

ESPECIAL LAW TO FACILITATE ACCESS TO CREDIT **LEFAC**



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The new regulation from the Special Law to Facilitate Access to Credit (LEFAC)

...Problems foreseeable in the near future

Recently the Legislature enacted the “Special Law to Facilitate Access to Credit” -LEFAC-, which basically seeks to facilitate access to credit by simplifying documentation requirements for credits below US \$ 30,000.

For its third edition, the SMEs Newsletter made a summary of the Law, which at the time was still waiting for the regulation that the Central Reserve Bank (BCR) has now issued.

Analyzing the Provisions of the Law

The regulation was incorporated in August of this year and it modified the regulation for Classifying Credit Risk Assets and for Establishing Sanitation Reserves (NCB-022). The BCR has granted financial institutions a 90 days term that expires on December 2 of this year, so that they can adapt their Policies to the changes required by the new regulation.

The regulation related to the LEFAC, as can be inferred logically, hasn't gone beyond what the LEFAC had previously established. To summarize it comprises the following provisions:

- The financial institutions that are obliged to comply with the regulation must establish in their internal credit-granting policies clear mechanisms to originate credits, based on simplified requirements and procedures, for all credits destined for productive activities that the LEFAC mentions.
- Each entity will define in its internal policies their own concept of productive activities, taking into consideration the provisions of article 2, literal d) of the LEFAC.
- The credits that the LEFAC refers to are grouped within the credits for companies indicated in the regulation.

- The evaluation and classification of credits under the LEFAC will be carried out following the content of the Annexes from the NCB-022 Normative and the information requirements established in the LEFAC.
- The resulting files for each credit debtor of productive activities under the LEFAC, must contain all the documents related to the request, analysis, approval, and follow-up, taking into consideration the information requirements established by the LEFAC for such credits. Also, these credits must be properly identified.
- The information that financial institutions send to the SSF each month must contain the portfolio classification of all their credit assets and the respective provisioning reserves referred to the balances at the end of the month. Also, the entities must identify in their registry all the credits granted by the LEFAC.

The LEFAC was issued and based on an essential assumption: that the problem of access to credit is an issue of requirements. In such a way that its focus is based on simplifying the processing of loans under US \$ 30,000, and it only increases them for businesses that demand loans above US \$ 30,000. For these amounts, it is assumed that because they are businesses with higher sales, they will be able to comply with the new formalization requirements that the Law demands from them.

However, the essential issue of why informal clients and businesses cannot meet these requirements is precisely a consequence of the informal nature of their operations. They cannot operate as formal businesses that comply with the requirements of the Law, due to a series of factors, among which are the low levels of sales, the absence of working capital, the cultural and socio-educational level, the low-profit margins, the market they serve, among others.

For this reason, traditional banks have problems when lending to the informal sector: they do not know how to evaluate businesses that lack documentation, and formal billing and accounting processes. Access to credit through a regulated financial institution depends on the ability of the business model to identify and reward good payers, and not on the weight or simplification of the documentation or the existence or not of guarantees.

What truly opens up the access to credit to entrepreneurs is the achievement of a certain level of development within their businesses, which allows them to gradually comply with legal requirements, as they continue to get linked to more formal business chains.

In El Salvador the Law recognizes that the regulation has a gradual approach, it depends on the capacity and development of informal SMEs entrepreneurs.

The table below shows the existing regulation before the LEFAC

REQUISITOS LEGALES PREVIOS A LEY LEFAC

REGULACION	CONDICION	GRADO DE FORMALIDAD
CÓDIGO DE COMERCIO	ACTIVOS >US \$34,000	CONTABILIDAD FORMAL
CÓDIGO DE COMERCIO	ACTIVOS >US \$12,000	MATRÍCULA DE COMERCIO COMO COMERCIANTE INDIVIDUAL
LEY DE IMPUESTO A LA TRANSFERENCIA DE BIENES MUEBLES Y A LA PRESTACIÓN DE SERVICIOS (IVA)	ACTIVOS >US \$2,286 VENTAS >US \$5,740 ANUALES	REGISTRO DEL IVA (NRC CONTRIBUYENTE)
CÓDIGO DE TRIBUTARIO	INGRESOS >US \$30,000	ESTADO DE INGRESOS Y GASTOS REPORTAR AL MINISTERIO DE HACIENDA
CÓDIGO MUNICIPAL	COMERCIANTE INDIVIDUAL	REGISTRO

As can be seen, in El Salvador we already have a regulation in place that micro-entrepreneurs (individual traders) must comply with according to their level of development, which is measured through sales volume, amount of assets, and total income, among others.

The new requirements that the LEFAC establishes for credits above US \$ 30,000, only add new ones, in a context where many microentrepreneurs already have trouble complying with the current Laws. In addition, the Pandemic has diminished the capacities of SMEs and had increased their informal operations' modalities.

Analysing a hypothetical case

If Mr. Pérez is an informal microentrepreneur and he requests a loan of US \$ 32,000, showcases sales of US \$ 40,000 per year, and has assets of US \$ 35,000; with the application of the LEFAC he wouldn't have access to formal banking institutions without first:



Therefore, Mr. Perez who needs financing to develop his business, but doesn't fulfill the requirements, will have only three options:

1. Initiating a process to formalize his business; ask for support, get consulting and check his business model. To reach this goal he will need more resources and a timeframe of a few months. If he can do this, he will finally be able to initiate his entrepreneurship venture, and once his business is formalized he will be able to ask for credit.

2. *Looking for a loan shark who will impose an annual interest rate of 80%, and will require a mortgage guarantee from the lender. After that, the loan shark will give him the US\$32,000 immediately.*
3. Divide his credit application into two in order to submit two credit applications to two different institutions simultaneously, for an amount that is less than US \$ 30,000.

It is mandatory to get formalized in order to have access to credit

The LEFAC has an implicit objective which is the formalization of this sector of the economy, which asks for or requires credits that surpass the amount of US \$ 30,000.

However, the objective of this analysis is not to discuss the apparent tax implications that are behind this legislation. Whilst it is true *that adequating the regulation and promoting regulation can be very positive if it is modified to the level of development and skills*, the problem is that the current regulation and the present law *lacks flexibility and it is not gradual*, because its requirements are something that the majority of SMEs entrepreneurs won't be able to fulfill during that timeframe.

The result, as we were foreseeing in our previous newsletter, is that many entrepreneurs from informal SMEs, which is also the most dynamic segment and the one that generates the most employment in the country, will have problems to request access to credit.

The business of Mr. Perez, from our previous example, would face many difficulties. He would have to look for solutions “under the rocks”, putting it into “slang” language, in order to find ways to keep his operations going.

This quick analysis showcases the necessity to check the LEFAC and recognize that a certain level of flexibility and graduality is required, because informal SMEs constitute a complex sector, with multiple size differences, profitability margins, and sociocultural characteristics that makes them unable to quickly adapt to this new regulation without making a continued effort and receiving training, consulting and support.

Depriving them of access to effective financing, after an almost apocalyptic pandemic, seems to be an inappropriate measure, to say the least, especially because of the extraordinary situation that the country is going through.

The need to rethink Laws such as the LEFAC seems the most reasonable path to take in the current context of the country, when the priority is to promote the generation of

employment, no matter of what nature: formal, semi-formal, or informal. What Salvadorans need are quick means that can provide them with employment, and livelihood, through the most flexible ways possible.

If the law doesn't follow such pragmatic logic, it runs the risk of being ineffective.

There is a basic principle that doesn't cease to be true: the law has to be adapted to the reality of the country and not the other way around. Without question, it is a correct measure if it is to be considered on a mid-term or long-term basis, but it requires time so that the necessary conditions for its application can be built.