><td colspan="6">Special contractual clauses for the first program. Condition precedent to the first disbursement:
Entry into force of the Operating Regulations, which must have the Bank's no objection (paragraph 3.7).
Special execution conditions: A midterm evaluation will be conducted after 18 months of execution or when 50% of the loan has been committed, as detailed in paragraph 3.10.</td></tr>
<tr><td colspan="6">Exceptions to Bank policies:
A waiver is requested to the current exchange rate policy (document GN-2415), in order to apply the exchange rate on the last day of the month prior to execution of the expenditure for the purpose of converting expenditures made in the borrower's local currency into U.S. dollars (paragraph 3.8).
The CCLIP concept would be expanded to include the use of guarantees, as has been done in several previous CCLIP operations.</td></tr>
<tr><td colspan="6">Project consistent with country strategy: Yes [X] No [ ]
Project qualifies as: SEQ [ ] PTI [ ] Sector [ ] Geographic [ ] Headcount [ ] %
Procurement: Bank policies will apply.</td></tr>
</table>

* The credit fee and inspection and supervision fee will be established periodically by the Board of Executive Directors as part of its review of the Bank's lending charges, in accordance with the applicable provisions of the Bank's policy on lending rate methodology for Ordinary Capital loans. In no case will the credit fee exceed 0.75% or the inspection and supervision fee exceed, in a given six-month period, the amount that would result from applying 1% to the loan amount divided by the number of six-month periods included in the original disbursement period.

I. DESCRIPTION AND RESULTS MONITORING

A. Frame of reference and problem addressed

1.1 This conditional credit line for investment projects (CCLIP) is conceived as a flexible tool for providing funding and technical assistance to strategic areas of mutual interest to the IDB and two jointly managed Mexican development banks, Nacional Financiera, S.N.C. (NAFIN) and Banco Nacional de Comercio Exterior (Bancomext). The first operation under the CCLIP will provide medium- and long-term funding to Mexican companies, primarily small and medium-sized enterprises (SMEs), in a context where access to credit has diminished significantly.

1.2 **Macroeconomic context**: The international financial crisis and influenza outbreak have seriously affected the Mexican economy. During the first six months of 2009, economic activity declined 9.3%, and the consensus among private analysts projects a cumulative decline of 6.9% for the year. The United States recession has affected exports, tourism, foreign investment, and remittance flows. Although the Mexican banking sector has escaped solvency problems, less financing is available. In addition, the negative impact of the influenza epidemic is projected at approximately 0.5% of growth. Given current economic trends, the fiscal outlook for 2009 and 2010 has deteriorated, leading to discussion of a possible downgrade of Mexico's sovereign debt rating. The fiscal deficit is expected to reach an estimated 2.3% of gross domestic product (GDP) in 2009.

1.3 The Government of Mexico responded quickly and decisively to these shocks (government measures) and ruled out the possibility of the country facing balance-of-payment problems. Sound economic fundamentals enabled Mexico for the first time to adopt countercyclical fiscal measures, equivalent to 1.5% of GDP in 2009, and to relax its monetary policy. Access to resources from the International Monetary Fund (IMF) and the United States Federal Reserve played a significant role in preserving financial stability. Despite this difficult economic climate, the institutional framework for monetary and fiscal policy will continue to provide certainty for economic agents. The autonomy of Mexico's central bank, Banco de México, will ensure that the relaxed monetary policy will continue to the extent permitted by inflationary pressures, and that countercyclical stimulus will be used in a manner consistent with the prudential obligations established by the Federal Budget and Fiscal Accountability Act.

1. Recent developments in the financial sector

1.4 The Mexican financial markets are characterized by high concentrations of foreign capital, significant external funding, and intermediation concentrated in relatively few borrowers. To a great extent, these phenomena relate to the impact of the 1994-1995 economic crisis and liberalization of the financial system, which led to: (i) a substantial increase in external participation in banking system assets, from approximately 25% in 1998 to over 75% in 2001; (ii) accelerated consolidation of the banking system, which reported that roughly 80% of total assets were held by the five largest banks in 2007, with each bank's 50 largest borrowers representing

close to 60% of the commercial portfolio; and (iii) a high proportion of external financing for enterprises, totaling close to 42% in 2007.

1.5 Since the collapse of Lehman Brothers in September 2008, the international financial crisis has deepened and spread, becoming the farthest-reaching, most acute slump since the Second World War, with impacts including higher liquidity and funding costs in international markets and tight credit policies. International banks reduced bank loans by US$5.5 billion in fourth quarter 2008 and by US$3.4 billion in first quarter 2009. This has limited access to funding and substantially increased the margins required to insure credits for Mexican companies (through derivatives contracts known as credit default swaps).

1.6 The financial reforms of recent years have strengthened Mexico's capacity to withstand the crisis. Financial regulations have established a wide range of prudential standards consistent with international best practices. The supervisory role of the Comisión Nacional Bancaria y de Valores [National Banking and Securities Commission] (CNBV) has also been strengthened. Limits on loans to related parties, a component of Mexico's prudential standards, have served to limit Mexican banks' actual exposure to the deterioration of assets in the international banking system, relatively speaking. Robust supervision has also ensured that the system has remained solvent despite the severity of the crisis.

1.7 Global aversion to risk, coupled with uncertainty following substantial losses on exchange-rate and interest-rate positions, have significantly tightened credit for Mexican enterprises in international markets. Companies that previously participated in foreign debt markets are finding it difficult to renew existing liabilities and face substantially higher costs (up to 300 basis points) and shorter terms. As a result, Mexican companies' external financing in dollars fell from close to 20% just before Lehman's collapse to nearly zero in March 2009.

1.8 The local debt market has not escaped turmoil. Between August 2007 and April 2009, the average term of capital market financing available to Mexican companies decreased from close to 70 days to approximately 45 days, and costs increased by an average of 200 basis points. The level of financing continued to fall, dropping at an annual rate of 1.5% during the first six months of 2009. At the same time, the Mexican public sector has increased its sourcing of funds, competing with private enterprises and financial institutions for available funds. According to Banco de México data, financing requirements for the broader public sector reached 35.8% of GDP in 2008—up 4.3% over 2007.[1]

1.9 In multi-purpose banking, the terms of bank loans to nonfinancial private enterprises began to contract in fourth quarter 2008. Peso-denominated loans to the sector at terms less than 90 days increased from an average of 59.5% of the total for the first three quarters of 2008 to an average of 67.8% between October 2008 and

[1] The decreased share of foreign-currency denominated debt as a proportion of public debt, which fell from 37.3% in 2004 to 25.6% in 2008, helped the government maintain a sustainable fiscal position.

May 2009. Overall, between August 2007 and April 2009 the average term of bank financing to Mexican enterprises decreased from approximately 220 days to close to 100 days. The cost of business financing has also increased, from 100 basis points over the Interbank Equilibrium Rate (TIIE) in August 2007 to TIIE plus 500 basis points in April 2009.

1.10 The constraints faced by companies, especially SMEs, in accessing medium- and long-term funding for productive investments tightened with the crisis. Foreign lines of funding have also been closed, reducing the net funding available and forcing companies that had previously sourced funds abroad to compete for scarce domestic funding, crowding out SMEs.

1.11 The Encuesta de Evaluación Coyuntural del Mercado de Crédito [Credit Market Trend Evaluation Survey] found that companies perceived tightened access to bank loans beginning in fourth quarter 2008. Among those surveyed that did not use bank financing, the percentage citing tightened restrictions as a limitation on access to bank loans rose from 29.3% in third quarter 2008 to 49.1% and 44.8% in fourth quarter 2008 and first quarter 2009, respectively. Regarding the cost of bank credit, while 29.3% identified higher interest rates as a barrier to using loans in third quarter 2008, the response rate was 49.8% in fourth quarter 2008 and 38.5% in first quarter 2009.

1.12 In response to tightened credit conditions, development banks have increased lending to enterprises, offsetting part of the cutback in commercial lending. In May 2009, outstanding direct loans by development banks to nonfinancial private enterprises had increased at a real annual rate of 56.3%; the variation for the previous year had been 0.1%. The proportion of financing allocated to nonfinancial private enterprises in the Mexican economy declined from 43.5% in 2007 to 42.2% in 2008, and impacted the SME sector disproportionately.

2. The SME sector

1.13 SMEs play a central role in Mexico's economy. According to 2006 figures from by the Organization for Economic Cooperation and Development (OECD), SMEs account for 99% of all Mexican companies, generate over 50% of GDP, and provide nearly 75% of all jobs. The smaller businesses lag in terms of profitability. In general, Mexican SMEs produce for the domestic market only, and their products lack the benefits of production and design technologies. Diagnostic assessments by the OECD, Mexico’s Department of Economic Affairs, and others conclude that SMEs' weak productivity and lack of investment in technology is largely due to lack of access to financing. SMEs account for only 6% of total exports, which is quite low in comparison with countries such as Italy and Spain where they account for close to 40% of total exports.[2]

[2] The statistics underestimate the real scope of the sector due to pervasive informality: only 9% of microenterprises and 17% of SMEs fully comply with tax and employment obligations.

1.14 Lack of access to financing is a critical obstacle to the growth and survival of Mexican SMEs. According to Banco de México data, only about 60% have obtained supplier financing in the past several years, paying high interest rates over short terms. According to data from the Asociación de Bancos de México [Association of Mexican Banks], SMEs' share of financing from the banking system is quite low compared with countries at similar levels of development: 9.4% in 2005, 11.5% in 2006, and 12.7% in 2007, representing 0.5%, 0.7%, and 0.9% of GDP, respectively. Tight credit conditions and crowding out by large corporations and the public sector have exacerbated SMEs' difficulties in accessing financing (SME financing). According to Banco de México data, overall bank lending to SMEs declined in the first quarter of 2009.

1.15 In developed economies, SMEs have been the drivers of the economy because they provide crucial flexibility in the changing global economy. Large corporations have adopted the strategy of downsizing, by curtailing their vertical integration and selling non-strategic units in order to reduce fixed costs. They rely increasingly on small enterprises as suppliers that are far more flexible and able to adapt to volatile, competitive environments. The linkage between SMEs and major corporations in Mexico is very weak, adding little value to exports and competitiveness. In the context of the international financial crisis, efforts to develop SMEs and productive chains, particularly with support from NAFIN and Bancomext, take on greater importance in view of their impact on generating income and creating jobs. As explained below, Mexico's oil sector could jump-start a supply chain system incorporating SMEs.

3. The oil industry and the importance of domestic suppliers, particularly SMEs

1.16 The oil industry is a key sector, representing close to 5% of the economy's gross value added and contributing 40% of public revenue. Between 2001-2006, it contributed 44% of total infrastructure investment (1.4% of GDP). The current administration plans to increase investment in the oil industry by 1.9% to 2.7% of GDP, equivalent to approximately 48% of total planned infrastructure investment.[3] In light of the magnitude of these investments, establishing linkages with Mexico's SMEs is of critical importance.

1.17 The new Petróleos Mexicanos (PEMEX) Act of November 2008 points to the industry's potential as a lever for development, and provides for a national supplier and contractor development strategy to increase its multiplier effect. Because oil is Mexico's most important industry, promoting linkages is key to increasing its impact on SME development. Increasing the domestic component of suppliers will not only offset the impact of lower oil revenue on domestic demand, but also provide the opportunity to design a production strategy integrating high-value-added productive chains from industries providing goods, services, and public works. It should be noted that the Mexican government must conduct these

[3] Based on the Plan Nacional de Infraestructura 2007- 2012 [2007-2012 National Infrastructure Plan].

activities within the framework established by the various free-trade agreements it has signed. The development of these industries will serve to increase the economy's overall productivity in the long term.

1.18 An IDB survey of current or potential suppliers to Mexico's oil industry indicates that financing needs are greater among SMEs than among larger companies (PEMEX survey). SMEs are more likely to report lack of machinery and inadequate technology, and are more likely to lack lines of credit or to have had loan applications rejected. It is not surprising, then, that access to financing is viewed by SMEs as the most critical obstacle to their serving as providers or increasing sales to PEMEX.[4]

1.19 The lack of liquidity and continued uncertainty in international and domestic financial markets have further complicated private-sector entities' efforts to source funds for productive investment. The impact of tightened credit and increased margins is most burdensome for SMEs, whose access to financing was already inadequate before the crisis. In this context, and given the turbulence of global financial markets, funding from NAFIN becomes even more critical.

1.20 The new PEMEX Act provides for the establishment of a fund within NAFIN to promote the development of national suppliers and contractors for the oil industry, with particular emphasis on SMEs. It was established in 2009 under the name Trust Fund to Promote the Development of National Suppliers and Contractors for the State Oil Industry (PEMEX survey, page 38) and can provide financial assistance, partial guarantees, or technical assistance to reduce specific barriers, in addition to access to funding. At the same time, NAFIN would provide funding to financial intermediaries to enable them to lend to SMEs to make investments and increase their installed capacity. The Act stipulates that in fiscal year 2009 Mex$5 billion will be guaranteed for such actions, along with Mex$2.5 billion in 2010, through budget allocations and loans from multilateral financial institutions.

B. Challenges for reducing greenhouse gas emissions

1.21 Mexico faces significant challenges in reducing greenhouse gas (GHG) emissions. According to the Special Program on Climate Change, Mexico emitted 715.3 million metric tons (MT) of carbon dioxide equivalent (CO_2e) in 2006.[5] This makes it the world's thirteenth largest GHG emitter and the largest CO_2 emitter in Latin America. Mexico currently generates 1.6% of the world's CO_2 emissions from combustion of fossil fuels. The sources of GHG emissions are energy generation, which includes oil, gas, and electricity (27.5%), energy use (transportation, residential, commercial, government, etc.) (32.7%), agriculture, forests and other land use (18.4%), waste, urban solid waste disposal, sewage and treatment of

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[4] IDB, *Encuesta de Opinión a Empresas Proveedoras de Petróleos Mexicanos* [Opinion Survey of Petróleos Mexicanos Suppliers], May 2009.

[5] Preliminary data from the National Institute of Statistics and Geography (INEGI) 2006, to be published in 2009.

wastewater and other waste (14%), and industrial processes (7.4%). The oil and gas sector is responsible for close to 12% of GHG emissions. The effort to mitigate GHG, with respect to the trend scenario, is aimed at reducing approximately 400 MT of CO_2e by 2030 and up to 750 MT of CO_2e by 2050. In accordance with that target, the greatest potential for a reduction in the period 2008-2030 is thought to be in the energy sector. Moreover, this entails a reduction of approximately 50 MT of CO_2e in the energy sector for 2008-2012.

1.22 Mexico has been proactive in combating climate change. In 2005, it established the Comisión Intersecretarial de Cambio Climático [Interdepartmental Commission on Climate Change] to formulate and coordinate national strategies on climate change and incorporate them into sector programs. In 2007, the Mexican government announced it National Strategy on Climate Change, which sets a long-term agenda and specific targets, and it recently set itself the goal of reducing GHG emissions to 50% of 2002 levels by the year 2050.

1.23 The clean energy sector, including investments in renewable energy and energy savings, is a fundamental priority for reducing GHG in Mexico. Access to financing is the primary roadblock to investments in this area. In addition to the impacts described above, financing is hindered by a number of sector-specific factors (see link) including: (i) steep initial costs; (ii) weak or misunderstood credit profiles of potential projects; (iii) banks' aversion to extending credit to unfamiliar lines of business; and (iv) lack of specialized expertise in analyzing and structuring clean energy projects.

1.24 The Mexican government has designated NAFIN as the entity that will support its GHG reduction efforts through a new Sustainable Climate Change Projects Unit. Consistent with NAFIN's mandate to support private enterprise, it will support projects with private sponsors to reduce GHG emissions in the oil sector. This is also consistent with the strategy to emphasize diversification of the energy matrix, now highly dependent on fossil fuels, and address climate change challenges. NAFIN would channel resources from different sources for energy efficiency and renewable energy projects through innovative financing mechanisms that are sustainable over the long term.

1.25 As the institution implementing the Climate Investment Fund (CIF), the Bank could mobilize additional resources from internal funding or the proposed CCLIP to complement existing lines of credit. The CIF is designed to support the transition to a low-carbon economy through investments in clean technologies that are replicable and help transform the corresponding sector. Leveraging the CCLIP with resources from the Clean Technology Fund (CTF)[6] could increase the value added of NAFIN's involvement with respect to federal government priorities as well as the Bank's leadership in sustainable energy initiatives for the region.

[6] The CTF is the fund within the CIF for investments in renewable energy and energy efficiency projects.

1. NAFIN and its role in financing SMEs

1.26 NAFIN is a national credit institution (*sociedad nacional de crédito*) established to promote savings and investment and channel financial and technical support for Mexico's industrial and economic development. NAFIN embarked on a restructuring process in 2001 to emphasize development of SMEs. Since then, it has focused on offering widely available, low-cost products by utilizing commercial banks and a network of nonbank financial intermediaries (institutional overview). NAFIN channels 99.6% of its development activities to the private sector; its most important product is for productive chains representing 54.7% of the total amount of credit allocated to the private sector in 2008 (297 billion Mexican pesos (Mex$)). NAFIN has also consolidated its position as a second-tier bank, reducing its first-tier banking activities from 30% in 2000 to 0.20% in 2008.

1.27 NAFIN has played a decisive role in promoting financing in Mexico and has been a catalyst in increasing the supply of private-sector financing to the SME sector. It has developed a number of credit products and instruments to promote SME competitiveness, the most significant of which include: (i) Productive chain program: This program benefits large companies with low credit risk and their suppliers that use factoring. In 2008, it channeled Mex$162.5 billion to the operation of 451 productive chains benefiting 22,000 enterprises; (ii) Guarantees and indirect credit: NAFIN shares credit risk with commercial banks through this product, which channeled Mex$82.9 billion to benefit over 73,000 enterprises in 2008. The guarantees and indirect credit program was NAFIN's second most important means of supporting enterprises in 2008; (iii) Microenterprise: This program provides lines of credit at terms of up to two years for working capital and the purchase of fixed assets, benefiting a large number of borrowers. In 2008, it channeled Mex$6.3 billion, reported 41.7% growth over the previous year, and benefited close to 550,000 microenterprises (close to 90% of the Programa de Fomento [Development Program] total); and (iv) Equipment: The importance of this program has decreased in recent years. In 2008 it represented only 1.87% of the Private Sector Credit and Guarantees Program and 3.34% of total assets.

1.28 NAFIN's activity is concentrated on short-term financing. Within its peso-denominated portfolio (90% of the total portfolio), which amounts to Mex$79.6 billion excluding mandatory reserves, 78% of credits are at terms of up to one year and 14% are between one and two years. In partnership with financial intermediaries, NAFIN has established a strong record of lending to SMEs, which could be candidates for medium- and long-term loans to finance investments. The Bank's support would enable NAFIN to sharpen its focus on deepening the market that provides financing to SMEs for fixed assets to support growth and consolidation in the sector—an area in which commercial banks' involvement has been limited thus far.

1.29 NAFIN is a solvent institution with exemplary risk management practices and the full backing of the Mexican government. In December 2008, its assets stood at Mex$166.508 billion, including a credit portfolio of Mex$90.752 billion. Net worth

totaled Mex$12.959 billion. Return on equity was 6.6% in December 2007 compared with 0.83% in December 2008, and return on assets fell from 0.64% to 0.05% during the same period.[7] Arrears stood at approximately 0.39% in December 2007 and fell to 0.25% in December 2008. Despite the volatile environment and decline in economic activity due to the financial crisis, NAFIN generated net profit of Mex$108.4 million in 2008. Additional positive indicators of its financial position include portfolio past due of 0.4%, loan loss reserves of more than 800% of that portfolio, and a capital ratio of 12.47%. See financial statements.

1.30 **Bancomext.** The first program will be executed by NAFIN, but the CCLIP also contemplates a role for Bancomext as a borrower and executing agency for certain programs.[8] Bancomext began a process of strategic redirection in 2007 to prioritize support for SMEs (institutional overview). NAFIN and Bancomext have shared the same senior management since 2006 and operate as a conglomerate dedicated to expanding the SME sector. As a result, they have expanded their client base from fewer than 400 enterprises to nearly 4,000 and now offer a broad range of products including guarantees and productive-chain financing for exports. Bancomext channeled US$4.312 billion to the sector in 2008, US$4.052 billion of which was in financing and US$260 million in guarantees. Its private-sector credit portfolio increased by 86% in 2008, to a total of Mex$43.849 billion in December 2008. Bancomext continues to finance larger projects, averaging US$4 million per loan (see financial statements.). Like NAFIN, Bancomext implemented countercyclical programs in 2008 to support Mexican companies.

2. The program in relation to government and Bank priorities

1.31 **The Bank's program with Mexico:** This operation is part of the Bank's program with Mexico and ties in with improving competitiveness and developing the financial sector for SMEs and financial intermediaries. In light of: (i) the limited availability and high costs of financing, made worse by the crisis, particularly for SMEs; (ii) SMEs' inability to access medium- and long-term funding for productive investments; (iii) the cutoff of external lines of credit; and (iv) deepening of the overall lack of access to credit, particularly for SMEs, this CCLIP and first program will support Mexican development banks in their role as lenders in response to tightened credit conditions in Mexico.

1.32 **Mexico's strategy for the sector:** In recent years, the Mexican government has introduced measures and policies to increase the efficiency of the SME sector. The current administration has identified the development of micro, small, and medium-sized enterprises (MSMEs) as a central strategy for growth.[9] The Department of

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[7] Profitability in 2008 was affected by earnings from intermediation, particularly unrealized losses in the investment portfolio and larger loan loss provisions.

[8] NAFIN and Bancomext have the required institutional, financial, and execution capacity to be eligible for the CCLIP.

[9] Programa Sectorial de Economía 2007-2012 [2007-2012 Sector Economic Program], part of the Plan Nacional de Desarrollo 2007-2012 [2007-2012 National Development Plan].

Economic Affairs' strategy is to establish a business development policy based on five segments: entrepreneurs, MSMEs, “Gazelles” (SMEs with above-average growth and job creation) and “Tractors” (large, established companies that serve as the backbone of productive chains). Resources from the Fondo PYME [SME Fund] are channeled to these segments under five strategies: financing, marketing, training and consulting services, management and innovation, and technological development. They are also served by the Sistema Nacional de Garantías [National Guarantee System], which allocated Mex$85.64 billion to 255,467 MSMEs between 2002 and 2008 through 403,499 loans. In 2009, the México Emprende initiative was launched to support business development and financing requirements. The México Emprende trust was established to promote a guarantee program with the public and private banking system using the NAFIN platforms.

1.33 Additional measures have also been adopted. For instance, the government announced (January 2009) that 20% of procurements under the government purchasing system would be from SMEs. That target has already increased by 30%, and procurements totaling Mex$17 billion have been awarded to SMEs.

C. Program objective, components, and characteristics

1.34 The general objective of the CCLIP is to strengthen the competitiveness of Mexican companies by channeling medium- and long-term financing for investment projects in different sectors. The objective of the first program is to strengthen the competitiveness of SMEs within the national oil industry’s value chain, by channeling medium- and long-term financing to that segment, as well as financing for projects to reduce GHG emissions associated with the national oil industry. The specific objectives of the first operation will be to (i) support the strategy to promote the development of suppliers and contractors for the national oil industry; (ii) support the development of SME suppliers and contractors within the oil sector’s value chains, complementing the actions of the Trust Fund to Promote the Development of National Suppliers and Contractors for the State Oil Industry; (iii) consolidate and develop the financing market for Mexican SMEs; (iv) finance private projects to increase energy efficiency and reduce GHG emissions associated with the oil industry; and (v) strengthen NAFIN's capacity to develop financing markets for SMEs and support the structuring of strategic projects.

1.35 The CCLIP and first program will help mitigate existing structural problems and the difficulties related to the financial crisis by channeling medium- and long-term financing. They will be structured as a multisector credit program in view of their additionality in meeting the demand characteristics of the target group (numerous projects distributed over various economic sectors and geographic regions) and capacity to facilitate access to a broad spectrum of the target group. The CCLIP and first program are designed to: (i) adapt to Mexican government policies in order to increase the supply of long-term financing to strengthen SMEs; (ii) provide relatively small loans in local currency; (iii) allocate resources transparently, based on market and profitability criteria; (iv) ensure proper management and supervision; and (v) maximize the impact of the financing.

1.36 The program includes the following components:

a. **Loan component (up to US$300 million):** This component includes two subcomponents: (i) SME credit (estimated at US$250 million) to enable NAFIN to flexibly respond to changes in credit markets with financing more suited to the composition of their liabilities, and offer medium- and long-term lines of credit to NAFIN-authorized financial intermediaries for loans and lease financing for eligible SMEs as provided by the Operating Regulations; and (ii) green credit (up to US$50 million) to provide funding to NAFIN to flexibly respond to financing needs for oil sector projects that help to reduce GHG emissions. These projects could leverage funds under the CTF program.

b. **Technical assistance component (US$1 million):** This component will support studies and other initiatives by NAFIN such as: (i) the design of innovative second-tier financing products; (ii) the design of structured projects, including ones that qualify for CTF financing; (iii) the design and implementation of a rigorous evaluation of NAFIN financing programs, including the system of guarantees; and (iv) other studies and technical assistance on issues related to the purpose of the program, to be agreed on by the borrower and the Bank.

D. Evaluation framework and outcome indicators

1.37 The proposed monitoring and evaluation system will be based on the performance indicators included in the program Results Matrix:

a. Support the strategy for promoting the development of SME suppliers and contractors: (i) **intermediate outcome**: increase in domestic companies supplying the sector ("domestic content"); and (ii) **final outcome**: degree of domestic content.

b. Develop the SME suppliers and contractors within the oil sector's value chains, complementing the actions of the Trust Fund to Promote the Development of National Suppliers and Contractors for the State Oil Industry: (i) **output**: program resources for the development of SMEs in the sector; (ii) **intermediate outcome**: (a) new medium- and long-term loans from financial intermediaries to SMEs in the sector, using NAFIN lines; (b) medium- and long-term loans made (in US$ millions); and (iii) **final outcome**: percentage of oil industry purchases from SMEs.

c. Develop the SME financing market: (i) **output**: increased access for SMEs to investment loans; (ii) **intermediate outcome**: (a) percentage of NAFIN portfolio of loans granted by financial intermediaries as medium- and long-term financing for SMEs; (b) SMEs that gain access to medium- and long-term financing from NAFIN for the first time; (c) average weighted life of SME loans from NAFIN; and (iii) **final outcome**: SMEs that use credit for investments.

d. Finance private projects to increase energy efficiency and reduce GHG emissions associated with the oil industry: (i) **output**: volume of investment loans for projects of this nature; (ii) **intermediate outcome**: reductions in GHG emissions, directly associated with the investments; and (iii) **final outcome**: reduction in Mexico's GHG emissions.

e. Strengthen NAFIN to develop SME financing markets and support the structuring of strategic projects: (i) **output**: (a) technical assistance resources allocated; (b) creation of a projects unit; (ii) **intermediate outcome**: (a) number of studies financed; (b) number of strategic projects supported; and (iii) **final outcome**: number of studies and projects completed.

II. RISKS AND EXECUTION MECHANISM

A. Principal risks and mitigating factors

2.1 **Macroeconomic risks.** The Mexican economy is closely linked to that of the United States, and that linkage has been strengthened by the North American Free Trade Agreement (NAFTA). The financial crisis in the United States is already impacting growth projections for Mexico. The economic slowdown is reducing the demand for SME financing and increasing that portfolio's arrears rate. Because the interventions of public-sector banks are countercyclical, the decline in economic growth would increase rather than reduce the importance of their funding. Lastly, financial regulation and supervision has been strengthened, and the financial system shows no evidence of decapitalization.

2.2 **Financial risks.** Because the operation is guaranteed by the Mexican government, there is no apparent credit risk for the Bank. NAFIN's franchise value is well established, and it has robust policies and procedures for managing its balance sheet. In addition, the Mexican financial system is adequately capitalized. However, the activities of sourcing funds and granting funds for loan origination pose certain financial risks, including: (i) credit risk; (ii) counterparty risk; and (iii) market and liquidity risks. (See Summary of financial risks). NAFIN has the appropriate personnel and systems to manage these risks. NAFIN's very purpose is to mitigate these risks, none of which pose a threat to achieving the operation's objectives. Moreover, the financial laws and regulations in force, combined with NAFIN and CNBV standards and procedures provide an adequate framework to supervise the performance, solvency, stability, and liquidity of financial intermediaries.

2.3 **Environmental and social risks.** The Environmental and Social Review Group (ESR) approved the environmental and social strategy on 13 July 2009. Under the Bank's Environment and Safeguards Compliance Policy (OP-703), the CCLIP and first program are considered a flexible lending instrument for which prior classification of environmental impacts is not feasible. Therefore no classification of the operation's potential impact is required. The anticipated environmental and social impacts will vary in nature, intensity, duration, and significance, and will depend on the specific activity of the SMEs supported by the program. The

procedure proposed for managing the potential variety of impacts and risks is use of the Procuraduría Federal de Protección Ambiental [Federal Environmental Protection Agency] voluntary audit program and the PEMEX risk management mechanisms (see Environmental and Social Management Report). The use of these external mechanisms, the differentiation of potential projects by risk, and the use of a negative list are spelled out in the Operating Regulations.

2.4 **Fiduciary risk.** NAFIN has been the borrower for over 130 operations with the Bank throughout its history. This includes several multisector credit programs, the last of which was completed in 2004. Bancomext has also been a borrower and executing agency. It is currently implementing loan 1677/OC-ME, which has encountered execution problems attributable not to a lack of institutional capacity but to a change in demand and in the market; an evaluation is therefore being conducted to redirect the operation. An institutional capacity assessment of NAFIN and Bancomext conducted during preparation of the CCLIP concluded that the risk level for both entities was low. It found that both institutions had: (i) demonstrated competence in fulfilling their responsibilities; (ii) the experience, administrative and operational capacity, and qualified personnel required; (iii) the largest network of financial intermediaries in Mexico of sufficient quality and scope to ensure that resources are distributed among regions and sectors; and (iv) appropriate procedures, standards, and evaluation and supervisory capacity to ensure satisfactory management.

III. SUMMARY OF IMPLEMENTATION ARRANGEMENTS

A. Summary of implementation arrangements

3.1 The proposed CCLIP will be implemented jointly with NAFIN and Bancomext, either of which may be borrowers under the CCLIP. The United Mexican States will serve as guarantor and execute the loans contracted.

3.2 The borrower and executing agency for the first program will be Nacional Financiera, S.N.C. (NAFIN), with the United Mexican States serving as guarantor.

3.3 NAFIN will execute the program under its current organizational structure. The provisions governing program execution, financial intermediaries' participation, and eligibility of individual loans will be established in the Operating Regulations agreed by the Bank and NAFIN, in accordance with NAFIN and Bank standards and policies, Mexican laws, and practices in Mexico's financial industry.

3.4 **Procurement.** NAFIN will submit a procurement plan in advance for approval. Consulting services will be selected and contracted in accordance with Bank policies, and goods and services will be procured in accordance with the Policies for the Procurement of Goods and Works Financed by the Bank. Mexico already has standard procurement documents agreed on by the Bank and the Civil Service Department, which will facilitate use of Bank policies and procedures.

3.5 **Execution and disbursement period.** Program resources will be committed within 30 months running from the effective date of the loan contract, and are expected to be disbursed within 36 months from that date.

3.6 **Revolving fund.** The Bank may establish a revolving fund of up to 5% of the total program resources to finance onlending under the program and other eligible expenses for financing from those resources, as provided in the loan contract.

3.7 **Disbursement mechanism.** Two disbursement mechanisms will be used: (i) the revolving fund; and (ii) reimbursement of expenditures, including onlending of Bank resources in accordance with Bank policy. **A condition precedent to the first disbursement is the entry into force of the Operating Regulations, which must have the Bank's no objection.**

3.8 **Exchange rate.** A waiver is requested to the current exchange rate policy (document GN-2415), in order to apply the exchange rate on the last day of the month prior to execution of the expenditure for the purpose of converting expenditures made in the borrower's local currency into U.S. dollars.

B. Monitoring and evaluation arrangements

3.9 **Reports.** The program will be monitored through semiannual reports prepared by the executing agency and presented to the Bank within 60 days after the close of each six-month period, measuring progress against the indicators in the Results Matrix and the reports indicated in the General Conditions.

3.10 **Evaluation.** The borrower and the Bank will conduct a midterm evaluation within 18 months from the date of the first disbursement of financing or once 50% of the loan has been committed, whichever occurs first. The evaluation will assess progress in accomplishing program objectives and outcomes based on the Results Matrix in order to identify any corrective action required. The borrower has opted not to conduct an ex post review at the end of program execution, but will provide the information necessary in the event the Bank chooses to conduct one. Progress on the various indicators will also be reported to the Bank periodically during program execution.

3.11 **Information.** NAFIN will compile and maintain all information, indicators and parameters, including annual work plans, midterm and final evaluations, and other documentation required to prepare the Project Completion Report and any ex post review the Bank may conduct.

3.12 **Audits.** NAFIN will present to the Bank its audited financial statements and those of the program. The audits will be conducted by an independent accounting firm acceptable to the Bank, in accordance with the policies and guidelines governing external audits and the terms of reference previously approved by the Bank. The annual audit and final reports will be presented up to 120 days after the close of the period, fiscal year, and date of last disbursement, respectively.

Annex I
(ME-X1010; ME-L1051)

Development Effectiveness Matrix
Summary

The content of this document is confidential.

RESULTS MATRIX
ME-X1010, ME-L1051

Objectives of the first program
Program objective: To help make the small and medium-sized enterprise (SME) sector within the national oil industry's value chain more competitive by channeling medium- and long-term financing to that segment, as well as financing for projects to reduce greenhouse gas (GHG) emissions associated with the national oil industry.
Specific program objectives: (i) support the strategy for developing suppliers and contractors within the national oil industry; (ii) support the development of SME suppliers and contractors within the oil sector's value chains, complementing the actions of the Trust Fund to Promote the Development of National Suppliers and Contractors for the State Oil Industry; (iii) consolidate and develop the financing market for Mexican SMEs; (iv) finance private projects to increase energy efficiency and reduce GHG emissions associated with the oil industry; and (v) strengthen NAFIN's capacity to develop financing markets for SMEs and support the structuring of strategic projects.

The outcome indicators will be monitored every six months as input for the monitoring reports NAFIN will present to the Bank throughout the execution period. Information for the indicators will come from NAFIN's database and the records it maintains for program execution and management.

Indicators	Baseline (Sept/09)	End of Year 1 (Dec/10)	End of Year 2 (Dec/11)	End of Year 3 (Dec/12)	Description and observations
LOAN COMPONENT					
Specific objective 1: Support the strategy to develop SME suppliers and contractors within the national oil industry.					
Intermediate outcome: Increase in domestic suppliers of the oil industry ("domestic content")		0.5%	0.5%	1.0%	Annual change in content.
Final outcome: Extent of domestic content in oil industry suppliers.	35.1%	35.6%	36.1%	37.1%	Percentage achieved as a result of the annual increase. Source of future monitoring: Petróleos Mexicanos Strategy.
Specific objective 2: Support the development of SME suppliers and contractors within the oil sector's value chains, complementing the actions of the Trust Fund to Promote the Development of National Suppliers and Contractors for the State Oil Industry.					
Output: Program resources used to develop SME suppliers and contractors in the oil sector's value chains	0	Up to 100%[1]	Up to 100%[1]	Up to 100%[1]	Percentage of program resources loaned through NAFIN lines to finance SMEs.

[1] This represents the maximum resources available for use under the loan component. The actual amount of resources used for this objective will depend on demand for loans and NAFIN's needs in funding them.

Indicators	Baseline (Sept/09)	End of Year 1 (Dec/10)	End of Year 2 (Dec/11)	End of Year 3 (Dec/12)	Description and observations
Intermediate outcome:					
New medium- and long-term financial intermediary loans using NAFIN lines to SMEs in the oil sector's value chains	0	37	125	150	Annual loans approved.
Medium- and long-term lending amount to SMEs in the oil industry (US$ millions)	$0	$30	$110	$125	Annual loans approved.
Final outcome:					
Percentage of oil industry purchases from SMEs	14.0%	14.5%	15.0%	15.5%	Source of future monitoring: Trust Fund Indicators
Specific objective 3: Consolidate and develop the financing market for Mexican SMEs.					
Output: Increased access to investment loans for SMEs	0	Up to 100%[2]	Up to 100%[1]	Up to 100%[1]	Percentage of program resources lent annually through NAFIN lines to provide investment financing for SMEs.
Intermediate outcome:					
Percentage of NAFIN SME portfolio made up of medium- and long-term loans granted by financial intermediaries	5%	8%	12%	18%	Out of the total SME portfolio.
SMEs that gain access to medium- and long-term NAFIN financing for the first time.	0	45	160	180	Out of NAFIN's total SME portfolio.
Average weighted life of new SME loans funded with NAFIN resources	n/a	1.2 years	1.5 years	1.8 years	
Final outcome:					
Mexican SMEs that report using loans for investment:	17.7%	17.8%	17.9%	18.0%	Reported in Banco de México's Credit Market Trend Evaluation Survey.
– Small businesses	17.0%	17.1%	17.2%	17.3%	
– Medium-sized enterprises	18.3%	18.5%	18.6%	18.6%	
Specific objective 4: Finance private projects to increase energy efficiency and reduce GHG emissions associated with the oil industry.					
Output: Financing for operations to reduce GHG emissions associated with the oil industry	0	10	10	15	Program resources funding green projects (US$ million).

[2] This represents the maximum resources available for use under the loan component. The actual amount of resources used for this objective will depend on demand for loans and NAFIN's needs in funding them.

Indicators	Baseline (Sept/09)	End of Year 1 (Dec/10)	End of Year 2 (Dec/11)	End of Year 3 (Dec/12)	Description and observations
Intermediate outcome: Reduction in GHG emissions in terms of tons of carbon dioxide equivalent (tCO_2e), directly associated with the investments.		45,000	50,000	100,000	It is assumed that the direct financing from this program will harness additional financial resources.
Final outcome: Reduction in Mexico's GHG emissions in terms of tCO_2e		10,000,000	10,000,000	10,000,000	This looks at the target reduction in GHG emissions for energy generation established by the Government of Mexico. A cumulative reduction of 51.78 million tCO_2e in the period 2008-2012, which is equivalent to approximately 10 million tCO_2e per year.
TECHNICAL ASSISTANCE COMPONENT					
Specific objective 5: Strengthen NAFIN's capacity to develop financing markets for SMEs and support the structuring of strategic projects.					
Output: Utilization of program resources for the technical assistance component.	0	Up to 100%	Up to 100%	Up to 100%	Percentage of program resources used.
Creation of a Sustainable Projects Unit in NAFIN	0	1	n/a	n/a	The unit will provide support in structuring clean energy projects.
Intermediate outcome:					
Cumulative number of studies financed with technical assistance component.	0	1	2	3	
Cumulative number of strategic projects supported with specialized consulting services.	0	1	3	5	
Final outcome:					
Cumulative number of studies and projects completed	0	2	5	8	

In addition to the Results Matrix, an ex post review of the following indicators will be conducted to supplement the information for quantifying the operation's impact:

Table of Purpose Indicators					
Purpose: Develop financing markets for SMEs in Mexico.					
Indicators	**Baseline (Sept/09)**	**End of Year 1 (Dec/10)**	**End of Year 2 (Dec/11)**	**End of Year 3 (Dec/12)**	**Description and observations**
Deepening of the SME market.					(Number of SME loans in Mexico) / (Total number of loans) * 100% (Value of loans to SMEs in Mexico) / (Total value of business loans) * 100%
Deepening of the financing market for renewable energy projects.					(Number of renewable energy loans in Mexico) / (Total number of loans) * 100% (Value of renewable energy loans) / (Total value of business loans) * 100%